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# Real Estate Diligence in Corporate Acquisitions



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Previous white papers have discussed successor liability and assembling a team in the context of a corporate acquisition (“Acquisition”) in the United States. It’s important for German companies acquiring a U.S. target (“Target”) to understand how to assemble the most effective group of professionals to conduct due diligence and to understand the cultural and legal landscape in which their transactions will take place. Part of this diligence, and part of this legal landscape, involves the real estate that the Target either owns or leases. Although it typically does not constitute a large portion of the transaction value, virtually every Acquisition involves real estate in some respect, and real estate can be essential to the operation of the Target’s business. Consequently, it is important to understand the potential risks involved in acquiring a Target’s real estate.

Whether the Acquisition is structured as an asset purchase or a stock acquisition, close attention must be paid to certain characteristics of real estate that is owned, and lease provisions of real estate that is leased, by the Target.

## **I. Owned Real Estate**

Regardless of whether the Acquisition is structured as an asset purchase or a stock purchase, if a German company (“Acquiror”) will be acquiring real estate that is owned by the Target, it’s important to investigate certain aspects of the real estate that could impact the value of the asset or the liability of the Acquiror after the transaction.

Perhaps most importantly, the Acquiror must understand the status of title to the property and any encroachments, encumbrances or other matters that could result in a cloud on title or costly remediation in the future. To this end, a thorough review of an updated commitment for title insurance and an ALTA land title survey is crucial. Title insurance is a commercially issued guaranty of ownership of real estate and identifies to which inferior party interests such ownership may be subject. It’s important for the Acquiror to hire experienced commercial real estate counsel for title and survey review, as the risks posed by certain encumbrances or survey matters could be lost on less experienced attorneys. Real estate counsel will review all instruments recorded against the real estate to determine whether there are any liens or encumbrances that may be superior to the Target’s interest in the real estate or that may otherwise jeopardize or reduce the value of the Acquiror’s potential interest in the real estate. In addition, real estate counsel will review the ALTA survey to determine whether there are any encroachments or other adverse survey matters and to confirm the location of easements. Depending on how detailed the Acquiror wants the survey to be, real estate counsel can also confirm matters such as vehicle access, utilities access, and the number and type of parking spaces.

In stock acquisitions, the Acquiror should receive either a new title insurance policy or a date down endorsement to the Target’s existing title insurance policy, which extends the effective date of the

policy, plus a non-imputation endorsement. The non-imputation endorsement insures the title-holding entity against losses arising from imputation by operation of law of the knowledge of its partners, officers, directors or employees of unrecorded defects in the title of the real estate. Whether a new policy or a date down endorsement is issued, a new title search will be performed, and real estate counsel must then conduct the same title review as is described above.

In addition to title and survey review, certain other aspects of owned real estate should be investigated during due diligence. Of particular importance are environmental review and zoning review. Real estate counsel for the Acquiror

should order a Phase I Environmental Site Assessment ("Phase I"), and a Phase II environmental assessment if necessary, and should confirm that the use to which it intends to put the property is permitted in accordance with local land use law. The Phase I will assess whether historical or current property uses are likely to have adversely impacted the property and therefore pose a threat to the environment and/or human health. A zoning report or letter from the municipality can be ordered and will sometimes be required by the title insurance company, but often a simple review of local ordinances will allow Acquiror's legal counsel to determine whether the real estate complies with the zoning code.

Other important factors that should be reviewed by real estate counsel for the Acquiror include the following:

- The condition of improvements located on the real estate, which can be addressed in a property condition report
- If expansion or development is contemplated by the Acquiror, the quality and composition of the subsurface elements of the real estate, which can be addressed in a geotechnical report
- Whether the Acquiror must take steps pursuant to state or federal law to safeguard or report archaeologically or historically significant finds on the real estate
- If the Target owns real estate in the proximity of an airport, whether the real estate complies and will continue to comply with the regulations and restrictions of the Federal Aviation Administration
- Whether there exists any asbestos and/or lead paint in or on the improvements located on the real estate, and, if so, whether and in what manner the condition must be remediated

- If the Acquiror is a foreign person or entity and the Target owns agricultural real estate, whether there are any state or federal statutes regulating or restricting the purchase, such as the Illinois Agricultural Foreign Investment Disclosure Act
- Whether the elevation or topography of the real estate may interfere with plans for future expansion or development by the Acquiror, which can be addressed in a topographical survey
- Whether there are any federally regulated wetlands on the Target's real estate, and, if so, whether and to what extent future activities or development on the real estate may be restricted thereby
- If the Acquiror is a foreign person or entity, whether a BE-13 filing must be made with the U.S. Department of Commerce's Bureau of Economic Analysis, and, if so, which form must be used

## II. Leased Real Property

The Target must of course provide copies of all leases for real property that it leases from third parties, including all amendments, extensions, renewals and guaranties thereof, to the Acquiror for review.

Real estate counsel must review the leases for any unusual terms, such as termination rights, non-market rent, purchase options or rights of first refusal. Additionally, it's crucial in stock purchases to determine whether the landlord's consent to the transaction will be required. Landlord's consent is typically required if the purchase will result in a change of control of the tenant entity, which is usually deemed an assignment of the lease requiring the landlord's consent.

If the Acquisition is structured as an asset purchase, then the landlord's consent to the assignment of the lease to the Acquiror will almost always be required,

but the assignment provision of the lease should still be reviewed to confirm this.

In the case of either stock or asset deals, but particularly in asset deals and stock deals in which the landlord's consent is not required, it is important to determine whether the Target has a right to request an estoppel certificate from the landlord under the lease. Among other things, an estoppel from the landlord would certify that the Target is current on rent payments and that there are no known defaults under the lease. Alternatively, it could show that the landlord believes the Target to be behind on rent or in default, which are important to learn during the due diligence process.

Finally, if the Acquisition will result in the purchase or lease by, or concession to, a foreign person or entity (or an entity that is controlled by a foreign person or entity), of real estate in the United States, due diligence must include a



determination of whether the property constitutes “covered real estate” for purposes of the Foreign Investment Risk Review Modernization Act of 2018. 31 C.F.R. § 802.211 defines “covered real estate” by reference to the proximity of the property to certain covered ports and U.S. military installations. Certain transactions are excepted from the definition of “covered real estate transactions,” including those involving real estate that is within “an urbanized area or urban cluster,” both of which terms are defined in the regulations, and the leasing of commercial space in a multi-unit building in specific circumstances. Covered real estate transactions are subject only to voluntary CFIUS review, but if a particular transaction is not approved by CFIUS the penalties can be severe, including the prohibition of the transaction completely.

### III. Conclusion

Conducting real estate due diligence in the context of a corporate acquisition in

the U.S. is a complex undertaking for any Acquiror, but particularly those with little or no previous experience in the U.S. market. At the beginning of such diligence, two threshold questions are crucial: (1) is the transaction structured as an asset purchase or a stock purchase, and (2) is the real estate owned or leased by the Target (or a mixture of both). From there, the Acquiror can narrow the set of questions it must ask and documents it must review. Some of the more crucial of these questions are listed above, but each deal is different and due diligence review must be tailored to the unique set of facts and circumstances presented by each transaction.

Masuda, Funai, Eifert & Mitchell, Ltd. has been advising companies on complex cross-border transactions for almost 100 years. Our firm prides itself on leveraging its client’s opportunities and achieving their goals by providing strategic advice on the legal issues they face.



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