

Real estate typically plays a part (from ancillary to integral) in nearly every asset purchase, stock purchase or merger transaction. Therefore, it is important to understand what due diligence might be required for the real estate assets involved in the transactions and the potential risks of not performing that due diligence.

Real estate due diligence consists of conducting specific research and investigation on the real property assets so that the parties can (i) account for real estate risks in decision-making processes, (ii) modify the deal structure to resolve real estate issues, (iii) account for diligence items requiring significant lead time in the deal timeline and (iv) identify potential costs required for a successful closing.

To start the diligence process, inventory all the properties included in the transaction, confirm which are owned versus leased and request any related documentation for each property. This should all happen during the early stages of an M&A deal, alongside the preliminary negotiations prior to contract execution. The diligence can then be broken down into five main categories.

Title Review

You cannot effectively purchase property from someone who does not own the property. Surprisingly, ownership of the assets is frequently overlooked. It is possible that the founder of a seller entity purchased the property as an individual and forgot to transfer it to the seller entity prior to selling his/her own interests in the company. This adds the obstacle of obtaining and recording corrective title instruments prior to the deal closing.

For the most protection, a purchaser should obtain a title policy that insures over specific title concerns. Depending on the policy type and proposed transaction, coverage may still apply under existing title policies after closing. If coverage applies, the purchaser may prefer to rely on the existing policies in lieu of obtaining new policies, especially if the policies are relatively recent and the insured amounts closely approximate current market values. A "date-down" endorsement (if available) to bring the coverage current may be more cost-effective than a new policy.

However, title policies are costly and could exceed certain budgets depending on the amount of applicable properties. A cheaper option would be to request a title report or title commitment (depending on the jurisdiction) for a smaller fee. The title report/commitment is a current status of title showing ownership, liens, encumbrances, restrictions and any other recorded matters against the property. This route does not insure but allows the purchaser to determine what issues present a risk to the deal. For example, restrictions could prevent desired future operations or the property could be subject to foreclosure for an unpaid lien.

Survey/Zoning

Obtaining updated surveys and zoning reports burns a deeper hole in the deal pocket. These materials could delay the deal due to the significant turnaround time but may be valuable if the deal includes (i) property headquarters, (ii) specialized facilities (i.e., power plants) or (iii) recent significant construction on the property.

Surveys show access drives, boundary lines, easements and encroachments. It is important to confirm boundary lines have a start and end that meet, there is access to the property from a main roadway, proper utility easements exist and that improvements are within the property lines. Surveys will also help understand the title report/commitment by listing out which exceptions actually affect the property and plotting such exceptions if applicable. Further, title companies usually require an updated survey for title insurance.

Zoning reports disclose (i) whether the use of the property is permitted in that zoning district, (ii) any nonconformities and whether such nonconformities are legally nonconforming, (iii) rebuild restrictions if there is a casualty and (iv) any open zoning, building or fire code violations. These reports provide an in-depth view on what issues need to be resolved to ensure compliance with zoning and local code regulations. A purchaser should consider the ultimate end goal for the property to determine whether rezoning is required.

Lease Review

For transactions involving leases, there are several important concepts to consider. First, confirm that all lease documents provided are complete. Review the lease file for possible references to any material agreements that might be missing from the file – i.e., is there reference to a guaranty, environmental agreement, development agreement or tax agreement? Obtaining these additional documents will provide a clearer picture of any exposure assumed with the transfer of the lease.

Second, depending on the importance of the lease to the transaction, a summary of the material terms may be crucial. These material terms include rent escalations, termination date, security deposits, renewal rights, assignability and any unusual terms such as a purchase option. Assignability may cause the biggest headache for M&A deals, since it is common for leases to prohibit any transfer of a tenant's interest without the landlord's prior consent. Any transfer

without prior consent could be a default under the lease, which could be grounds for termination by the landlord. Unfortunately, transfer may be broadly defined in leases to include by operation of law (merger) or purchase of substantially all of the tenant's assets (asset sale). Reviewing the assignment provision is critical given that some lease assignments might also trigger (i) a transfer cost due to the landlord, (ii) recapture rights, (iii) changed lease terms, (iv) a new guaranty agreement, (v) termination rights and (vi) a purchase option. On the other hand, landlords can be slow in responding to such requests and typically have no incentive to cooperate. A tenant may be inclined to take a risk and not pursue landlord consent if the rent due under the lease is above market value, given that a landlord may be more likely to waive its right to terminate to avoid having to re-let at a lower rental rate.

Ensure that the diligence is prioritized for any headquarter leases or other critical leases that are material to the business operations.

Environmental Review

The environmental condition of real property could present major economic risk. Although a seller may be agreeable to providing representations and warranties regarding the presence of hazardous materials or any current violations of environmental law, the purchaser may want to alleviate any issues by obtaining a Phase I environmental report. The Phase I, a non-invasive routine checkup on the property, may also be required by the lender financing the deal. The Phase I may take weeks to complete but would reveal any environmental risks such as old storage tanks from previous use on the property or spill of hazardous materials. If these issues are present, the purchaser may want to order a Phase II environmental report, which is more invasive and takes more time.

Although obtaining an environmental report requires additional time and money, the report would indicate the type of cleanup and other expenditures required to restore the property, which should be accounted for in the transaction costs and may provide leverage to negotiate the purchase price of a deal. Additionally, purchasers would not otherwise qualify for liability exemptions under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 unless it obtains a current Phase I.

The type of deal structure should be another important consideration. In an asset transaction, the purchaser is generally not responsible for environmental liabilities of the seller that are unrelated to the properties being transferred (unless a third party is able to prevail against the purchaser on a claim under a successor liability doctrine). On the other hand, the purchaser in a stock transaction will automatically succeed to all of the seller's environmental liabilities. Accordingly, the environmental diligence should be larger in scope for a stock transaction.

Transfer Taxes

Transfer taxes and other related fees can be a silent killer in M&A deals. Transferring title to a property often requires a payment of fees that is assessed as a percentage of either the sale price or fair market value of the property. Even a transfer of an entity (as opposed to real property) can trigger the transfer tax obligation in some jurisdictions. Local counsel should be utilized to help assess exposure since the rates vary according to jurisdiction, with some of the highest being in Philadelphia and New York City. Each jurisdiction has its own set transfer taxes, rules and exemptions depending on the type of assets and transfer involved.

The transfer tax analysis should be a priority diligence item occurring prior to contract execution, as the exposure may be material. The parties should negotiate who will pay the transfer taxes and potentially allocate the amounts into the overall pricing decision.

Representations and Warranties

In normal real estate purchase deals, the seller will provide a list of representations and warranties in the purchase agreement, which are used to (i) make sure that the purchaser is obtaining the proper diligence materials by having the seller certify to certain items and (ii) obtain disclosures from the seller regarding what they know about the condition of the property and any issues with title or violations of applicable law. These representations and warranties are required to be true as of the execution of the agreement through the closing date.

Alternatively, M&A deals rely on post-closing indemnification claims due to confidentiality concerns. Given that real estate diligence takes a back seat in many M&A deals, parties should be more inclined to negotiate broader representations and warranties concerning the real estate assets involved. Although the representations and warranties should not replace diligence, they will be a good security blanket to rely on in the event damages arise from a breach of such representations and warranties.

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