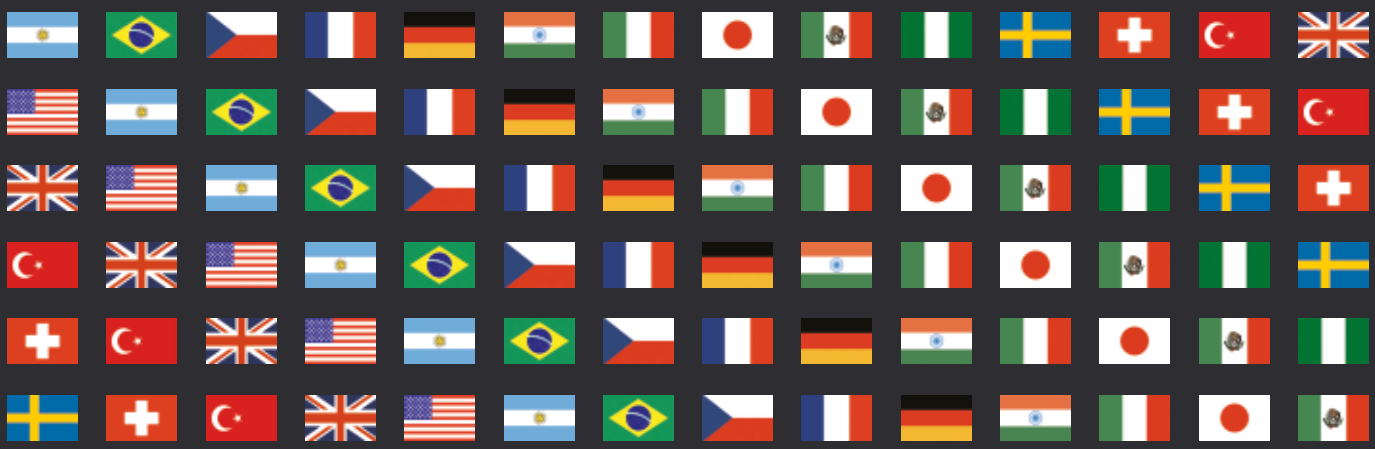
Real Estate M&A 2020

Contributing editors
Neil Whoriskey, Joseph Lanzkron and Jason R Factor



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Getting The Deal Through

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Neil Whoriskey, Joseph Lanzkron and Jason R Factor
Cleary Gottlieb Steen & Hamilton LLP

Lexology Getting The Deal Through is delighted to publish the third edition of *Real Estate M&A*, which is available in print and online at www.lexology.com/gtdt.

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting The Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes a new chapter on Nigeria.

Lexology Getting The Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.lexology.com/gtdt.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting The Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editors, Neil Whoriskey, Joseph Lanzkron and Jason R Factor of Cleary Gottlieb Steen & Hamilton LLP, for their continued assistance with this volume.

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Getting The Deal Through

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Contents

Argentina 3
Pedro Nicholson and Delfina Calabró
Beccar Varela

Brazil 11
Luanda Pinto Backheuser
DDSA Advogados

Czech Republic 20
Thu Nga Haškovcová, Petr Dušek and Karolína Hanzlíková
Haškovcová&Co

France 28
Guillaume Aubatier, Aurélia de Viry, Anne Vrignaud and Dorian Scemama
King & Spalding LLP

Germany 36
Carsten Loll, Katharina Engels, Henriette Hosemann, Barbara Rybka, Isabelle-Carmen Weis and Alexander Zitzl
Linklaters LLP

India 44
Hardeep Sachdeva, Ravi Bhasin and Abhishek Awasthi
AZB & Partners, Advocates & Solicitors

Italy 53
Marco Gubitosi, Gabriele Capecchi, Giuseppe Abbruzzese and Giulia Ponomarev
Legance – Avvocati Associati

Japan 61
Haruo Narimoto, Junji Shiraki, Takenobu Imaeda, Kensei Ikeda, Masaki Tsujioka and Hideaki Kurauchi
TMI Associates

Mexico 69
Carlo Cannizzo, Vanessa Romero and Karen Ortega
Cannizzo, Ortiz y Asociados, SC

Nigeria 76
Abutu Odu and Samuel Salako
Olajide Oyewole LLP

Sweden 84
Johan Lindberg and Måns Derk
AG Advokat KB

Switzerland 91
Wolfgang Müller, Andrea Sieber and Denise Läubli
Meyerlustenberger Lachenal AG

Turkey 98
Serhan Koçaklı, Alp Erçetin, Büşra Özden and Gökçe İldiri
Kolcuoğlu Demirkan Koçaklı Attorneys at Law

United Kingdom 108
David Manifould, Michelle Jones, Clive Garston, John Dunlop and Andrew Boulton
DAC Beachcroft LLP

United States 124
Neil Whoriskey, Joseph Lanzkron and Jason R Factor
Cleary Gottlieb Steen & Hamilton LLP

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OVERVIEW

Typical transaction structures – public companies

1 What is the typical structure of a business combination involving a publicly traded real estate-owning entity?

Generally, business combinations of real estate-related businesses occur through the merger or acquisition of a publicly traded real estate company. These public real estate merger and acquisition (M&A) deals are structured to take into account tax, regulatory and operational considerations. Typically, such transactions are structured as 'triangular mergers' in which a wholly owned subsidiary of the acquirer is merged with the target. Triangular mergers take one of two forms: 'forward' or 'reverse'. In a forward triangular merger, the acquirer's merger subsidiary, not the target, survives the merger. In the reverse triangular merger, the target survives, resulting in the target becoming a wholly owned subsidiary of the acquirer. Reverse triangular mergers frequently provide the benefit of avoiding third-party consent rights resulting from changes of control or assignment. Public M&A deals (other than where underlying assets are few in number) are rarely, if ever, structured as asset sales because of the potential for two levels of taxation of proceeds, the time and expense required to evaluate direct transfer restrictions and to prepare title transfer documents for each property individually.

The structuring of public transactions involving one or more real estate investment trusts (REITs) depends on the corporate structure of each REIT. REITs are often structured as umbrella partnership REITs (UPREITs) that hold and operate properties through a wholly owned or partially owned operating partnership in which the REIT is the general partner. In this scenario, in addition to a merger of the publicly traded entity operating as a REIT (which is typically a corporation), the operating partnership of the target may be merged with the acquirer or survive the merger as subsidiary. The structuring analysis is influenced by limitations in the governing documents of the entities, tax treatment of the transaction and the most efficient tax treatment of the post-closing company.

Typical transaction structures – private companies

2 Are there any significant differences if the transaction involves a privately held real estate-owning entity?

As described in question 1, combinations of publicly traded real estate-owning entities are more prevalent than combinations of privately held real estate-owning entities. Transactions involving private real estate businesses are more often structured as asset purchases, either of single assets or portfolios, which allow the acquirer to avoid inheriting certain entity-level liabilities of the previous property-owning entity. While private entities are sometimes purchased to accommodate specific objectives; for example, transfer tax savings, such transactions are rarely combinations of entire enterprises. Transactions involving a privately held real estate-owning entity are, in general, similar to transactions involving publicly held real estate-owning entities, except that such transactions typically include an obligation by the seller to indemnify the buyer for liability (up to a cap) resulting from breaches of the seller's representations and warranties (R&Ws).

Typical transaction process

3 Describe the process by which public and private real estate business combinations are typically initiated, negotiated and completed.

Transactions follow many different paths, including as a result of conversations between a potential acquirer and a target owing to perceived synergies, including cost savings, geographic or asset type diversification, an auction sale process initiated by the target to create value for its shareholders or an 'activist investor' commencing a campaign to change management or sell the company. Recently, activists have taken an increasing role in triggering public M&A transactions by targeting REITs perceived to be undervalued or ripe for a strategic combination. Activists have also targeted real estate-intensive operating companies (eg, Macy's and Target) in an effort to foment sales or spin-offs of real estate assets that are undervalued.

LAW AND REGULATION

Legislative and regulatory framework

4 What are some of the primary laws and regulations governing or implicated in real estate business combinations? Are there any specific regulations or laws governing transfers of real estate that would be material in a typical transaction?

Foremost among the multiple laws governing public real estate combinations are the corporate laws of the target's state of organisation and federal securities laws applicable to M&A transactions involving publicly traded companies generally. In addition, each US state and local jurisdiction has a separate regime of real property law that could potentially impact an M&A deal. For instance, local law governs the imposition of transfer taxes and mortgage recording taxes. Furthermore, there are some jurisdictions that require reassessments of real property in the event of certain changes in control. As a result, local counsel should be consulted in states where material components of a target's portfolio are located to advise on matters of local law.

Cross-border combinations and foreign investment

5 Are there any specific material regulations or structuring considerations relating to cross-border real estate business combinations or foreign investors acquiring an interest in a real estate business entity?

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) can subject foreign owners of US real estate, or of shares in domestic US real property holding corporations, to taxes on gains in value upon the sale of such real estate, including assets held in a REIT. However, FIRPTA does not apply to shares of REITs that are domestically controlled (ie, with a majority of shares held directly and indirectly by domestic owners), or to portfolio interests (10 per cent or less) in publicly traded REITs that are US real property holding corporations or (5 per cent or less) in non-REIT US real property holding corporations. Certain types of shareholders (eg, qualified foreign pensions or sovereigns) also may be exempt from taxation under FIRPTA.

Foreign investors should be aware that the Committee on Foreign Investment in the US (CFIUS) might review the acquisition of real estate that is proximate to, or is itself, critical infrastructure or otherwise poses a sensitive security risk. Examples have included assets that adjoin sensitive US military installations or US government tenants. Submitting to CFIUS review is initially voluntary on the part of parties to a transaction, but CFIUS (or an individual agency member of CFIUS) can initiate a review on its own, and CFIUS has subpoena power to compel the production of information.

Over the past few years, foreign investment in real estate has received increased attention from US authorities that focus on national security, which has included CFIUS reviews of high-profile real estate transactions, such as the 2014 acquisition of the Waldorf Astoria by the Anbang Insurance Group Co. Although the recently enacted Foreign Investment Risk Review Modernization Act of 2018 expands the scope of transactions subject to CFIUS review to include acquisition of real estate assets that do not in the aggregate constitute an operable business, it does not materially change policy with respect to combinations of publicly traded real estate businesses, which were already subject to CFIUS review prior to this Law's enactment.

Choice of law and jurisdiction

6 What territory's law typically governs the definitive agreements in the context of real estate business combinations? Which courts typically have subject-matter jurisdiction over a real estate business combination?

Each US state has a separate corporate law regime that governs entities organised in the state. Because many entities in the US are organised in the state of Delaware, and because there is generally a high degree of comfort with the application of Delaware law, Delaware law is often selected to govern corporate and M&A purchase agreements. REITs are frequently organised under Maryland law and are typically corporations. When Maryland law governs the REIT, Maryland law is often chosen to govern definitive agreements.

Parties can also agree to submit to the exclusive jurisdiction of courts in a particular state and often a particular city. Courts in the state of New York, and specifically Manhattan, are often chosen. The Delaware Chancery Court is often chosen for public-company deals involving Delaware companies, and Maryland courts may be chosen for deals involving public Maryland REITs. Note that in certain circumstances the state whose courts are selected may be different from the state whose law applies to the documents. Relevant factors in determining the combination of law or jurisdiction relate to the selection of a neutral venue, convenience of the parties and sophistication of the judiciary.

US securities laws and the rules of the US Securities and Exchange Commission (SEC) also apply to acquisitions of a publicly traded company.

APPROVAL AND WITHDRAWAL

Public disclosure

7 What information must be publicly disclosed in a public-company real estate business combination?

Under the applicable proxy rules (in a one-step merger) or tender offer rules (in a tender offer), all agreements with the target and any of its shareholders or executive officers must be publicly filed and summarised for shareholders. The bidder's sources of funds are also disclosed, and for a tender offer, any financing agreements are summarised and publicly filed. A fairly detailed description of negotiations and other transaction background (including other bidders' proposals) is also required. Any other information that would be material to a target shareholder must also be disclosed.

If the acquisition consideration offered to shareholders includes securities, the buyer must register the offered securities under the Securities Act of 1933, requiring, among other things, two or three years of SEC-compliant financial statements, with a management discussion and analysis and, usually, pro forma financial statements, and a full business description. If the buyer is already an SEC-reporting company, much of this can be done through incorporation by reference to already publicly filed materials; if not, this is a major undertaking, akin to a US initial public offering.

Duties towards shareholders

8 Give an overview of the material duties, if any, of the directors and officers of a public company towards shareholders in connection with a real estate business combination. Do controlling shareholders have any similar duties?

Directors' duties depend on the entity type and state of organisation. Most publicly traded real estate-related companies are either Delaware corporations or Maryland REITs.

In an acquisition of a Delaware corporation, entirely or significantly for cash, directors of the target corporation have a duty to use reasonable efforts to obtain the highest value reasonably obtainable ('Revlon' duties). This does not always require an auction or even a confidential solicitation of bids, but until the shareholders vote to approve (or a tender offer is consummated) the board must:

- retain the ability to respond to bona fide indications of interest;
- provide information to and negotiate with another bidder;
- change its recommendation of the initial deal to shareholders; and
- usually retain the right to terminate an acquisition agreement to accept a superior proposal (subject to paying an agreed termination fee).

A controlling shareholder does not have a duty to agree to sell, even if that prevents other shareholders from receiving an attractive offer. If the acquirer already controls a Delaware corporation, see question 16.

While Revlon does not apply to publicly traded Maryland REITs, directors have duties to act in good faith and what they reasonably believe is in the REIT's best interest and act with due care. Generally, acquisition agreements for these types of REITs are very similar to agreements for acquisitions of Delaware corporations as to these types of provisions.

Shareholders' rights

9 What rights do shareholders have in a public-company real estate business combination? Can parties structure around shareholder dissent or rejection of a real estate business combination, and what structures are available?

If the acquisition is structured as a tender offer, shareholders have the right, after receiving full and accurate disclosure, to decide whether to tender.

In most situations involving a Delaware target, if a majority of the outstanding shares are tendered and acquired, the acquirer may (and will likely by contract be required to) immediately be able to squeeze out the remaining shareholders in exchange for the same consideration. The same is true for targets in other jurisdictions, though the threshold for a squeeze-out merger is more typically 90 per cent. If a bidder acquires more than 50 per cent but less than the 90 per cent threshold in such jurisdictions, they will by contract typically be required to acquire the remaining shares by means of a second-step merger.

If the acquisition is instead structured as a one-step merger, the merger must be approved by holders of a majority of outstanding shares (or a higher threshold specified in the certificate of incorporation) in the case of a Delaware corporation or by holders of two-thirds of outstanding shares (or a higher or lower threshold specified in the declaration of trust, but not less than a majority) in the case of a Maryland REIT.

In Delaware, if shareholders of a listed company are required to accept anything other than listed shares (or American depositary receipts) of the acquirer, shareholders who do not tender their shares or do not vote in favour of the merger can exercise 'appraisal rights' and receive the court-determined fair value of their shares in cash, excluding value arising from the completion or expectation of the merger. For a publicly traded Maryland REIT, there are generally no appraisal rights available unless the REIT is organised as a corporation, shareholders are required to receive cash as consideration and the REIT's directors and executive officers beneficially own in aggregate, more than 5 per cent of the REIT's outstanding shares, and any of them have the right to roll over their shares for shares of the acquirer, which right is not made available to all shareholders.

Termination fees

10 Are termination fees typical in a real estate business combination, and what is their typical size?

A Delaware corporation can agree to pay a reasonable termination fee if its board terminates the transaction to accept (or changes its recommendation in light of) what it concludes is a superior proposal. Such a fee is also commonly payable if the shareholders reject the tender offer or merger following a third-party's competing proposal, and if the target is acquired within a specified period following the termination. While there is no precise definition of a reasonable termination fee, fees of 2.5 per cent to 3.5 per cent (or for small deals, 4 per cent) of the equity value of the deal are common and regularly upheld (often inclusive of expense reimbursement, but sometimes in addition to reimbursement up to a cap). Similar fees are generally included in acquisition agreements for Maryland REITs.

If the acquirer is relying on external financing or is subject to a difficult regulatory condition, there may be a reverse termination fee (generally as large as the termination fee or substantially larger) payable if the deal does not close because financing falls through or the regulatory condition is not met (see question 34).

Takeover defences

11 Are there any methods that targets in a real estate business combination can employ to protect against an unsolicited acquisition? Are there any limitations on these methods?

Defensive methods similar to those used in the general public M&A context are also used against hostile bids for publicly traded real estate businesses. For example, a real estate-owning company may amend its organisational documents to require an increased threshold for the required percentage of shareholders necessary to approve business combinations. A business may also have a board of directors comprised of multiple classes of directors with staggered terms, such that a hostile bidder is unable to replace the majority of directors within a single year with directors more favourable to the hostile bidder.

Additionally, publicly listed Maryland REITs typically have provisions in their organisational documents prohibiting any investor from acquiring more than 9.8 per cent (as a result of the need to maintain the REIT's preferential tax status) without prior board approval. In both Delaware and Maryland, a corporation can adopt a 'poison pill' shareholder rights plan, pursuant to which if any entity or group acquires more than a specified percentage of shares, its ownership will be subject to possibly massive dilution.

Notifying shareholders

12 How much advance notice must a public target give its shareholders in connection with approving a real estate business combination, and what factors inform this analysis? How is shareholder approval typically sought in this context?

In a one-step merger, the target must generally mail the proxy statement at least 20 business days before the shareholder meeting at which the vote takes place. In a merger, the target must file the proxy statement in 'preliminary form' with the SEC, which may be reviewed by the SEC staff, and must respond to comments (often multiple rounds) before mailing the proxy statement.

In a tender offer, the bidder must mail offer documents to the target shareholders at least 20 business days before the offer's scheduled expiration. In a tender offer, there is no prior filing with the SEC, though SEC staff may review the tender offer during the pendency of the offer and can require supplemental disclosure, which on rare occasions requires an extension of the offer period.

TAXATION AND ACQUISITION VEHICLES

Typical tax issues and structuring

13 What are some of the typical tax issues involved in real estate business combinations and to what extent do these typically drive structuring considerations? Are there certain considerations that stem from the tax status of a target?

Tax issues may be relevant for selling shareholders, acquirers or the target company. Many of the issues are the same as those relevant for M&A transactions generally. For selling shareholders, one major question is whether the transaction is a taxable transaction (eg, a cash acquisition) or is tax-free (eg, a corporate reorganisation or a contribution to a partnership). Acquirers often want a step-up in tax basis (available in a taxable asset acquisition) rather than a carryover basis. Where REITs are acquired, it may be possible to liquidate the REIT and obtain an asset basis step-up. Transactions may also trigger real property transfer taxes, mortgage recording taxes or reassessment of the real property value for purposes of property taxes. In private M&A transactions there are generally negotiations over the allocation of taxes pre- and post-closing and over contingent tax risks (eg, whether

a REIT election was properly in effect). Because of the widely different characteristics and requirements of different types of entities, differing tax considerations may apply if the target is a US corporation, REIT or partnership.

Mitigating tax risk

14 What measures are normally taken to mitigate typical tax risks in a real estate business combination?

As with any M&A transaction, before entering a definitive agreement acquirers generally engage in due diligence to obtain a better understanding of the corporate and tax structure of a target and any tax and other contingent exposures of the target. In public-company transactions, due diligence is typically conducted prior to signing the purchase agreement. After signing, very few matters rise to the level of allowing the acquirer to refuse to close based upon its findings.

Tax issues often drive M&A transaction structuring: whether the acquisition is a stock acquisition or an asset acquisition, whether consideration is stock or cash, which company survives a merger and how financing is structured. This is true in all M&A transactions, although often more stark in a real estate M&A transaction because of FIRPTA and the special tax characteristics of partnerships and REITs.

Types of acquisition vehicle

15 What form of acquisition vehicle is typically used in connection with a real estate business combination, and does the form vary depending on structuring alternatives or structure of the target company?

The acquisition vehicle form varies and can include one or more corporations, limited liability companies and limited partnerships. The selection of the acquisition vehicle, and whether additional newly formed entities that participate in the acquisition are necessary, depends on a variety of factors, including the current corporate structure of the parties, tax considerations, financing requirements and the intended structure of the company following closing. For example, if the target is an UPREIT (as discussed in question 1), the acquirer may want to keep the structure in place following closing, which may require a merger of the REIT with an acquiring corporation and the merger of the operating limited partnership with an acquiring limited partnership.

TAKE-PRIVATE TRANSACTIONS

Board considerations in take-private transactions

16 What issues typically face boards of real estate public companies considering a take-private transaction? Do these considerations vary according to the structure of the target?

A traditional take-private transaction involves a controlling shareholder acquiring the company it controls. If a controlling shareholder of a Delaware corporation tries to take the corporation private, the transaction will generally be subject to 'entire fairness' judicial review. Entire fairness includes fairness of price and process, and to help establish the fair process aspect, the target board normally establishes a special committee of independent directors (ie, non-management directors unaffiliated with the controlling shareholder) that can retain advisers, negotiate and reject any offer. The court will not apply entire fairness review if the controlling shareholder makes the transaction irrevocably subject to approval by both a special committee and holders of a majority of unaffiliated shareholders, in both cases with full disclosure.

Normally, a special committee process will also be followed in connection with any take-private of a Maryland REIT.

In any acquisition by a controlling shareholder (or other target affiliate), in addition to tender offer rules or proxy rules described in question 7, additional SEC disclosure will be required under Rule 13e–3 unless an exemption is available.

Time frame for take-private transactions

17 How long do take-private transactions typically take in the context of a public real estate business? What are the major milestones in this process? What factors could expedite or extend the process?

As discussed in question 16, going-private transactions typically involve the establishment of a special committee of independent directors, which retains advisers and subsequently negotiates. This process will often extend the time needed for negotiations.

In one-step mergers, proxy statements (including additional information required by Rule 13e–3) are prepared and filed with the SEC, subject to SEC review, and mailed to shareholders prior to the shareholders' meeting. As the SEC will review and comment on any 13e-3 filing, this post-agreement process generally takes another three to four months.

NEGOTIATION

Non-binding agreements

18 Are non-binding preliminary agreements before the execution of a definitive agreement typical in real estate business combinations, and does this depend on the ownership structure of the target? Can such non-binding agreements be judicially enforced?

Letters of intent (LOIs) (also called memoranda of understanding) are rarely utilised in acquisitions of public real estate companies as a result of disclosure obligations, but are quite common for private companies. While such agreements are typically non-binding, there are a number of provisions that parties typically include as binding obligations including confidentiality, non-circumvention, choice of law, exclusivity and expense provisions.

Courts, as a general matter, respect provisions contained in LOIs that are intended to be enforceable. So long as the terms of the LOI are clearly and unambiguously non-binding, courts will respect the agreement of the parties. If, however, a party challenges the non-binding nature of the LOI and the LOI is ambiguous, courts will review and may find aspects of the letter to be enforceable so long as they contain all relevant material terms. For these reasons, it is a good practice to clearly state in the LOI that it is non-binding except with respect to the specified provisions in order to avoid ambiguity and potentially damages. Unless expressly disclaimed, most jurisdictions in the US will imply a general obligation of all parties to a transaction to negotiate in good faith.

Although public real estate companies rarely enter into an LOI to avoid being required to publicly disclose its content, they will require the target to enter into a non-disclosure agreement and in some cases will agree to enter into an exclusivity agreement for a short period of time to give the target time to formulate a proposal.

Typical provisions

19 Describe some of the provisions contained in a purchase agreement that are specific to real estate business combinations. Describe any standard provisions that are contained in such agreements.

Real estate M&A purchase agreements are substantially similar to purchase agreements for other business combinations. However, real estate M&A agreements often include additional property-specific

R&Ws, including with respect to the status of the target's ownership rights to the real property, tax status, existing liens on real properties, existing leases and insurance affecting the real property. These R&Ws force the target to disclose diligence materials prior to signing. Qualifications to these representations are based upon the target's knowledge and the level of materiality necessary to cause a breach of the agreement are common.

Purchase agreements also include closing conditions. In general, closing conditions fall into the following four categories:

- regulatory-related matters (eg, antitrust clearance and CFIUS);
- required shareholder approval;
- required deliverables (eg, in some REIT acquisitions, delivery of tax opinions); and
- the absence of a 'material adverse change' of the target.

These closing conditions are typically significantly negotiated and, in particular with respect to the determination of a 'material adverse change', are the subject of the negotiated exceptions.

The target typically covenants to continue operating its business in the ordinary course between signing and closing, which usually prohibits incurring debt, selling or acquiring properties or undertaking major capital projects. In real estate M&A deals involving REITs, the seller may also covenant to not take actions that would compromise its REIT status.

Stakebuilding

20 Are there any limitations on a buyer's ability to gradually acquire an interest in a public company in the context of a real estate business combination? Are these limitations typically built into organisational documents or inherent in applicable state or regulatory related regimes?

As discussed in question 11, there may be limitations on a buyer's ability to acquire an interest due to limitations within the target's organisational documents or a shareholder rights plan. In any event, if the target has more than a minimal amount of any non-real property assets before acquiring more than US$80.8 million of stock (subject to a cost-of-living based adjustment annually) the acquirer must obtain prior clearance by one of the US antitrust authorities pursuant to the Hart–Scott–Rodino Act. Additionally, if 5 per cent or more of the stock is acquired, the buyer will need to make a public filing with the SEC on Schedule 13D within 10 days containing specified information. The target's board of directors may well consider the accumulation of a toehold to be a precursor to a hostile offer.

Certainty of closing

21 Describe some of the key issues that typically arise between a seller and a buyer when negotiating the purchase agreement for a real estate business combination, with an emphasis on building in certainty of closing. How are these issues typically resolved?

Public real estate M&A transactions typically include an array of deal protections and closing conditions that are heavily negotiated. 'No-shop' covenants are often included, which prevent the target from soliciting bids from other potential acquirers, but such provisions are uniformly subject to 'fiduciary out' provisions allowing the board to provide information to, and negotiate with, another bidder. Sometimes, particularly in private equity deals, the parties agree to 'go-shop' provisions that allow the target to affirmatively solicit competing bids for a limited period of time and, if that process leads to a superior deal during that period (or sometimes even later, if with a bidder who had surfaced during that period) then the size of the termination fee is significantly reduced. Under a no-shop or a go-shop, if a superior proposal surfaces, the bidder normally has 'matching rights' for several days before the target board is permitted to exercise its rights to withdraw its recommendation of the original deal and, if it has actual termination rights, before it can exercise such rights. Termination or break-up fees payable by the target (see question 10) somewhat reduce the bidder's risk of a competing bid and provide some compensation if it is outbid.

Also heavily negotiated are the target's rights if the acquirer fails to close, whether because of breach or a failure of its lenders to fund even though the acquirer did not breach (see question 29). Another heavily negotiated provision in real estate M&A purchase agreements is the exact scope of the ubiquitous closing condition that the target not have suffered a material adverse effect that is continuing as of the closing.

Environmental liability

22 Who typically bears responsibility for environmental remediation following the closing of a real estate business combination? What contractual provisions regarding environmental liability do parties usually agree?

In public-company sales, including public REITs, the acquired company continues to have the pre-closing liabilities and the selling shareholders retain no liability post-closing. The acquirer typically has the right to inspect the properties to gauge the scope of its potential liability and may require the target to perform environmental testing of the properties to assess liability. In some cases, the parties may negotiate environmental insurance coverage for known clean-up issues.

Other typical liability issues

23 What other liability issues are typically major points of negotiation in the context of a real estate business combination?

As described in question 22, in a public-company real estate acquisition the selling shareholders do not retain any liability or risk of liability post-closing. Conversely, in the context of a private M&A deal, the sellers will often retain some risk of pre-closing liabilities. The scope of the liability risk the sellers agree to keep post-closing is the subject of significant negotiation. Issues include the threshold of damages giving rise to a claim, the cap on overall damages and the way in which the seller gives the acquirer comfort that it will be able to perform its obligation (eg, establishing an escrow arrangement, a holdback by the target or by delivering a guarantee from a creditworthy entity).

Sellers' representations regarding leases

24 In the context of a real estate business combination, what are the typical representations and covenants made by a seller regarding existing and new leases?

Common lease-related R&Ws include those relating to whether there are any defaults under leases in place, any outstanding amounts owed to tenants under the leases and whether the leases contain any right for the tenant to purchase an individual property. Typically, there will be a covenant in the purchase agreement preventing the target from entering into any new lease or leases above certain thresholds between signing and closing and restrictions on terminating existing leases.

DUE DILIGENCE

Legal due diligence

25 Describe the legal due diligence required in the context of a real estate business combination and any due diligence specific to a real estate business combination. What specialists are typically involved and at what point in the transaction are the various teams typically brought in?

The scope and degree of due diligence depends on the target's portfolio of real estate assets. In a public real estate M&A deal, if the target's portfolio consists of a limited number of material properties, or includes a few material properties among many immaterial properties, the acquirer may focus only on those material properties. Otherwise, the acquirer may perform diligence on a representative sample of properties or forego property-level diligence entirely. Property-level diligence may include reviewing the status of the target's legal title to some or all of the property (eg, whether a clear chain of conveyance documents evidences ownership, whether there are liens on the property, and whether other parties have rights to the property, such as easements) and reviewing change of control provisions, anti-assignment clauses, third-party consent rights, termination rights or economic terms under material contracts. In any real estate M&A transaction, research may also be conducted on the target's owners or major shareholders to determine whether the acquirer should expect resistance to the transaction.

In addition to the above, a review of tax, employment and environmental diligence will typically be undertaken. Litigation-related diligence may also be necessary if the target is the subject of a material litigation.

Searches

26 How are title, lien, bankruptcy, litigation and tax searches typically conducted? On what levels are these searches typically run? What protection from bad title is available to buyers, and does this depend on the nature of the underlying asset?

As described in 25, the scope and degree of due diligence is a function of the target's portfolio and the acquirer's risk analysis. Bankruptcy, tax and litigation searches are typically run by third-party service providers that search multiple local and national databases to determine any issues.

With respect to title to the property, the acquirer may engage a title insurance company to perform title searches. These searches check land records and other sources to determine the current owner's state of title (eg, ownership and any encumbrances, conditions, covenants or restrictions to which such ownership is subject) and any issues of which the acquirer should be aware. If the target does not currently have title insurance policies, the acquirer may purchase the policies, which provide coverage against claims by third parties against an owner's title to real property.

Representation and warranty insurance

27 Do sellers of non-public real estate businesses typically purchase representation and warranty insurance to cover post-closing liability?

R&W insurance is available for purchase in the US to cover liability to the purchaser for breaches of a seller's R&Ws. This insurance is typically used as a replacement for the seller's obligation to indemnify the purchaser for such liability and is often used in the context of transactions involving privately held business combinations. However, such insurance has not become widely used in privately held real estate entity combinations unless a significant tax issue is involved. In that case, insurance is purchased to cover the seller's liability for the specific tax-related R&Ws.

Review of business contracts

28 What are some of the primary agreements that the legal teams customarily review in the context of a real estate business combination, and does the scope vary with the structure of the transaction?

Typically, acquirers will review some or all of the leases and other contracts entered into by the real estate-owning entity as part of its due diligence. The primary concern regarding material contracts and leases is whether the target's counterparty has a termination or consent right that will be triggered by a change of control or assignment resulting from the transaction. Depending on the transaction, each material agreement or a specified selection of agreements will receive individual analysis. An acquirer may also review individual leases and agreements for their economic terms, which may be fundamental to the underlying M&A transaction.

BREACH OF CONTRACT

Remedies for breach of contract

29 What are the typical remedies for breach of a contract in the context of a real estate business combination, and do they vary with the ownership of target or the structure of the transaction?

In real estate M&A deals involving a publicly traded REIT or other company, the acquirer does not have the benefit of post-closing breach of contract remedies, such as surviving R&Ws and indemnities. The target's remedies only protect against the risk of the acquirer breaching the purchase agreement or being unable to close.

Prior to termination of the purchase agreement, the target may have the right to specific performance to enforce the acquirer's obligations under the purchase agreement. In deals that are strategic combinations (eg, the merger of two REITs), specific performance may entail forcing the acquirer to close the transaction regardless of the availability of funding for the deal. In deals involving the acquisition of a REIT by a private fund, specific performance may be limited by the availability of the acquirer's funding source.

After termination of the purchase agreement, the target may pursue damages for the acquirer's breach or, for certain breaches or certain failures to close not involving a breach, may be entitled to a reverse break-up fee. In strategic combinations, the target's claims may not be capped, whereas in acquisitions by private funds such claims may be capped at a reverse break-up fee amount with all claims released upon payment of such fee. The parties negotiate which breaches survive termination and which do not. Damages may be defined to clarify that damages are not limited to the target's own damages (largely just expenses) but include shareholders' expectations of the deal premium.

FINANCING

Market overview

30 How does a buyer typically finance real estate business combinations?

Transactions may be financed by real estate-secured debt, corporate debt, such as syndicated bank debt or corporate bonds, or a combination of both. The financing arrangement for a transaction depends on,

among other considerations, the size of the transaction, interest rate environment, the terms of existing financing at target and whether the acquirer is required or permitted to assume the target's current debt. Procurement of financing is almost never a closing condition, but the target and acquirer typically require a commitment letter from a lender or other evidence of availability of funds before signing the purchase agreement.

Seller's obligations

31 | What are the typical obligations of the seller in the financing?

The target (or seller, in a private transaction) usually insists that the acquirer has a firm financing commitment, which is often not the financing that is ultimately incurred at closing. The target typically agrees to cooperate with the acquirer's efforts to obtain better financing and the lenders' syndication efforts. The parties may negotiate that upon provision of certain required information by the target and the satisfaction of other conditions, a marketing period commences in which the acquirer must complete financing and be able to close. The required information varies depending on whether a deep level of property information is required, and often such cooperation is limited to reasonable requests, customary requirements or commercially reasonable efforts.

Some items that may be included in financing cooperation provisions include:

- providing historical financial statements;
- assisting in the preparation of pro forma financial statements;
- assisting in obtaining title insurance and surveys;
- permitting field examinations for third-party reports and appraisals;
- providing information in connection with 'know your customer' and anti-money laundering rules;
- senior officers reasonably participating in meetings, calls, presentations and other activities;
- providing information for rating agency presentations;
- participating in the preparation of pledge and collateral documents;
- obtaining third-party consents, as required (eg, consents from joint venture partners); and
- obtaining customary pay-off letters.

Repayment guarantees

32 | What repayment guarantees do lenders typically require in the context of a property-level financing of a real estate business combination? For what purposes are reserves usually required in the context of property-level indebtedness?

If the transaction is financed with a loan secured by the real property, lenders typically require that cash flow from the properties be used to fund debt service and reserves for the operation of the property (eg, taxes, insurance, capital improvements). Cash flows are either immediately or upon the occurrence of certain events, including events of default and failure to meet negotiated financial thresholds (eg, debt yield and debt service coverage ratio), held in a lender-controlled account. These property-level loans are typically non-recourse, meaning the borrower's liability is generally limited to its interest in the collateral property, but there are some notable exceptions. Lenders typically require that a creditworthy and liquid guarantor execute an indemnity for all losses related to environmental matters and a guarantee for losses arising from certain acts by the borrower (eg, fraud, intentional misrepresentation) and the entire debt under very limited circumstances (eg, bankruptcy of the borrower or an impermissible transfer of the property).

Corporate-style loans are typically recourse to the target and its subsidiaries (through the use of guarantees) and, if secured, often require the target to provide mortgages on its properties.

Borrower covenants

33 | What covenants do lenders usually insist on in the context of a property-level financing of a real estate business combination?

In the context of property-level real estate-secured debt, the borrower (usually a special-purpose subsidiary of the target) typically undertakes covenants to operate the properties in the ordinary course, maintain existing contracts, permits and leases, and not take any action to impair the assets.

Typical equity financing provisions

34 | What equity financing provisions are common in a transaction involving a real estate business that is being taken private? Does it depend on the structure of the buyer?

The need for debt financing to facilitate going-private real estate-related transactions adds risks that must be addressed and allocated between the parties. Given their structures and investment theses, private equity funds want to ensure that they are only obligated to close if the debt financing materialises. In the US, the customary market practice is to allocate this risk by including no express financing closing condition and allowing the target to force the private equity fund to draw on its equity to close the deal only if debt financing has or will be funded. The target is given the right to terminate the purchase agreement if the acquirer fails to close the deal when required. If the target terminates, the acquirer pays a reverse break-up fee and sometimes reimburses the target's expenses (often capped). Typically, payment of a reverse break-up fee caps the acquirer's liability for its failure to close. This provides the private equity fund with comfort that it is not liable beyond the reverse break-up fee and target's expenses, while allowing the target to look to a capitalised counterparty in the event of termination.

COLLECTIVE INVESTMENT SCHEMES

REITs

35 | Are real estate investment trusts (REITs) that have tax-saving advantages available? Are there particular legal considerations that shape the formation and activities of REITs?

REITs in the US are tax-advantaged, in that they are corporations that can eliminate (or substantially eliminate) their corporate taxation so long as they pay dividends equal to their taxable income. REITs that qualify as domestically controlled REITs are not treated as US real property for the purposes of FIRPTA. Where appropriate, therefore, REITs are often desirable.

Qualifying for REIT status imposes a number of limitations, however, on the ownership and governance of the REIT, the assets it can hold, the income it can receive and the activities it performs. As a result, there can be significant compliance burdens incident to REIT status and substantial limitations on its assets and activities, so REITs should only be used where it is also appropriate from a business perspective.

Private equity funds

36 | Are there particular legal considerations that shape the formation and activities of real estate-focused private equity funds? Does this vary depending on the target assets or investors?

Private equity funds often have investors with widely varying characteristics, including foreign sovereigns, other foreign investors, US tax-exempt investors or US taxable investors. Each type of investor

has its own considerations. For example, foreign sovereigns are often sensitive to whether they will be treated as engaged in commercial activities, foreign investors are sensitive to whether they will be treated as engaged in a US trade or business, US tax-exempt investors are sensitive to whether they will receive unrelated business taxable income and US taxable investors are sensitive to the timing and character of the income and losses they are allocated. Private equity funds therefore are often structured using parallel partnerships (or 'sleeves'), using blocker corporations as appropriate, or organising REITs to hold assets. The appropriate structure is driven by the characteristics and concerns of the investors and the types of assets being invested in and their expected return profiles.

UPDATE AND TRENDS

Key developments of the past year

37 | Are there any other current developments or emerging trends that should be noted?

No updates at this time.

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Pharma & Medical Device Regulation
Pharmaceutical Antitrust
Ports & Terminals
Private Antitrust Litigation
Private Banking & Wealth Management
Private Client
Private Equity
Private M&A
Product Liability
Product Recall
Project Finance
Public M&A
Public Procurement
Public-Private Partnerships
Rail Transport
Real Estate
Real Estate M&A
Renewable Energy
Restructuring & Insolvency
Right of Publicity
Risk & Compliance Management
Securities Finance
Securities Litigation
Shareholder Activism & Engagement
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