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Real Estate Considerations In M&A Transactions

--By *Kenneth A. Neale, Arnold & Porter LLP*

Law360, New York (October 31, 2013, 5:45 PM ET) -- Most merger and acquisition transactions involve some component of real property, whether it is property owned by the target company, leased, or both. This raises a number of legal issues specific to real property that should be considered, and in many cases, addressed in the definitive agreement, whether the transaction is structured as an asset or stock purchase, merger or consolidation.

Owned Real Property

In M&A transactions where the target company (or any of its subsidiaries) owns real property, the parties should consider the following issues:

Title Insurance. Real property is a unique asset with a well-established system of title insurance for insuring ownership and rights. Generally, title insurance will provide certain assurances as to ownership of the property and whether there are any liens or other encumbrances (e.g., easements or restrictive covenants) that could adversely affect the property or its use.

Decision to Purchase. An acquiring company should consider obtaining title insurance in stock, as well as asset deals, as purchasing stock in a company that owns real property is an indirect purchase of the property. In stock deals, an acquiror may benefit if there is already a title insurance policy in favor of the target company in place.

Depending on the age and amount of the policy, it may be acceptable to forego a new title policy. If relying on an existing policy, however, it is important to verify the proposed transaction does not negate the insurance. Modern title policies provide more flexibility in allowing successors in interest or related companies to benefit from an existing title policy. In some cases, however, a new title policy or endorsement to the existing policy may be necessary.

Nonimputation Endorsements. In addition to many standard title insurance endorsements, in a transaction involving the acquisition of stock or other ownership interests, an acquiror should consider obtaining a nonimputation endorsement so that it is not imputed with the knowledge of a partner, officer, director or employee of the target company, which could potentially negate the benefit of the title policy.

Surveys. An acquiring company should consider obtaining an American Land Title Association survey of any real property owned by the target company. This is particularly true of properties with potentially complicated boundaries, such as golf courses or resorts.

A survey will identify the boundaries of the property and establish whether certain easements burdening the property might impact the current or future use. The survey should also show encroachments onto the property or by the property onto neighboring properties.

A survey would also allow an acquiror to obtain extended coverage title insurance protecting it from certain off-title matters, such as encroachments, not shown on the survey. Surveys can be expensive, however. If there is an existing survey, it may be possible to update it at a reduced cost.

Conveyance. In an asset deal, real property is conveyed by deed. A general warranty deed provides the highest level of warranty. Special warranty deeds are the most typical and provide warranties against acts of seller. Quitclaim deeds are not commonly used and should be avoided by the acquiror.

Property Taxes, Reassessment. In California, owned real property would normally be reassessed for property tax purposes to fair market value upon the closing of an asset or stock transaction.

In an asset deal, the transaction is reported on a preliminary change of ownership report. In a stock deal, the purchaser must file a BOE-100-B (Statement of Change in Control of Ownership of Legal Entities) within 90 days of the closing of the transaction. Failing to do so could result in a penalty.

Transfer Taxes. Where owned real property is involved, a transfer tax will apply in an asset deal in many jurisdictions, including California. Depending on the jurisdiction, transfer taxes can be quite expensive.

Some California counties (such as the counties of San Francisco and Santa Clara) also may impose a transfer tax on change in control transactions even where no deed is recorded. In the typical real estate transaction, transfer taxes are paid by the seller.

Leased Real Property

For M&A transactions involving real property leases, consider the following issues:

Assignment/Sublease

Asset Deal. In asset deals, leases are often assigned to the purchaser at closing. Many leases require the consent of the landlord to an assignment, although it is not unusual to find an exception for change in control transactions. Assignment provisions in leases can be complicated, and there are a number of issues to consider.

- **Assignment requirements.** Many leases will have notification and data requirements before landlord will consider consenting to an assignment. A typical provision will require that landlord be provided with 30 days' notice as well as a copy of the proposed assignment and financial statements from the purchaser/assignee. For sensitive, nonpublic transactions, this could create disclosure concerns, and it may be advisable to ask that the landlord sign a nondisclosure agreement with regard to both the transaction itself and the financial information provided by the acquiring company.
- **Recapture.** Many leases, especially office leases, allow the landlord to terminate the lease and recapture the premises in the event of an assignment or a request for an assignment. This is usually an alternative to the landlord granting consent. There may be an exception in the lease for change in control transactions. If not, there may be ways to structure a transaction to avoid the issue.
- **Options.** Many leases will provide that any options (to extend, expand, purchase or otherwise) contained in the lease are personal to the original tenant. This usually means that options cannot be assigned, even if the lease is. There may be ways to draft the lease assignment and

landlord consent to effectively assign these options notwithstanding contrary language in the lease.

- Rent increases. Some leases allow the landlord to increase the rent (e.g., to fair market value) in the event of an assignment.
- Bonus rent. Many leases provide that a landlord is entitled to some or all of the consideration provided in the event of an assignment of the lease. In an M&A transaction, where an acquiror is obtaining an undermarket lease, a landlord may argue that it is entitled to some consideration upon the closing of the transaction. The parties should consider this possibility when allocating the purchase price in a transaction.
- Release. An assignment does not typically release the original tenant from liability. In an asset transaction, a seller may want to include such a release in the landlord's consent. If the lease is guaranteed, a seller may also want the guaranty to be released, and depending upon the financial strength of the acquiring entity, the landlord may want a substitute guarantor.

Stock Deal. Generally, the sale of stock does not constitute an assignment absent language to the contrary in the lease. Most sophisticated leases, however, will deem such a transaction to be an assignment and thus subject to landlord's consent, unless there is an exception for change of control transactions. If landlord's consent is required, some of the same issues relating to recapture, options, etc., as referenced above, would apply.

Repairs and Maintenance. An acquiror will want to carefully review and understand its obligations with respect to repairs and maintenance of leased facilities.

To the extent that a lease imposes significant repair/maintenance obligations on the tenant, an acquiror will want to make sure it has strong representations and warranties in the definitive agreement with respect to condition of facilities. An acquiror may also want to conduct a physical inspection of the property.

Restoration Obligations. An acquiror needs to understand the scope of any restoration obligations included in any leases that it assumes. These obligations may require the tenant to restore the premises to the condition that they were in upon the commencement of the lease term. Such obligations could be significant if there have been major improvements or alterations to the premises since the commencement date.

Title Insurance. Leasehold title insurance should be considered for leases that are particularly valuable or which have a particularly long term. This is especially true for ground leases.

Nondisturbance Agreements. Ideally, for each lease in place there will be a nondisturbance agreement from any lender having a lien on the leased property and, if applicable, any ground lessor. If not, the acquiror should consider requiring a nondisturbance agreement as a condition to the closing.

Estoppel Certificates. An acquiror should consider requiring estoppel certificates from landlords under leases to be assumed at the closing. These will usually contain certifications as to which documents constitute the lease, whether there are any defaults under the lease, the existence of any options, and other matters. It may be convenient to include these provisions in the landlord consent.

Landlord's Lien. In situations where the acquiror is financing the acquisition, the lender may require a lien on the personal property and fixtures located on the leased premises. In that case, the lease needs to be reviewed to determine whether landlord has a contractual lien on such personal property that will need to be waived. In some jurisdictions, the landlord may have a statutory lien as well.

Reassessment for Long-Term Leases. In California, an acquiror should be aware that an assignment of a lease with a remaining term of 35 years or more could result in a reassessment of the underlying property for property tax purposes.

Representations and Warranties

Real estate representations and warranties are usually separately specified in an M&A agreement but cover many of the same issues as other representations and warranties, such as compliance with laws and material contracts. This raises the issues of consistency and conflict.

Are the representations regarding the real property consistent with the other representations made in the agreement, including representations as to compliance with laws, material contracts, title to assets, etc.? Should the real estate representations control as to other representations?

A selling company should also be careful to limit representations on property that the company does not own or control, particularly where the selling company may be one of many tenants occupying the property.

Due Diligence

Real estate assets present unique due diligence concerns. As mentioned above, an acquiror may want to obtain an ALTA survey for purposes of uncovering potential encroachments or off-record title issues, a Phase I (and perhaps a Phase II) environmental assessment of the property to determine potential environmental liabilities, and physical inspection reports for the property and its components (e.g., roof; heating, ventilation and air conditioning system; electrical system).

Inspections may also be important for leased property depending on the nature of the use and the obligations of the tenant under the lease to maintain, repair and replace building systems and components. And, of course, any leases should be carefully reviewed for the issues described in the Leased Real Property section above.

The foregoing describes some, but not all, of the most important issues relating to real estate arising in an M&A transaction. One very important area that is beyond the purview of this article relates to environmental matters associated with real property, which the parties will also want to carefully consider.

[Kenneth Neale](#) is a partner in Arnold & Porter's San Francisco office.

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