New York Law Journal
Real Estate Trends
WWW.NYLJ.COM
An ALM Publication
VOLUME 254—NO. 77
WEDNESDAY, OCTOBER 21, 2015

TRANSACTIONAL REAL ESTATE

Real Estate Provisions In M&A v. Real Estate Transactions

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A 27 percent year-over-year increase in global mergers and acquisitions activity in 2014[1] was followed by a strong first half of 2015, with 4,652 M&A deals worth $875 billion closing between Jan. 1 and May 31, 2015. As corporate M&A activity grows to pre-2007 levels,[2] the expertise of real estate attorneys is being more frequently drawn upon to provide advice regarding real estate-specific components of corporate transactions. Real estate practitioners should be aware that conventions governing merger and stock purchase agreements in M&A transactions differ in certain significant respects from those that apply to purchase and sale agreements in real estate transactions.

Representations, Warranties

Like real estate purchase and sale agreements, M&A agreements contain representations and warranties concerning the seller and the subject matter of the transaction. However, in a real estate transaction—which is typically structured as an asset sale without the issues that arise when an entity with pre-existing obligations and liabilities is being sold—the principle of caveat emptor applies with much greater force than in a typical M&A transaction.

This distinction exists in part because many aspects of a real estate asset—its physical condition, state of title and environmental status, as well as the existence of noticed violations of law and the status of real estate tax payments—are particularly susceptible to due diligence, and purchasers are expected to rely largely on such diligence rather than on representations of the seller. While real estate contracts often provide for a due diligence period during which the purchaser may take a "free look" at the property (and review title reports, surveys, Phase I environmental reports, and engineering reports) before it agrees, on the basis of its due diligence, to become bound to purchase the property, M&A agreements rarely provide for a due diligence period; instead, although the buyer will typically conduct some due diligence prior to entering into a binding purchase agreement, it will often defer some of its due diligence (and the attendant costs) to the post-signing stages, when it is assured that it has the contractual right to purchase the stock or assets that are the subject of the agreement.

Such post-signing due diligence does not perform the same function as due diligence in a real estate transaction—that is, it is not a precondition to "going hard" under a contract—but serves primarily to confirm the accuracy of warranties and representations under a contract that is already binding. If it emerges from the buyer's due diligence that the seller's warranties and representations are not accurate and the inaccuracy rises to the requisite level of materiality, the buyer can claim that a closing condition under the agreement has been breached and that it has the rights to terminate the agreement. However, the requisite level of materiality tends to be higher in an M&A transaction, and in a transaction involving a public company target, the closing condition standard is even higher.

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The greater reliance on warranties and representations than on detailed diligence in a corporate purchase agreement—at least insofar as real estate is concerned—results not only from the different conventions governing real estate and corporate contracts, but also from the fact that the real estate of the entity being sold is often a less significant component of its business. As a result, the buyer may be unwilling to devote the time and money to real estate due diligence that would typically be expended where the real estate is the focus of the transaction and more willing to rely on the seller's representations than on its own due diligence.

The buyer may be willing to rely on representations notwithstanding the potential difficulty of pursuing a successful claim against the seller and the limitation on such claims that may be contained in the purchase agreement. When the real estate assets are critical—for example, if the target company owns or operates hotels, health care facilities, retail properties or other income-producing real estate—the level of due diligence will typically be the same as in a pure real estate transaction.

Examples

Examples of representations that are sometimes included in corporate purchase or merger agreements but not in real estate contracts include representations as to state of title, the physical condition the company's properties, access of the properties to public roads and compliance of the real estate with legal requirements. In a real estate transaction, the purchaser will usually rely on title reports and surveys with regard to title and access, engineering reports with respect to physical condition, and municipal searches with regard to legal violations.

One respect in which real estate contracts and M&A agreements differ dramatically is in their treatment of title. As noted above, the purchaser in an M&A transaction typically relies on a title representation, although it may order a title report and survey for due diligence purposes. In addition, because the buyer will often enter into the purchase agreement without having reviewed title and specifically identified the title exceptions it is willing to accept, the permitted title exceptions are often generic in nature and reflect the fact that the company is an operating business to which real estate is important not because of its market value but because of the functional role it plays in an ongoing business.

The buyer will often agree to take title subject to unidentified easements, restrictions and other non-monetary liens, so long as they do not interfere with the use and operation of the real estate, and to mechanics' liens which are incurred in the ordinary course of business so long as they secure amounts that are not yet due and payable or that are being properly contested. This approach contrasts with the approach taken in real estate contracts, which requires the buyer to take title subject only to specified title exceptions identified after review of a title report.

Another area of distinction between a real estate transaction and an M&A transaction relates to the use of title insurance. Whereas a real estate purchaser will always rely on title insurance (and will not expect the seller to give a title representation), many corporate buyers will not obtain title insurance with respect to properties owned by the acquired

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company. There are several reasons for this. First, the buyer usually relies primarily on the seller's title representation (although such a representation is less desirable than title insurance as it is often subject to limited survival and to baskets (dollar thresholds below which the buyer may not recover damages) and caps on liability).

Second, where the corporate transaction is a stock sale or merger rather than an asset sale, a title policy is of limited efficacy because of the standard exclusion from the insurer's liability for matters caused by, or within the knowledge of, the insured. Since this exclusion will apply to any title exception created by or known to the company that is being purchased, it significantly reduces the usefulness of the title policy. This problem can be solved if a purchaser obtains a non-imputation endorsement stating that knowledge or action of the company (through its officers and directors) prior to the closing will not be imputed to the insured.

However, such an endorsement is not available in all states, and will not be issued without the delivery by the seller of an affidavit and indemnity that is typically broader than the corresponding indemnity from the seller to the purchaser in the merger or purchase agreement (and unlike the title representation in the agreement, is not subject to limitation on survival, baskets and caps). Accordingly, many corporate sellers are not willing to deliver such an affidavit and indemnity.

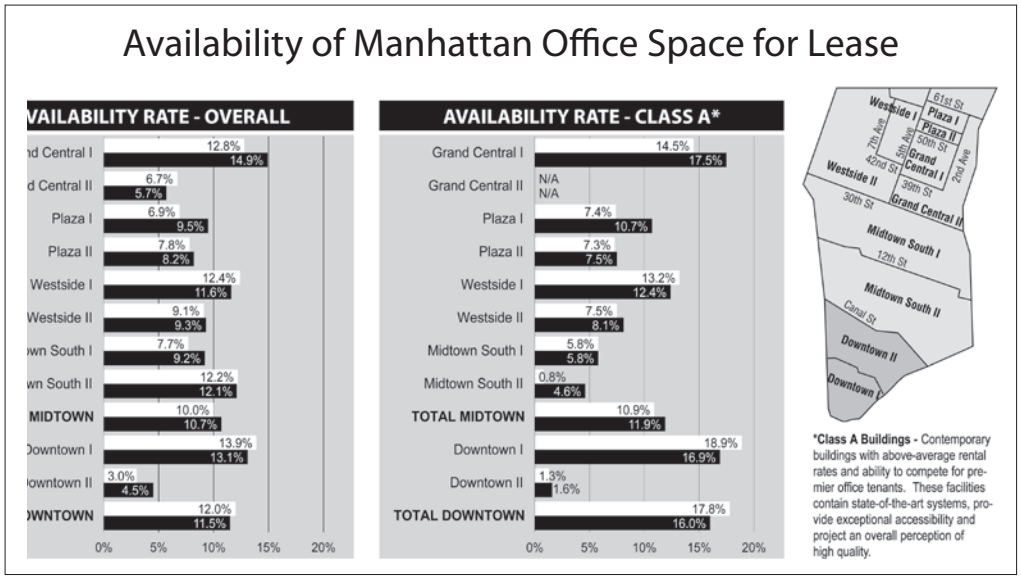
Representations attesting to the physical condition and legal compliance of the property (other than, in some cases, with respect to noticed violations) are almost never given in real estate contracts. The purchaser is expected to conduct its own diligence related to the condition of the property by making on-site visits, hiring an engineer, and ordering various third-party reports (including surveys, zoning reports and environmental reports). In contrast, a representation as to the condition of the real property is often given in M&A agreements, and a representation on the property's legal compliance is routinely given in M&A agreements.

Deposit, Liquidated Damages

A fundamental principle of real estate contracts is that the purchaser's liability for a breach is limited to a deposit (typically cash though sometimes in the form of a letter of credit) posted at contract signing and/or at the expiration of a due diligence period, and the deposit expressly constitutes liquidated damages for any purchaser breach. Purchasers in corporate transactions are rarely required to post a deposit at contract signing. Rather, in the event the purchaser breaches the agreement, the seller's remedy is generally to sue the purchaser for actual damages (with no liquidated damage limitation). Occasionally, M&A agreements include a reverse break-up fee, whereby the purchaser agrees to pay a specified termination fee for default—which serves the same purpose as liquidated damages—but there is almost never a deposit.

Indemnification

Corporate M&A agreements typically contain indemnification provisions requiring the breaching party to pay for the other party's damages sustained as a result of a breach of representations, warranties and covenants. Real estate contracts often do not include such indemnification provisions. Without an indemnification provision, the purchaser's recourse would be limited to suing the seller for the amount of the damages sustained by reason of the breach. Other costs, including attorney fees, would not be subject to reimbursement by the seller in the absence of indemnification (or a prevailing party attorney fees provision), as the default rule in most states is that each party pays its own legal expenses.



> Real estate contracts typically provide that "time is of the essence" with respect to the parties' obligations to close on the date provided in the contract. Failure to perform one's obligation on the stated date is a material breach of the contract. M&A agreements do not include such a clause, thereby allowing for some flexibility as to when the closing is held.

Adjustments

Real estate contracts typically apportion specified items of revenues and expenses between the seller and purchaser as of the closing. For example, amounts payable under service contracts, rent receivables and real estate taxes are apportioned on a per diem basis as of the closing date between seller and purchaser. Any errors in the apportionments can be corrected within a defined period of time after closing, upon notice to the other party and with supporting calculations.

M&A transactions, on the other hand, account for these items through working capital adjustments (as the items typically adjusted for in a real estate transaction constitute prepaid expenses, accounts receivable, accounts payable or deferred income and are therefore taken into account in computing net working capital on a company's balance sheet). The purchase price is adjusted upward or downward after closing based on a comparison between a balance sheet prepared as of the closing date and an initial balance sheet used as a baseline.

Closing Conditions

In both the real estate and M&A context, there is a closing condition based on the accuracy of the seller's representations and warranties as of closing, though the standards differ. In a real estate contract, the representations and warranties must be true as of the closing date "in all material respects." There is no generally accepted definition of "all material respects" (although it is often agreed that the amount of the basket defines materiality). M&A agreements typically allow a seller much more flexibility, with the applicable standard being a company-wide "material adverse effect" that is defined in the agreement. The term "material adverse effect" is often defined as any event, development or change that has a material adverse effect on the assets, business, operations or financial condition of the company or its subsidiaries, taken as a whole (with certain carve-outs for changes in law, market events, force majeure, or acts taken pursuant to the transaction document).

Closing Dates

Real estate contracts typically provide that "time is of the essence" with respect to the parties' obligations to close on the date provided in the contract. Failure to perform one's obligation on the stated date is a material breach of the contract. M&A agreements do not include such a clause, thereby allowing for some flexibility as to when the closing is held. The general rule, absent an express statement to the contrary (such as a "time is of the essence" clause), is that parties may perform their obligations within a reasonable time of the stated closing date.

1. J.P. Morgan Insights, "The M&A Market is Poised for Continued Growth in 2015: Outlook and Expected Trends," (https://www.jpmorgan.com/pages/insights/ma-market-poised-for-growth).
2. Wall Street Journal, "M&A Deal Activity on Pace for Record Year," (http://www.wsj.com/articles/m-a-deal-activity-on-pace-for-record-year-1439249011).