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*Structuring Transactions: The Case  
of Real Estate Finance*

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COMPLEX ECONOMIC TRANSACTIONS, especially those engaging multiple jurisdictions, are creating considerable problems in regulation and management that are taxing states' resources. The result is that alternative support structures are generated to resolve these difficulties and lacunae (Gessner, 2008a, this volume). While states provide some legislative frameworks, the vast majority of the support structures are brought into existence by other sources. Among them are candidates such as *lex mercatoria* (Konradi, 2008, this volume), real-time contract evaluation (Dietz and Nieswandt, 2008, this volume) and large and medium-sized law firms (Flood and Sosa, 2008).

The liquidity crisis originally prompted by the 2007 sub-prime mortgage debacle in the United States is an exemplar of the type of complexity referred to here that has caused chaos in international financial markets. Here, although the individual steps in the creation of the sub-prime market and its extension and amplification through the collateralised debt obligation market were carried out legitimately, the cumulative effect of the steps combined with the lack of necessary regulatory oversight by the authorities produced a series of effects that rippled out worldwide and that most states were unable to manage competently or foresee, or even begin to calculate how to prevent their future re-occurrence.<sup>1</sup> Indeed, the regulatory conundrum was such that whichever way governments acted, they would be accused of participating in the creation of moral hazards by rescuing institutions or failing to insure weak, unprotected investors from the seamy side of market exploitation.

<sup>1</sup> By the first quarter of 2008, the 'credit crunch' had caused one major British mortgage bank to threaten bankruptcy and ultimately be nationalised by the government, and at least two German banks to be rescued by state authorities to avoid insolvency. In both cases, their exposure to sub-prime mortgage hazards through their dealings in asset-backed paper was the genesis of their problems.

Although a number of institutions participated in the creation of the market (for example, investment banks, mortgage banks, credit rating agencies, hedge funds and mono-line insurers), crucial to the piecing together of the market was the documentation produced by the law firms that enabled the participants to engage in this uncertain venture. Due to the inherent complexity of these transactions, they cannot be conceived without the assemblage of documents that accompany them (Flood, 2007). They would be impossible to do 'on a handshake'. The role of lawyers and law firms in structuring these types of transaction is vital and necessary to their accomplishment.

In this chapter, we examine how a particular kind of transaction is structured to enable actors from a variety of countries and jurisdictions to co-manage and create a communal perspective that incorporates complexity, yet produces certainty and calculability. It also enables us to answer one question to which the solution remains elusive: what do lawyers do (Abel and Lewis, 1989)? Although academics have pursued this question (for example, Gilson, 1984; Felstiner, 2001; Flood, 1991; Sosa, 2008, this volume; Flood and Sosa, 2008), practitioners rarely write on the topic (but see, for example, Freund, 1975; and Neate, 1987). It has been suggested that lawyers manage uncertainty in their roles as practitioners, providing solutions that enable business to capitalise on its ventures. The problem is exacerbated in the context of cross-border business where the parties are attempting to reach agreement but must overcome the insecurity inherent in the fallibility of their knowledge of the other's system (Gessner, 2008b, this volume). In this chapter, we draw on Luhmann's ideas of the stabilisation of expectations (1985).

Luhmann defines the function of law as the stabilisation of normative expectations through regulation of its temporal, social and material generalisation. The primary means here for the stabilisation of expectations or risk reduction is through the construction of typified solutions which correspond to legal instruments, in that they contain the full panoply of guarantees, warranties, default clauses, arbitration clauses, and so on (cf Gilson, 1984). In doing this, lawyers create a series of private legal systems that effectively have the force of the state legal system. In part, they have this effect because they are constructed within the shadow of the law (since they have to refer to national legal systems), and also because they are produced by highly qualified experts whose imprimatur is widely accepted. The authority and legitimacy of their licence is conferred in two ways: one is by virtue of their individual expertise; and the other is through the status of their law firm. These are interrelated in that each derives to an extent from the other. Expertise comes from training and experience, which have to be acquired in the right place and under the right people. Thus, obtaining the benefits of another's human capital can only be maximised in the appropriate law firms that contain the leading

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experts. Moreover, the law firm then confers legitimacy on its members and simultaneously has its authority augmented by the presence of experts. This double legitimisation process enables the movement of experts from firm to firm so that alternative sites of expertise can be established and nurtured. While it has an enabling effect, it can also be destructive in that if an expert or group of experts leave one firm for another, although the new firm acquires heightened status, the previous firm can be left bereft of appropriate expertise and so suffer a loss of authority in that field. The balance between lawyer and firm is a delicate one.

In this chapter, we illustrate some of these processes in the case of real estate finance lawyers and their structuring of transactions. The crucial term is 'structure', because the way in which a transaction is put together determines its outcome. It works within the confines of law, it takes account of law; but, ultimately, structure is guided by the requirements of the transaction, which for business lawyers means what the participants desire from the deal.

Real estate finance is an area which captures many aspects of traditional legal thinking. It is concerned with real immovable property (for example, title, covenants and easements), security, mortgages, financing and tax. The area is one in which little global harmonisation has occurred. Indeed, even inside the European Union, local rules on property rights vary enormously from Member State to Member State. In countries external to the EU, rules involving property ownership can be even more obscure (EBRD, 1995: 101–17).<sup>2</sup> Yet varieties of real estate finance are creating enormous value. Furthermore, real estate finance has ballooned as the complex derivatives markets have soared. Therefore, much of what occurs in real estate finance is in the nature of off-balance sheet transactions and deals with risk planning versus realisable expectations. It is the intersection of real estate and capital markets that is driving innovation in this field.

Real estate finance is concerned with ways of enabling investment in commercial property. It brings together a number of specialisms, banking, real estate, securitisation, tax and derivatives. Although the core is property, the manner in which it is financed and structured is the concern of banking and corporate lawyers. They have created new ways of importing techniques from their areas into new fields. Because property has enduring value, it provides for the creation of novel means of arranging its holding and financing.

Secured lending started with 'vanilla-flavoured' lending, ie lending backed by security over specific assets. Over time, secured lending has become increasingly complex, with the introduction of concepts such as

<sup>2</sup> For example, in Hungary, land ownership is permitted, although foreigners may own land only through local companies; whereas in Georgia, foreigners or foreign-owned local companies may not own land (EBRD, 1995: 110–12).

the floating charge, where the creditor is not restricted to specific existing assets. With the advent of securitisation and derivatives, markets have developed to exploit more marginal risks and earn potentially greater rewards. For example, new types of investment include, as Davies (2006: 43) describes:

Commercial real estate collateralised debt obligations, or CRE CDOs, mostly pool together the riskier slices of commercial mortgages with the more junior bits of commercial mortgage backed securities, which by themselves repackage pools of property debt.<sup>3</sup>

It is also possible to incorporate other kinds of debt into these complex packages so that their apparent complexity is hedged over a number of elements. Yet, as Davies argues:

... commercial property can be a volatile asset and many of the instruments set to be included in CDOs have not been tested in a downturn.<sup>4</sup>

Most transactions handled by real estate finance lawyers are carried out in conjunction with a series of repeat players, including banks and clients, who may be real estate investment trusts or funds, or companies. Their key attribute is their continuous interplay. Their embedded ties comprise both social contacts and network positions which aid the construction of trust that tends to override arm's length ties (Uzzi *et al*, 2007). The heavy repeat nature of this market creates high barriers to entry for many lawyers. While they may have substantial reputations in banking or corporate law, unless they have been part of a law firm that has traditionally done real estate finance or been mentored by a lawyer so engaged, it is very difficult to break into the market as banks and clients are risk averse. The market for real estate finance, therefore, is constrained to a relatively small number of law firms and lawyers. Identifying them is relatively straightforward, as the legal directories (for example, *Legal 500* and *Chambers UK*) now rank real estate finance lawyers separately from banking and property lawyers. Moreover, both directories rate lawyers by canvassing opinions in the profession and among clients. *Chambers*, for example, ranks lawyers on a scale of one to six (one being the highest) and states:

The qualities on which rankings are assessed include technical legal ability, professional conduct, client service, commercial awareness/astuteness, diligence, commitment and other qualities most valued by the client.<sup>5</sup>

<sup>3</sup> See the implications of this statement in the discussion of the sub-prime crisis above and in Gessner (2008a, this volume).

<sup>4</sup> Despite the guarded optimism of these commentators, the viability of CDOs and other securitised structures have been tested and found wanting in a downturn.

<sup>5</sup> <<http://www.chamberssecure.com/global/research-ranking.aspx>> accessed 18 June 2008.

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The initiation of a transaction is usually the beginning of a series of actions. Once a deal is completed, it commits itself to future restructurings when the same—but not always—parties collaborate on extending the deal and leveraging it further.<sup>6</sup> In addition, it will continue to be restructured even if the property is sold to others. Efficient minimising of tax liabilities, changes in interest rates by central banks and intensification of leveraging, among other things, drive restructuring.

For the purpose of this chapter, we focus on real estate financing in Europe. The market is driven both by the banks who lend and the investors who are seeking fresh opportunities for their money. The investors seem to pull along the debt providers. Since the majority of both are situated in London, there is an enormous advantage given to UK lawyers as the providers of expertise. Once lenders and investors step outside their home markets, their risk expectations soar. The need for the lawyer's guiding hand is correspondingly increased. What is clear to all of the actors is the lack of uniformity in the European real estate market. It can broadly be divided into 'mature' and 'secondary' markets with, for example, Paris, Madrid and Barcelona in the former category and cities in Croatia, Romania, Greece, Slovenia and Bulgaria in the latter. Different types of property investment are favoured in different markets. The mature market attracts investors in shopping centres, retail parks, hotels and offices, whereas in the secondary market, industrial properties and also some residential properties are selected in preference to others.

Despite the interest in the European market, there is little harmonisation to aid cross-border acquisitions, nor is there much initiative towards convergence. Certain aspects of property transactions cause major problems for investors when transplanted outside of the UK. Local property laws, as mentioned above, and tax laws have resolutely escaped all moves to harmonisation. For example, Swiss laws on leases cause considerable angst to investors, as they are exceedingly specific in their requirements when compared to English law. In addition, most debt providers insist on as full a security package as they would obtain under English law. However, both banks and investors have realised that attempting to reproduce an entire English property transaction when venturing beyond the borders of Britain is a fruitless task because local rules render it impossible. This puts the real estate finance lawyer in a key position: it is up to the lawyer to create a structure that will satisfy not merely the immediate needs of investors and funders, but accommodate local jurisdictional needs without compromising the essential aspects of the transaction.

<sup>6</sup> See Regan (2004) for a dramatic version of what happens to a company when its finances are continuously restructured, thus endangering its existence.

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It is at this juncture that the role of structure comes to the foreground. Although there are significant differences between jurisdictions and systems, English common law enables an assembly of structures that are transportable across borders. The structure can be compared to a prefabricated building delivered to the relevant site which is then adjusted in order to stand securely. In some instances, only minor adjustments are needed, but in other cases, where the peculiarities of local property and tax laws show the structure to be less than stable and likely to collapse unless serious modifications are made, the tweaking stage is most critical. For example, the regulatory regime for Portuguese closed-end property funds delivers an extremely tax-efficient means of property ownership, but also makes it nigh impossible to grant security over such property. The lawyers here had to act as mediators between conflicting demands. Although they acted for the London branch of an international bank, they had to explain the requirements of an English-based debt structure to the fund managers of a Portuguese closed-end property fund who had to accept that 'London' did business in a particular way, while convincing the bank that the deal could not be structured as if it were an English property transaction.

How, then, does structuring function? Property is peculiar in that most people think in terms of 'location' as the prime attribute of the transaction. For lawyers, however, structure is paramount. Two main types of structure come into play:

- a) tax-led structures:
  - i) these entail tax withholding issues on interest payments to non-resident lenders;
  - ii) there are issues involving withholding tax in respect of dividends to an international parent; and
  - iii) they involve tax-efficient vehicles and local regulatory restrictions;
- b) corporate structures:
  - i) the movement of income and gains across groups;
  - ii) thin capitalisation (interest re-characterised as dividends); and
  - iii) the changing role of the real estate finance lawyer, moving to structuring as opposed to servicing property transactions.

None of these structures would be feasible without the ability of the English common law to create and innovate in ways difficult, if not at times impossible, for civil law.<sup>7</sup> They escape the formalism of the logically rational and reside with the norms of material rationality in accordance with:

<sup>7</sup> One important feature, often neglected in the academic study of law, of the use of common lawyers, and English and American in particular, is their use of the English language, which market participants welcome and encourage. Cf the use of German law in the software contracts discussed by Dietz and Nieswandt (2008, this volume).

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... ethical imperatives, utilitarian and other expediential rules, and political maxims, all of which diverge from the formalism of the 'external characteristics' variety as well as from that which uses logical abstraction (Weber, 1978: 657).

Although the London lawyer is in charge of the overall drafting of the agreements that integrate the transaction, the local jurisdictional elements are sub-contracted to local lawyers. One problem for London lawyers is ensuring that local lawyers understand what 'London' needs. London lawyers are essentially commercially minded, but this is not always the case with, for example, Portuguese or Italian lawyers. Having a network of law firms that can adopt the London mentality when required is a necessary part of the London lawyer's armoury. Developing such networks is thorny when investors and funders are moving into new markets where sophisticated property financing techniques are completely unknown.<sup>8</sup>

We illustrate the role of these structures in the following examples. Assume, in a simple 'vanilla-flavoured' transaction, company A wants to buy company B by taking a loan from a bank. The key for the bank is to obtain security for its loan by, say, taking a charge of a pool of assets. Some jurisdictions, for example, France and Italy, have legal impediments that prevent banks from doing this. A way around these impediments is to have B create a limited liability partnership or a special purpose vehicle and transfer the assets for value to the orphan company, thereby protecting the assets in case of B's default and enabling the bank to take a charge. See Figure I.

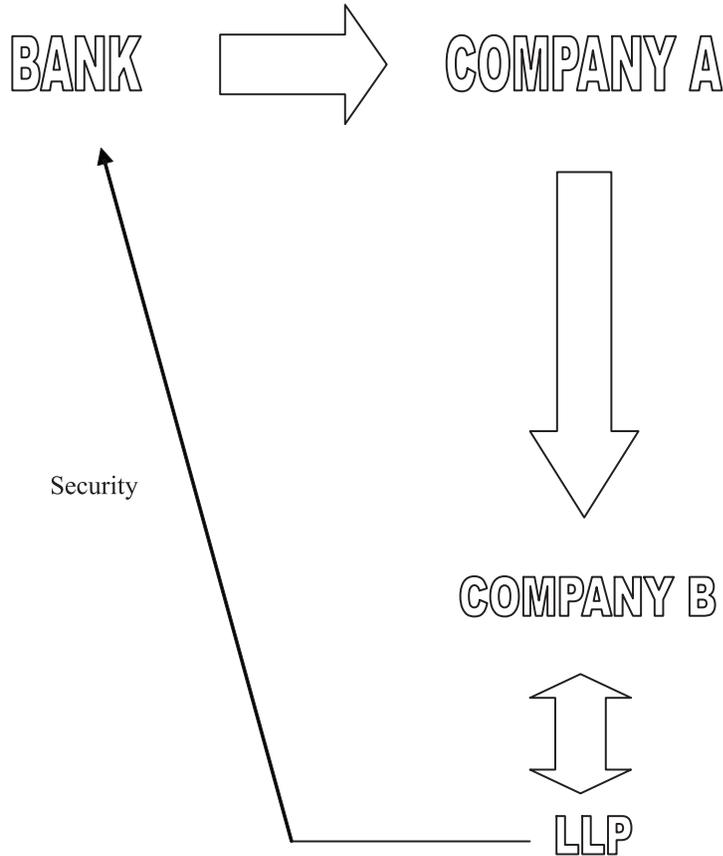
This type of transaction becomes even more complex when more than one or two jurisdictions are involved. Assume company A wants to buy company B in France, company C in Luxembourg and company D in Italy, all with bank funding. Each country has its own rules regarding legal and beneficial ownership and the ability of the bank to obtain security.<sup>9</sup> Thus, the real estate finance lawyer has to structure the deal to give the bank the required security and yet honour each country's particular rules. Problems arise when investors and lenders tackle problems of cross-collateralisation and cross-guarantee. In English law, these create no difficulties in their application. However, in countries such as Belgium, France and Italy, companies can only cross-guarantee and cross-collateralise obligations owed by wholly-owned subsidiaries. If a company wants to cross-collateralise or guarantee the obligations of a sister or parent company in these civil code countries, problems arise unless corporate benefit is shown,

<sup>8</sup> The problem is not necessarily resolved by using the foreign branch of a law firm. Smets' (2006) research on banking lawyers in the London and Frankfurt branches of an English law firm showed frequent misunderstandings and misinterpretations when English and German lawyers worked on the same transaction.

<sup>9</sup> The UK security regime allows various self-help remedies that do not require the intermediation of a court, but in civil code countries this type of self-help is rarely available.

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Figure I—The Structure of a Company Purchase

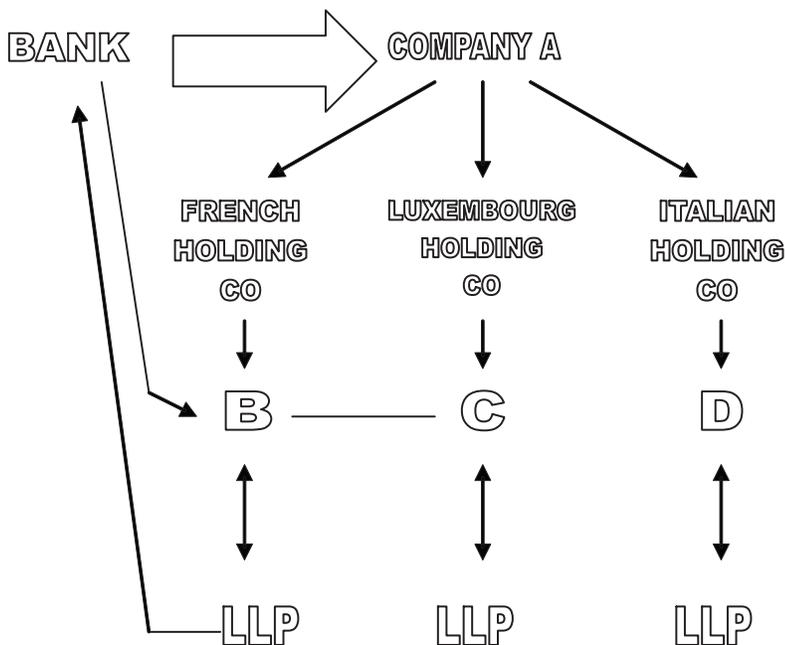


leading in the case of France to criminal penalties against the directors of the company. Typically, in the UK all properties would be in one company, where cross-collateralisation could be accomplished. Figure II illustrates how the transaction might operate under these constraints.

In this transaction, the ideas from the first example are translated into the different jurisdictions. Each individual jurisdiction carries out the procedures in its particular way by creating a series of special purpose vehicles (SPVs) that collectively enable the bank finally to obtain security. By importing the Anglo-American concept of SPVs, the peculiarities of the individual jurisdictions were sidestepped and the ultimate aim of granting security was achieved. Risk and uncertainty were minimised without appearing to compromise the integrity of the individual jurisdictions' competences.

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Figure II—The Structure of a Multi-jurisdictional Company Purchase



On occasion, real estate finance projects are combined with corporate acquisitions so that the financing bank moves from its ‘normal’ range of financing into areas where it has less expertise. In this situation, the lawyers have to create structures that satisfy both real estate and corporate issues. In one such transaction, a sports equipment company was bought by its management with the backing of a private equity fund. The majority of the debt was provided by the bank, which also had a recurring relationship with the private equity fund that was providing equity, and was therefore familiar with its own approach to transactions. On this transaction, in addition to the usual requirement of a commercial property valuation, the bank and the private equity investors required a commercial due diligence review of the sports equipment business. Estimates were arrived at for future potential retail and wholesale growth, based on detailed qualitative and quantitative surveys of participants in the company’s key areas of sailing, shooting and riding. Both the bank and the investors required a thorough understanding of the value of the sports equipment brand and its potential for growth.

In addition to the usual security over the real estate assets of the company and security over the shares of the group companies, the transaction needed to consider taking security over other classes of assets,

including intellectual property rights or rights under commercial agreements, such as agency and distribution agreements, trade mark licences and certified manufacturer agreements. As the business had a specialist technical clothing focus, the terms of agreements entered into by the company relating to the use of other brands (for example, the Gore-Tex brand) were of particular interest, not only to the private equity investors, but also to the bank. For this type of business, it was also important to consider the large number of trademarks held by the company worldwide and any practical issues arising in connection with registering security over these trademarks as a condition precedent to completion.

In more traditional real estate finance transactions, the term 'financial covenants' has come to mean two main types of financial test: 'loan to value' (the ratio of the fair market value of the real property assets to the amount of the loan financing the purchase of such assets) and 'interest cover' (the amount of interest and other finance costs paid by a company on its borrowings against the income generated by the properties that are the subject of such borrowings in the same period). In a transaction such as this—involving real estate, but also other types of assets owned in the course of an operating business—a more complex approach to financial covenants was required. In addition to the usual 'loan to value' test (in relation to the company group's warehouse assets), the financial test of 'EBITDA to loan' (earnings before interest, taxes, depreciation and amortisation) aimed to test the consolidated profits of the company against the aggregate amount of the bank's loan facilities. The requirements of this test reflected the projected growth of EBITDA in the company's business plan.

In addition to this 'acquisition facility' financing the acquisition of the sports equipment company, the bank provided ancillary facilities to assist the operating activities of the company. These included the employment of a 'capex facility' (capital expenditures) to fund approved capital expenditure projects carried out in the company's retail sites. To enable the company and its management to plan for growth, the capex facility was also made available for 'immature' retail sites where return on capital was expected to be below a certain threshold.

Transactions such as these are no longer exceptional in the specialist real estate finance field. The financing of real estate has expanded to include a set of practices that recognises the value of an operating business alongside a pool of real estate assets, but also responds to the need of a business to be allowed to continue its operations with minimal intervention by funders. No lender can take much comfort from the expertise of its borrower's management unless it is prepared to allow the management to manage its business. Examples of operating businesses that have become particularly suitable for this type of financing (due to their ownership of substantial real estate assets integral to the operation of the business) include care and nursing homes, restaurants, petrol stations and private educational institutions.

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Some projects are so large that their financing structure becomes a *sui generis*. Canary Wharf in the Docklands of East London is one such project. The Thatcher Government in the 1980s considered ways of regenerating run-down neighbourhoods and increasing the influence of the City of London. In 1987, the Docklands area was created to construct a second City of London. It had few zoning restrictions and also had favourable tax treatments, thus allowing rapid development of the land. By 1991, the main buildings had been erected and let. Within one or two years, the developer Olympia & York was caught up in the worldwide recession and entered administration in the UK and Chapter 11 in the US (Flood and Skordaki, 1997). After considerable restructuring, the original investors were able to buy their way back into Canary Wharf. The purpose of this particular refinancing was to fund the construction of the remainder of the Canary Wharf property. The transaction raised over £1 billion in a series of notes to be redeemed in 2033, some with fixed interest rates and others with variable ones, and including various kinds of swap agreement. Because of the huge tax liabilities that can be incurred in such transactions, the planning of the structure was crucial to minimising these costs while preserving the rights of the interested parties, especially those of the funding banks. Figure III shows the complexity of the structure and how it was created.

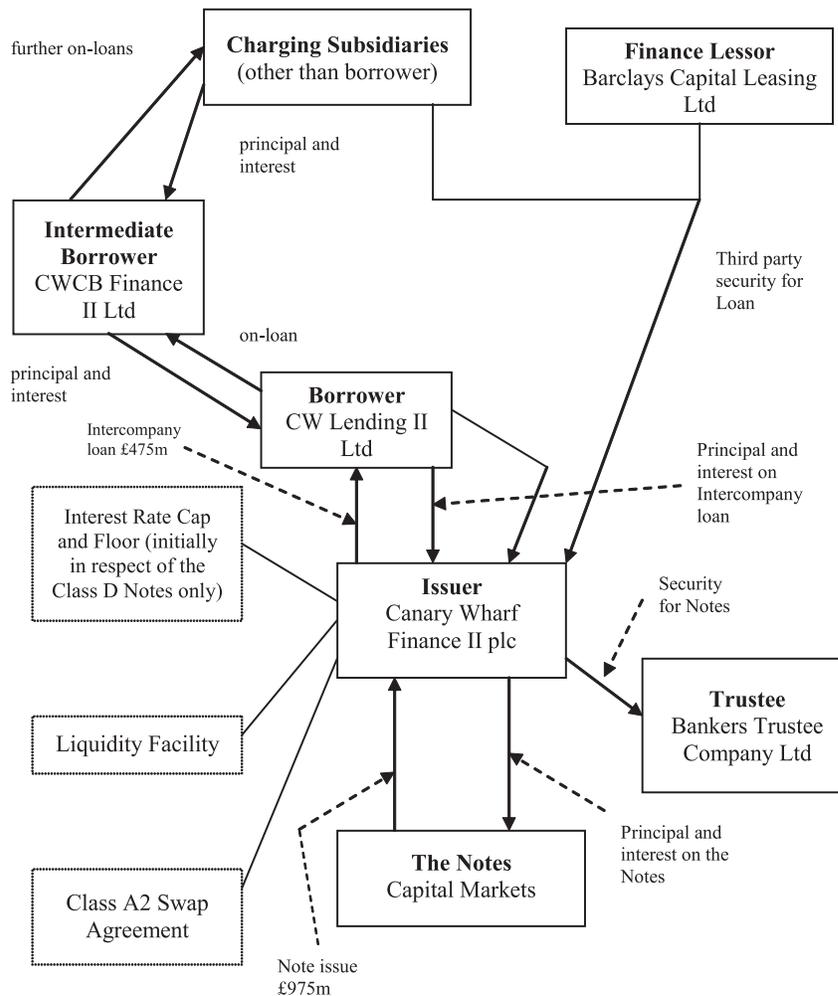
The transaction document ran to 135 pages. In order to complete the package, two Magic Circle law firms—one for the issuer, borrower and charging subsidiaries; and one for the managers, trustee and liquidity facility provider—were involved, together with five banks, two real estate valuers and one Big Four firm of accountants. There would be other law firms, not listed in the document, who would have acted for various other involved parties.

The rapid development of real estate finance markets has created a push to innovation, partly in response to new entrants to the market and also to generate new returns from existing assets. One example of the former is the growth in Sharia-compliant transactions.<sup>10</sup> For example, a Middle Eastern investment fund based in London wanted to establish a German real estate fund to allow Arabs to invest in German property. (Again, the use of the English language is important here in the structuring of the transaction.) The key to enabling the setting up of the fund was to adopt the '*ijara wa iqtina*', 'in which a bank buys an item and leases it to the purchaser, who agrees to buy the item at the end of a pre-agreed period. Rental payments

<sup>10</sup> The *Qur'an* warns against the evils of usury and, in particular, *riba*, the charging of interest for loans. Since money has value and entails costs, Islamic finance has developed a number of techniques to avoid interest payments, yet reward banks and other lenders for financing projects. Some of these may involve building the payment of fees or some other means of acknowledging the cost of money. *Sharia* is the law revealed in the *Qur'an*.

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Figure III—The Transaction Structure of the Canary Wharf 2001 Financing



include an amount towards the value of the item, so that the final payment is generally a token amount. Thus, a profit is earned by the lender, but, technically, interest is not collected.<sup>11</sup> The structure of this fund allowed the investors to benefit from Western-style bank financing and leveraging without violating Sharia. The structure crossed legal jurisdictional, cultural and religious boundaries.

<sup>11</sup> <[http://www.everything2.com/index.pl?node\\_id=1771357](http://www.everything2.com/index.pl?node_id=1771357)> accessed 18 June 2008.

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When transactions reach these levels of complexity, they become private ordering systems with their own forms of governance. The role played by the credit rating agencies is crucial to their effectiveness (Flood, 2005). As issues involve various kinds of derivative and securitisation, external monitoring is carried out by the agencies, such as Standard & Poors and Moodys. Without their imprimatur of a triple-A rating, a transaction cannot successfully conclude. Moreover, where orphan companies (SPVs) are implicated, the rating agencies oversee their activities during their intended life-spans to ensure compliance with the transaction.

The cross-border aspects of transactions are often a matter of reconciling some jurisdiction-specific issues within a UK-based legal document, thus harmonising differences so that a bank has the confidence to rely on the structure captured in the document. Alternatively, the transaction may be a case of using several different jurisdictions as key attributes of the structure. In this type of transaction, the relationship of the jurisdictions is based on their relative merits to the entire structure. This occurs typically when bank accounts are located in offshore regimes and tax-efficient countries are used to channel funds.

Transactions take their character and shape from the initial driver, which in the case of real estate finance is most often a bank. Banks seek to minimise the risk of the strange and maximise their range of normality. In the examples provided in this chapter, the majority of the banks were UK-based, which meant that their strong preference was for structures to be documented ultimately in some form of English law. Ideally, other jurisdictions would be subordinated to the overall rule of the primary legal system. However, given the contingent nature of these structures, future restructurings could easily provide for different approaches. From that perspective, as solid as these structures appear, they are ultimately noumenal with the appearance of the phenomenal.

It is clear that the analysis and discussion presented strongly support the fact that international legal structures are weak and fragmentary, which follows Gessner's findings on international cases in courts (1996: 155). Moreover, the legal coordination structures available are few and many lawyers and other actors instead rely on relational coordination structures. However, these are unable to provide effective protection under all circumstances and so the risk increases as business crosses borders. The lack of such established structures emphasises the importance of the lawyer as the creator and provider of contingent structures that fill the gaps. Thus, what we observe is lawyers simulating the proximity of the state legal system when they use typified solutions to resolve conflicts. Gilson (1984) augments the argument when he refers to lawyers as transaction cost engineers who manage the process of contracting between the parties: in adjusting, modifying and tweaking structures, lawyers lubricate the flow of the parties' business. What we see are lawyers and law firms implicated in

the creation of structures that minimise risk and uncertainty for investors. While the ability to reduce normative uncertainty is restricted because local rules will not permit their being breached or trumped by others' rules, behavioural uncertainty is substantially reduced by the importation of user-friendly structures via documentation that sidesteps individual peculiarities. Moreover, the complexity of these structures is such that many regulatory authorities within jurisdictions not amenable to their normal usage would be unable to comprehend them. Furthermore, because of that ignorance or lack of comprehension, they are unable to reject them. Thus English law ultimately does 'trump' the other jurisdictions. The real estate finance lawyer therefore demonstrates graphically how lawyers provide solutions and create support structures when cross-border norms do not exist.

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