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Commercial Lease Diligence

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In many acquisition and merger transactions, a component of the real estate holdings of the selling entity is leased commercial property. Counsel to a potential purchaser in an acquisition transaction, whether in the form of an asset purchase, stock or membership interest purchase, or merger, must be equipped to advise the client regarding the leased property both for negotiation of the purchase agreement and for the client's use of the property after the transaction has closed. This article reviews the recommended due diligence efforts of the purchaser's counsel with respect to leased commercial property, and elaborates on the pre- and post-closing rationales for completing such diligence review. The main focus of this article is the due diligence activities and rationale of counsel to a potential purchaser of all of the stock of a selling entity. Where relevant, it incorporates the alternate considerations that might arise in the context of an asset purchase or merger structure.

The Scope of the Transaction

Prior to an immersive review of the minutiae of each piece of leased commercial property, the attorney should engage in an efficient and high-level overview of the seller's real estate holdings in order to become comfortable with the scope and type of leased commercial property involved in the proposed transaction. In a stock purchase structure, the purchaser will take all assets and liabilities associated with each leased property (unless the parties negotiate for a termination of the lease prior to closing), and therefore consideration of the purchaser's goals is relevant to counsel's diligence efforts. During initial discussions with the client, counsel should understand whether the purchaser needs the leased space for its operations if the transaction is consummated. The attorney's knowledge of the general use (manufacturing, office, raw land), location (and proximity to the client's current facilities), and the length of each lease (including any options to purchase) will aid the client in outlining its overall goals in the context of all of the seller's real property interests.

Substantive Due Diligence

Once armed with the client's high-level objectives, the attorney can then delve into a substantive due diligence review of the leased properties with a firm understanding of how the leased property fits into the deal structure in terms of importance and breadth. If the purchaser anticipates that it will need to operate in all or the majority of the leased property post-closing, the attorney may find it helpful to prepare a lease abstract for each property. A lease abstract is a useful diligence tool for purchaser's counsel in reviewing disclosure schedules to the stock purchase agreement, as a quick reference tool for certain notable provisions or information, and as a guide for the pre- and post-closing actions that purchaser's counsel should recommend. A lease abstract can also serve as a starting point for identification of any open items that arise from the attorney's diligence review, and can aid the purchaser's personnel for operational planning purposes.

Immediately relevant in connection with the potential stock purchase is the consideration of what type of third-party consents might be required under the terms of each lease (*e.g.*, landlord or a governmental entity). In an asset deal, consent of the landlord is almost always required because the lease is assigned from the seller to the purchaser. In a stock deal, however, a review of whether the lease contains a provision requiring the landlord's consent to a "change of control" is necessary. Change of control provisions run the gamut from brief, overly broad statements (*i.e.*, "tenant may not assign (by operation of law, change of control or otherwise) this lease without Landlord's consent") to more nuanced provisions that incorporate a lengthy definition of "change of control." Changes of control requiring the consent of the landlord may be defined to include, for example, a dissolution, merger, consolidation, or other reorganization of a tenant, including the issuance or transfer of at least a certain percentage of the stock of the tenant. Some provisions may include carve-outs from the consent requirement for transfers to an affiliate of the tenant, or the sale of a *de minimis* amount of stock (often 20% or less). Due to the often convoluted nature of these assignment and change of control provisions, attorneys need to review each provision carefully within the context of the larger transaction. Counsel should consider researching the applicable state law to determine whether stock purchases or mergers have been deemed to be treated as assignments for purposes of consent requirements, which may change the attorney's review and advice to the purchaser.

If the landlord's consent is required, a notice and request for consent must be prepared and sent out by the seller and its counsel. In certain leases, the landlord's consent to a change of control is conditioned upon a number of different requirements that the seller and purchaser must work through in tandem. Examples of these requirements include that tenant is not then in default (or has never been in default); evidence that purchaser's net worth is equal to or greater than the current tenant (or equal to or greater than a certain amount); the assignment is evidenced by an instrument in writing where the assignee assumes all terms and conditions of the lease; or certain copies are delivered to the landlord within a certain period of time. In order to facilitate the approval process, the purchaser's attorney should prepare the client to meet the landlord's requests for information promptly, and potentially negotiate on the purchaser's behalf with its new landlord.

Although the assignment and change of control requirements of the lease often take precedence because of the preparation of disclosure schedules and timing of the landlord consent process, other provisions of the lease should be considered for potential pre- and post-closing issues. The current term of the lease and any options to extend the term or terminate the lease early should be noted and information about any expired or soon-to-be expired leases should be passed along to the purchaser for review and consideration. As a pre-closing matter, the seller (and current tenant) may be better equipped to begin negotiating with the landlord for a renewal or extension of the lease term (it likely would only occur if the particular parcel is uniquely valuable to the business, post-closing).

Any rights of first refusal to purchase leased property (or to purchase or lease adjacent space) should be highlighted for the purchaser for post-closing consideration. As mentioned above, the seller's use of the property and any restrictions on the use of the property should be noted so the purchaser can ensure that it plans to operate within those parameters. Use provisions are widely varied; some may allow only the existing use of the tenant and no other, some may allow any legal use, and some may prohibit certain specific uses (for example, operation as a bar or grocery store).

Further, a description of both the current rent and the current operating costs should be provided to the client for post-closing budgeting purposes. If the lease is a triple net lease, counsel may consider requesting an estimate of the annual payments for maintenance (and whether such maintenance includes such things as the roof, parking lot and foundation), repairs, taxes, insurance and other costs associated with the property. For other leases, an estimate of the annual operating expenses and the seller's percentage thereof is similarly helpful for post-closing planning. Another consideration for a purchaser is the type of notice or consent required by the landlord for any interior or exterior alterations to the leased property.

A lease may require, for example, the landlord's consent for any alteration (including exterior, interior, structural or non-structural) exceeding a certain dollar amount. This information is helpful for the purchaser to consider when formulating any post-closing plans to change equipment, décor, or office space in the leased property. The tenant's right to display certain signage is usually addressed separately in the lease, and if the purchaser is contemplating a signage change post-closing, this provision should be reviewed carefully. Counsel should also point out any requirement to remove improvements from the leased premises upon termination or expiration of the lease.

Similarly important, the subordination and non-disturbance provisions of leases should be reviewed to ensure that if the lease is automatically subordinate to any mortgage or lien on the property (which is common), that the lease is also recognized in the event of foreclosure. In addition, purchaser's counsel should recommend obtaining non-disturbance agreements from any lenders of landlords with interests having priority over the leases. If a lease does not contain a non-disturbance provision benefiting a tenant, the purchaser should be advised that a post-closing risk exists that in the event of foreclosure; the lender would not be required to recognize the lease and could terminate the lease. Counsel may also review and advise the purchaser on the landlord's obligation to provide an estoppel certificate, and relatedly, the tenant's obligation to provide an estoppel certificate. If the landlord is obligated to provide an estoppel certificate under the lease, counsel should recommend obtaining one as a pre- or post-closing diligence action or as part of the consent to the change of control.

Although much of a thoughtful diligence review can be carried out through a careful and concise review of the lease itself, other diligence tools can be used to supplement the lease review. Attorneys may recommend obtaining leasehold title commitments to show any existing liens (including leasehold liens) on the property and to confirm that ownership is vested in the named landlord. Ordinarily, this diligence item can be obtained after signing of the purchase agreement, but prior to closing. Similarly, attorneys may counsel the purchaser to obtain zoning compliance letters for each leased property, especially when the property is used for something other than office space (such as manufacturing, waste treatment, or distribution). The purchaser should also consider obtaining surveys for those leased properties where the tenant maintains the improvements, especially if the purchaser intends to expand the facility or exercise a right of first refusal or an option to purchase.

Further, the attorney may recommend that the purchaser engage someone (an employee or contractor) to complete a property inspection to ensure that no red flags exist regarding the use or structure of the leased property. Each of these ancillary diligence tools will provide the purchaser with additional measures of comfort and knowledge regarding the leased property and will enable the purchaser to confidently negotiate any pre-closing issues and address any post-closing matters.

Conclusion

Attorneys who represent potential purchasers in the acquisition of or merger with a selling entity that leases commercial real property must engage in careful and nuanced diligence of the leasehold assets of a seller. By keeping in mind a purchaser's high-level goals with respect to the leased real property of a seller, coupled with an attorney's knowledge of how diligence efforts can assist with issues in pre-closing negotiations (such as the landlord's consent to a change of control) and in post-closing review (such as obtaining estoppel certificates from landlords), counsel can add material value to the purchaser's deal team.

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