



## Real Estate Diligence in Merger and Acquisition Transactions

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As merger and acquisition activity has increased during the past few years,<sup>1</sup> so too has the need for attorneys to counsel their clients effectively and efficiently regarding the diligence activities that accompany those deals. Attorneys will be well-positioned to counsel their clients if they have a comprehensive awareness of the purposes of diligence activities and of the multiple roles that attorneys must play in those activities.

It is particularly important that the actions of attorneys tasked with performing diligence regarding real property assets and liabilities reflect this awareness. Although transactions involving the purchase and sale of solely real estate assets have always provided an opportunity for attorneys to work with their clients on diligence activities, real estate diligence in the context of a deal where real estate assets are but one of many types of

assets being acquired arguably requires a different approach.

This Article describes some purposes of diligence activities and the roles that attorneys play in those activities and then focuses upon real estate diligence. A brief description of typical real estate diligence<sup>2</sup> is followed by suggestions for navigating the process in the context of a merger and acquisition transaction where real estate assets and other assets are targeted.

### Purposes of Diligence

There are at least two purposes for diligence: Diligence guides the negotiations of the deal parties, and diligence assists the buyer with identifying the assets and liabilities being acquired and with charting a post-closing plan for them. Each of these purposes is of great magnitude. One of the reasons that merger and acquisition deals produce a significant

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<sup>1</sup> Jeff Golman, *6 Reasons 2014 Will Be a Strong Year for M&A Activity*, Forbes (Jan. 13, 2014, 10:06 AM), <http://www.forbes.com/sites/jeffgolman/2014/01/13/6-reasons-2014-will-be-a-strong-year-for-ma-activity/>.

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<sup>2</sup> Although this Article presents a description of certain real estate diligence, it should not be relied upon as a comprehensive real estate diligence checklist.

volume and intensity of lawyering work is that the deal parties (particularly the buyer) and their advisors must attempt to juggle both of these purposes simultaneously.<sup>3</sup>

An attorney's attempts to effectively perform diligence will be materially hampered if that attorney does not understand how such diligence might affect the negotiations between the deal parties. Moreover, an attorney's efforts to understand how diligence might affect such negotiations will be hampered if that attorney is not aware of the typical features of acquisition agreements.<sup>4</sup> If real estate attorneys desire to be effective and efficient providers of diligence services, they should not fail to become

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3 Among the other tasks that the deal lawyers (particularly on the buyer's side) might be juggling are negotiating the financing necessary to fund the purchase price, obtaining regulatory approvals, and obtaining the consent of critical customers or suppliers. The seller's attorneys will be kept busy responding to diligence requests and negotiating the acquisition agreement.

4 Among these typical features are a description of the target assets and liabilities, a description of any excluded assets and liabilities, descriptions of the amount of the purchase price and the manner in which it will be paid, a listing of conditions to be satisfied prior to the closing, representations and warranties by the seller regarding the seller and the assets and liabilities to be acquired, exceptions to those representations and warranties (typically listed on a disclosure schedule), covenants regarding post-closing matters, an agreement by the seller to indemnify the buyer with respect to certain matters, and a discussion regarding the circumstances (if any) under which the acquisition agreement can be terminated.

familiar with the various moving parts of the agreements typically used in merger and acquisition transactions.<sup>5</sup>

An attorney who is aware of the features of acquisition agreements will be able to receive, evaluate, and act upon the results of diligence activities with productive precision. An attorney who is less familiar with these features might overreact to diligence results and pursue a less-than-ideal negotiating path (which could result, in a worst-case scenario, in threatening the deal parties' willingness to continue pursuing the proposed transaction). By pushing or pulling the various levers available through the negotiation of the typical features of an acquisition agreement, the buyer's attorneys are able to address an issue revealed through diligence. Skilled buyer's attorneys are able to address these issues in an elegant manner that protects their client's interests while simultaneously moving the negotiation forward productively.<sup>6</sup>

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5 Acquisition agreements typically bear titles such as Asset Purchase and Sale Agreement, Stock Purchase and Sale Agreement, or Agreement and Plan of Merger.

6 Consider, for instance, how the receipt of certain diligence results might affect the buyer's negotiation of the acquisition agreement: If diligence revealed that the seller of multiple parcels of real estate did not own one of those parcels, the parties simply could amend the description of assets to be acquired to delete such parcel and could decrease the purchase price. More complex examples exist: If diligence revealed that a former tenant had failed to vacate one of those owned parcels, the parties could (a) exclude from assumed liabilities any damages resulting from such holdover tenant's possession of the parcel, (b) decrease the

A second purpose of diligence is that it assists the buyer with determining the identity, quantity, and characteristics of the assets and liabilities being acquired and with charting a plan for how to manage those assets and liabilities following the closing. The buyer in a typical merger and acquisition transaction is rarely intimately and accurately aware of each of the assets and liabilities that will be acquired in the deal. Rather, the buyer likely has entered into the negotiation and diligence phase with only a general sense of the assets and liabilities.

The buyer likely was attracted to the deal by other characteristics of the seller (such as its financial performance or the popularity of one or more of segments of its business).

The buyer will take a critical step toward achieving success in its post-closing operations if it uses pre-closing diligence activities to assess the deal's assets and liabilities. Attorneys who assist with that assessment step are well-positioned to counsel the buyer not only through the closing of the acquisition transaction but beyond.

### **Attorneys' Roles in Diligence**

Deal quarterback. Diligence request author. Survey reader. Response evaluator. These

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purchase price or require a certain portion of it to be held in escrow until such holdover tenant vacated the parcel, (c) list such holdover tenant's vacating the parcel as a condition upon the buyer's obligation to close the deal, (d) revise the seller's representations and warranties to account for the existence of such holdover tenant, (e) expressly list liability related to such holdover tenant as a matter with respect to which the seller's indemnity protects the buyer, and/or (f) make other changes to the acquisition agreement.

titles describe only some of the roles that real estate attorneys serve with respect to diligence activities (and those titles focus primarily on the buyer's attorneys' roles). Diligence activities present to attorneys on either side of the deal opportunities to demonstrate a host of excellent lawyering skills, including responsiveness, attention to detail, project management, clear communication, negotiation, issue-spotting, and risk assessment.

The buyer's attorneys' roles are aimed at achieving the primary purposes of diligence described earlier in this Article. The seller's attorneys' roles are aimed at responding to the buyer's diligence requests while advancing the deal toward closing, maintaining a purchase price and other deal terms appealing to the seller, and limiting the pre- and post-closing risks for the seller.

The deal parties are guided through the diligence activities by a request and response process. The buyer's attorneys typically prepare an initial request list. That list seeks from the seller both information and documents. The seller's attorneys typically assist the seller with preparing responses to those requests. As responses to those requests trickle (or pour) in, the buyer's attorneys evaluate which steps to take next. In some cases, those responses will prompt the buyer's attorneys to deliver follow-up requests to the seller. In other cases, the buyer's attorneys will elect to undertake an additional diligence activity that previously had not been performed, such as engaging an advisor to undertake an environmental inspection. In other cases, the buyer's attorneys and the seller's attorneys will

negotiate whether the responses received to-date have been sufficient.

There are at least two steps that the buyer's attorneys should consider with respect to each response received, even though the buyer's diligence activities might not yet be complete. The buyer's attorneys should determine whether the then-current version of the acquisition agreement under negotiation should be modified on account of such response and should also advise the buyer of those diligence responses so that the buyer can begin to shape its post-closing plan. Waiting until the conclusion of diligence activities to begin negotiating changes to the proposed acquisition agreement could result in an enormous task that might have been better handled incrementally over the course of diligence activities. Failing to advise the buyer of diligence responses as they are received could produce consequences no less severe. The buyer preciously values each day prior to closing as another day during which it can prepare for the transition of the assets and liabilities and the post-closing operation of its business.

### **Real Estate Diligence**

Attorneys performing diligence with respect to any aspect of a merger and acquisition transaction bear significant responsibilities. The attorneys engaged in that deal's real estate diligence must be particularly focused due to the variety of diligence instruments, other professionals, and—if the target parcels are located in multiple states—applicable law with which those attorneys might be dealing.

Attorneys typically conduct real estate diligence through a number of different instruments and with the assistance of other professionals. The brief summary that follows of a handful of those instruments and professionals demonstrates why the attorneys performing real estate diligence for a merger and acquisition transaction must be diligent attorneys and excellent project managers.

Obtaining a report examining the title status of each parcel of real estate that is an asset to be acquired in the deal is a typical first step for attorneys engaged in diligence activities on behalf of the buyer. Such reports vary from jurisdiction to jurisdiction, but title insurers are often the issuers of these reports. The reports typically identify the current owner of record of such parcel, describe the parcel, list exceptions to such owner's fee simple absolute ownership of the parcel (such as easement rights granted to a utility), and provide other information. The time required to obtain a title examination report on a particular parcel can range from less than twenty-four hours to multiple weeks, depending upon the remoteness of the parcel, the title history of the parcel, the responsiveness of the title examiner, and other factors.

Another typical early step in real estate diligence is engaging a professional surveyor to perform a survey of each parcel.<sup>7</sup> That survey should result in a plat or map that provides a plain visual illustration of the

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<sup>7</sup> "Survey" refers to the work performed by the professional surveyor. "Plat or map" refers to the drawing produced by the professional surveyor as a result of that work.

parcel. Although a similar illustration might be readily available in a matter of seconds using a service such as Google Earth, a survey plat is an instrument through which the buyer can obtain significant comfort not available through such services. From a survey plat, the buyer learns about the legal boundaries of the parcel, the location of easements on the parcel, the current record description of the parcel, the relationship of the parcel's boundaries to the boundaries of adjoining parcels (including encroachments), and other information.<sup>8</sup> The time required to obtain a survey plat on a particular parcel can range from a few days to multiple weeks, depending upon the remoteness of the parcel, the size of the parcel, the improvements upon the parcel, the responsiveness of the professional surveyor, the weather conditions, and other factors.

Once the initial title examination report and the initial survey plat have been obtained, the buyer's attorneys typically work with the title examiner and the professional surveyor to coordinate revisions to that report and to that survey plat. The visual illustration on the survey plat might allow the title examiner to narrow the description of exception items

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<sup>8</sup> See *Minimum Standard Detail Requirements for ALTA/ACSM Land Title Surveys*, American Land Title Association (Effective February 23, 2011). The Requirements permit the buyer to designate to the professional surveyor those items that the buyer desires to be shown on the survey plat. Among the available items are flood zone classifications, gross land area, exterior dimensions of all buildings at ground level, measured height of all buildings above grade, striping, number, and type of parking spaces, and names of adjoining owners.

listed on the initial title examination report or to remove those exception items from the report.<sup>9</sup> The recording references in the title examination report can be printed upon the survey plat so that the survey plat serves as a convenient, cross-referenced tool for the buyer, its lenders, future owners, and others. This coordination takes time, but it results in a strengthened diligence product.

Real estate attorneys performing diligence activities should assume that significant time will be required to maximize the value of each diligence instrument obtained.<sup>10</sup> As described above, obtaining and revising title examination reports and survey plats could take weeks or longer. The same could be true for other real estate diligence instruments, such as appraisals, environmental reports, confirmations of zoning designation, building inspections, and tenant estoppel certificates. The buyer's attorneys performing real estate diligence should create their checklists, conduct their work, and manage their client's expectations accordingly.

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<sup>9</sup> Once the survey plat has been obtained, easements that previously were expressed on the initial title examination report as being an exception item with respect to the entire parcel can now be referred to as affecting only the easement area shown on the survey plat within that parcel. If the survey plat reveals that a deed of trust listed as an exception item on the initial title examination report encumbers neighboring property, but not the subject parcel, reference to that deed of trust can be removed from the exception items.

<sup>10</sup> Significance, of course, is relative. Waiting two weeks for an initial survey plat might cause no problems on one deal but create significant challenges on the next.

## What's Different with M&A?

Performing real estate diligence in a merger and acquisition transaction where a variety of assets are targeted can be a significantly different experience than performing diligence where real estate is the sole target asset. The diligence purposes, attorneys' roles, and diligence instruments are the same in either case, but the deal parties' expectations and the deal team's needs often create a different diligence environment for which real estate attorneys should make a few adjustments.

One of the first adjustments in approach is to realize that most merger and acquisition deals move at a frantic pace. The work is often conducted around the clock, on weekends, and through holidays. Comparing that pace to the timelines described earlier in this Article for receiving, evaluating, and otherwise working with real estate diligence instruments underscores the fact that real estate attorneys must be exceptional project managers. The pace is also the reason why the real estate attorneys' law partners who are leading the deal<sup>11</sup> and the buyer's other deal team members will have only limited time within which to receive, evaluate, and act upon the results of real estate diligence.

Another adjustment in approach is for the real estate attorneys to attempt to be the best customer servant they can to the M&A attorneys and to the buyer's other deal team members. Those M&A attorneys will be working with the buyer on the acquisition

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11 Such attorneys are referred to hereafter as the "M&A attorneys".

agreement and on the buyer's post-closing plans. They will be evaluating diligence results across a range of legal practice areas (including real estate).<sup>12</sup> Due to the breadth of information for which they are responsible and the pace at which the deal might be moving, the M&A attorneys will be particularly appreciative if the real estate attorneys clearly communicate practical counsel.

The buyer's other deal team members will also appreciate an exceptional customer service experience from the real estate attorneys. Although the buyer's deal team members on a real-estate-only transaction might be experts in real estate matters, the buyer's deal team members on a deal with a variety of target assets might not be familiar with real estate matters. Rather, they might be experts in finance, information technology, and other operations. Accordingly, they might not appreciate the nuances of certain real estate matters and might even become frustrated with less-than-practical counsel.

A final adjustment for real estate attorneys performing diligence on behalf of a buyer is to realize that because the real estate assets are not the only assets being acquired, unattractive features of the real estate assets (occasionally referred to as "warts") might not be as important to the buyer as they would be otherwise. In fact, the buyer might not have even considered the real estate assets and liabilities when it elected

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12 Among the legal practice areas whose diligence the M&A attorneys might be incorporating are corporate governance, contracts, employment, employee benefits, intellectual property, privacy and data security and litigation.

to enter into the proposed transaction, and thus unless the real estate attorneys locate a liability of significant magnitude, the buyer most likely will have little tolerance for being troubled by it.<sup>13</sup>

## **Conclusion**

The keys to effective and efficient diligence of real property assets and liabilities have always included diligence and excellence in project management and communication. When attorneys are performing that diligence in the context of a merger and acquisition transaction through which the buyer is acquiring more than just real estate assets, the diligence environment requires more. Real estate attorneys who make a few adjustments in their approach to diligence on such a deal will be valuable members of the buyer's legal deal team.

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<sup>13</sup> The determination of magnitude will most likely be tied to the deal's purchase price and the buyer's post-closing plans, although other factors might apply.