

# DON'T LET REAL ESTATE DERAIL THE DEAL

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► **When doing M&A due diligence, it's crucial to consider all aspects of the target's real estate situation.**

**W**hether acquiring the assets of an existing company or acquiring or merging with an existing company, important considerations about the real estate holdings of the target company are often overlooked. Typically, due diligence in corporate transactions is focused on the review of organizational documents, capitalization, federal and state income tax filings and returns, intellectual property (i.e., trademarks, copyrights and other intangible assets), and regulatory compliance. Frequently not enough attention is given to the real estate assets of the target company, whether they be fee or leasehold interests, which can lead to substantial liability risks and last-minute impediments to the completion of the transaction. Here, we provide a brief overview of important aspects of real estate due diligence that should be considered, as well as issues that can be avoided or ameliorated if the proper inspection of real estate assets are undertaken early in the due diligence process.

## **Title and Survey Review**

Probably the most important aspect of real estate due diligence is confirming the current ownership of the target entity's real estate holdings. But even if the property is owned by the target, simply getting a copy of the deed is not enough. An appropriate review of an updated title report and recent survey will identify any existing monetary liabilities, ownership issues, special use

and operation restrictions, and existing violations and potential impediments to future property development, including any expansion of operations. A current title search will verify real property ownership and indicate whether there are any outstanding loans or liens for which the target is liable. Such a search will also identify existing encumbrances that may restrict the use and operation of the property, including agreements of record that may contain restrictions on transfers of the property or the controlling interests of the property owner. If requested, a title report will also provide Uniform Commercial Code filings, as well as identify real property tax amounts and special taxes and assessments. And in some jurisdictions, it can provide information regarding local code violations existing against the property.

A survey will confirm whether the legal description attached to the deed is accurate and will help put the encumbrances raised in the title report into perspective. Moreover, the survey will show the location of improvements to the property, whether the improvements encroach upon adjacent property (or whether improvements to adjacent property encroach upon the target's property). The survey may also show the location of wetland areas, access to public streets, and nearby flood plains.

## **Lease Review**

In some instances, the target company might not own the real estate, but instead will be leasing it from a third party. In such cases, a review of existing leases is important to determine the rights and obligations of the target, as well as potential obstacles to completing the corporate transaction. The assignment provision

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of a lease is the top consideration when undertaking a lease review. Most sophisticated leases will include mergers, acquisitions, and sales of assets as transfers that require, at a minimum, notice to the landlord. Some provisions may require the landlord's consent prior to consummation of the transaction, the failure of which gives rise to a default under the lease. Other leases may require profit sharing with the landlord, pursuant to which the landlord gets a percentage of the consideration paid for the tenant's assignment of the lease. A lease review will also identify any potential rights of expansion, any rights regarding fee ownership of the property in the event of a sale (referred to as rights of first refusal or first offer), as well as any rights to make alterations to the premises, and rights to monetary contributions from the landlord in the form of improve-

ment allowances. Finding out whether a target or its landlord is in default under a lease is also important. In this regard, it is prudent to obtain an estoppel certificate from the landlord confirming no defaults or specifying what defaults do exist.

#### **Use and Development**

In many instances, particularly where there may be plans for future expansion of operations or site upgrades, a title or lease review may not be enough, and further

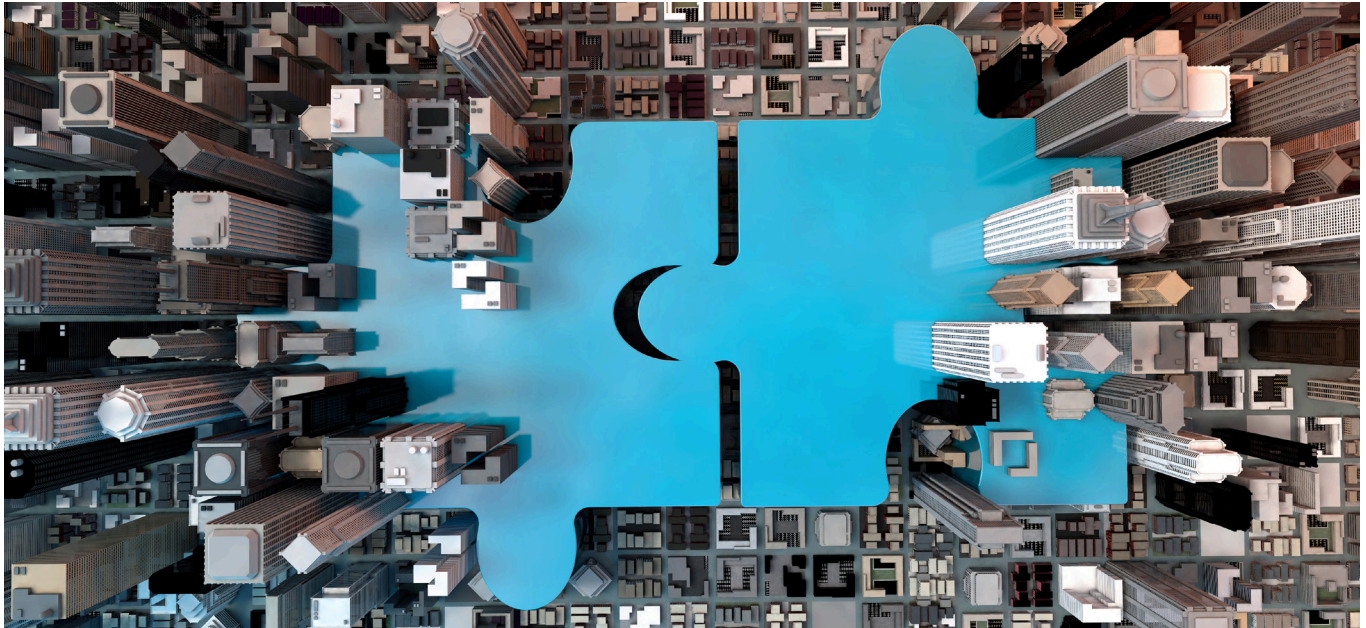
investigations into the permitted uses, operations and development rights of the real property must be undertaken. This involves reviews of the zoning of the property, the existing entitlements and the process for obtaining new ones, and a review of any violations and certificates of occupancy. Oftentimes a zoning letter from the municipality or other governing authority is warranted to confirm approved uses for the property, as well as any special restrictions. If the real estate asset is valuable, or if there is anticipated future development or other special circumstances, inquiries to the city clerk, building department, and city engineer may be made to help determine the existence of any violations and/or active and available permits and licenses. A review of existing contracts, guaranties and warranties will help determine operational costs and obligations. Existing redevelopment or developer's agreements and/or tax incentives agreements with local governmental authorities may require third-party consents for asset transfers or changes in control. These should be explored to preserve existing rights and avoid defaults.

#### **Environmental**

Whether the real estate asset is leased or owned, environmental liabilities can pose a huge problem if they are not adequately identified and addressed during the due diligence process. Special development permits, compliance issues, existing remediation obligations, and potential environmental hazards are just a few of the issues that must be thoroughly reviewed. To that end, the following documents should be requested and reviewed early in the process: any and all environmental permits and violation notices; environmental studies and impact reports; correspondence with governmental authorities; lists of hazardous materials used, manu-



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factured or stored at the property; and any agreements pertaining to environmental obligations or remediation. Since environmental liability can exceed the value of the real property and improvements, it is imperative that potential exposures like remediation costs, third-party claims, natural resource damages, and environmental enforcement actions be identified. At a minimum, due diligence in this area requires an environmental assessment that involves a review of all available reports, records, and documents from both the owner of the property and the environmental agencies with jurisdiction over it.

### **Taxes**

There are several reasons for investigating the potential impact of real estate-related taxes, which go beyond real property taxes. Some jurisdictions may require

non-deed transfer taxes upon the acquisition of a target company, although the real property itself remains owned by the target. There may be special district taxes or tax abatement agreements whereby taxes are reduced for a limited period of time. There may be pending tax appeals or a potential to appeal taxes, both of which will have deadlines for action.

Failure to properly conduct real estate due diligence can give rise to defaults leading to a risk of forfeiture of property rights or other incentives. Other negative consequences may include the assumption of unanticipated and costly liabilities, limitations on future business expansion and operations, and delays and stumbling blocks to consummation of the main corporate transaction. Thus, a carefully planned investigation into a target company and its assets cannot ignore real estate holdings. ■