Leases: A Ticking Time Bomb in Your Company's Merger?

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INTRODUCTION

When buying or selling a business, there will likely be real estate tenant leases that are part of the business assets. If these leases are important to the business, their assignment to the buyer may be essential to the transaction. For example, the leased premises may be an essential office or plant. Implicit in the price may have been the buyer's ability to use and exploit these key locations through the tenancy. That means the seller and buyer need to deal with the assignment provisions found in those leases. Ideally, the assignment provisions of a lease should not hold up the sale of the entire business. Also, the parties should be aware that closing the sale may trigger the loss to the buyer of important lease rights based on the terms of the lease, or result in the seller or its principal continuing to be liable under the lease even after it was assigned. This article is intended to be informative and important to anyone involved in the real estate aspects of the purchase or sale of a business with leasehold interests among the assets.

Early in the transaction it is crucial for both buyer and seller to review the assignment provisions of the seller's tenant leases, analyze whether an assignment of the lease is required and, if so, determine what could interfere with the assignment. This assessment should take into account whether the landlord's consent is required for assignment and, if consent is required, how easy or difficult securing the consent will be. Obstacles to assignment of leases may affect structuring of the transaction, particularly where the leases in question relate to key operating assets or account for substantial revenue. Some structures (e.g., stock sale vs. merger) may facilitate assignments more readily than others. Nevertheless, the choice of structure is often driven by corporate and tax concerns, and then the parties must try to make problematic assignment provisions work with whatever transaction structure is selected.

About the Author

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Strauss has lectured and published on such subjects as real estate workouts, corporate real estate disaster contingency planning, construction loans and lease issues. He was honored by Law & Politics in its listing of New York Super Lawyers® *and rated AV® Preeminent™ in his field by* Martindale-Hubbell®.

If there are serious problems involving assignability, the sale agreement should deal with the possibility that when the closing is to occur, the obstacles to an assignment have not been overcome.

The following issues are addressed in this article:

- general legal rules regarding assignability of tenant leases in sale transactions, and specific rules relating to different deal structures;
- determining how the specific assignment provisions found in the leases work with the structure of the deal;

- what the impact is on the closing of the sale if the lease is not assignable, and if the sale nevertheless closes;
- what can be negotiated in the sale agreement to cover these considerations;
- if the sale closes, what adverse consequences concerning the leases may nevertheless occur, such as loss of rights, unintended liabilities and unexpected taxes.

BASIC DEAL STRUCTURES

First, consider the common structures for selling a business:

- **Equity Sale:** Only the equity (stock or membership interest) of the business entity is being transferred, which could be all the outstanding equity of the entity or just a controlling interest. Or, possibly, new equity will be created and issued to the buyer so as to change control. Of importance is the fact that the seller is the owner of the business and the party to the lease does not change.
- **Asset Sale:** The buyer acquires the seller's business assets, and typically assumes some related liabilities (often, the buyer forms a new entity or uses an existing entity into which the business assets will be transferred). In an asset sale the seller is the business entity and it transfers its rights, duties and obligations under the leases so that the "new" tenant is a different legal entity than that of the seller. The leases of the business will be specifically assigned by the tenant to the buyer entity by a comprehensive assignment document in which the buyer would assume post-closing obligations thereunder.
- **Merger or Consolidation:** In a merger, two or more entities merge, with one of the entities being the "surviving company" and the other entities' separate legal existence ceases to exist. Whether or not an acquired company's agreements are deemed to have been assigned in a merger may depend on the structure of the merger itself—specifically, whether the acquired company is the surviving or non-surviving company. Very generally, if the acquiring company is the survivor, and thereby the transferee of the target's business agreements, an assignment of the agreements may be deemed to have occurred because the acquirer is now the legal entity party to the contract. But if the acquired company is the survivor (a reverse merger), the target's business agreements may be seen as not to have been assigned, because the target is still the legal entity party to the contract.

BASIC PRINCIPLES

Generally, courts disfavor restrictions on the ability to transfer property. So if the lease is silent on assignability, an assignment by tenant is permitted (in most jurisdictions) without landlord consent. However, while express lease provisions prohibiting assignment are generally enforceable, a covenant against one form of transfer does not necessarily prohibit another form. With that in mind, the applicable lease must be analyzed to see what assignments are permitted without landlord consent, and the law of the state governing the lease might need to be consulted to determine how the provision (or the absence of a provision) would be treated under that law.

Applying these principles to deal structures:

- A general restriction against assignment by a tenant in a lease is usually construed by judges to apply to an asset sale and not to a merger. [*"This lease may not be assigned without the prior written consent of landlord."*][1] That is because in a merger, the business entity's assets vest in the acquirer by operation of the merger statute.
- Therefore, a restriction on transfer *"by operation of law"* is usually construed to prohibit a merger. However, as noted previously, a reverse merger might not result in a transfer "by operation of law."
- A general restriction on the tenant's assigning the lease that does not specifically prohibit a transfer of the tenant's equity usually is construed not to prohibit an equity sale or changes in control of the tenant, as the identity of the tenant remains the same. [*"This lease may not be assigned without the prior written consent of landlord."*]
- A provision making transfer of equity of the tenant a prohibited assignment if read literally might not bar a change of control by way of creating new stock and issuing the new stock to a third party. Or a prohibition on transfer of the *"stock of tenant"* might not be construed as prohibiting the transfer of the stock of the parent entity of the tenant (where the tenant was a subsidiary), since technically the owner of the tenant's stock is unchanged.

PARTICULAR LEASE PROVISIONS FOR BUSINESS TRANSFERS

In order to fill in the gaps left by the legal rules, most real estate leases specifically define an assignment to include equity transfers, mergers and asset sales. Also some leases specify that "change of control" is a forbidden assignment and include a definition of change of control to the effect that: *"This lease may not be assigned without the prior written consent of landlord. A merger or other transfer of stock of Tenant shall constitute a prohibited assignment hereunder. A change in the management and control of the Tenant from that in effect when the lease was signed shall constitute a prohibited assignment."* These provisions thus trigger landlord consent for all the various business sale structures.

However, so that the assignment provision of a lease should not hold up the sale of an entire business, a sophisticated tenant may have negotiated "safe harbor" provisions in the lease to permit transfers resulting from the sale of its business without landlord consent. [*"Notwithstanding anything to the contrary contained in this Lease, Landlord's consent is not required in connection with any merger or consolidation of Tenant with another entity or the sale of all or substantially all of Tenant's assets or of 50 percent or more of the ownership interests (whether partnership, stock or otherwise) in Tenant (or those of a parent or successor to Tenant) whether directly or indirectly."*] These lease provisions should be reviewed carefully because often there are requirements to be able to utilize the "safe harbor." A common requirement is that the assignment be part of a transaction to transfer an ongoing business rather than a means of circumventing the restriction on assigning the lease, or more specifically:

- that *"the interest of Tenant in the Lease is not the sole or principal asset of Tenant," or that "the transfer be made for a good business purpose;"*
- or a net worth test may substitute for consent. This could mean that the successor tenant must have a specific dollar net worth [*"provided, however, that the net worth of Tenant immediately after the assignment shall not be less than a negotiated dollar amount;*
- or, there could be a requirement that *"the net worth immediately after the assignment be at least equal to that which the tenant had at the time the lease was entered into"* (which can be an issue if there is no way of determining what that net worth was, such as when the lease was entered into some years ago and had already been assigned once, so the original tenant is now unrelated to the seller).
- a common requirement is that *"the net worth of the Tenant immediately after the assignment be at least equal to that which the Tenant had immediately prior thereto."* However, net worth could be reduced by the buyer's financing of the purchase price (which, if that results in more leverage than the seller had, could run afoul of the requirement that net worth not be diminished).

Very often the net worth tests are combined, requiring that the higher net worth be satisfied. The net worth test immediately after the assignment seems more appropriate, because the landlord could argue that in giving up its consent right it should not have its position diminished, while the net worth test at the time of the lease is at variance with the norm in leases where there are no financial requirements which must be maintained throughout the term. The net worth of the resulting entity upon the assignment usually can be demonstrated by a pro forma net worth statement prepared by the buyer and seller in cooperation.

While typically a lease specifies that an equity transfer of control is a lease assignment, oddly enough leases often fail to also have these safe harbor provisions apply to equity sales, leaving a requirement to obtain landlord consent in the situation where the tenant entity does not even change.

CONSENT REQUIREMENT TRIGGERED BY THE SALE

What if the lease does not permit the proposed sale without first obtaining landlord consent? This will happen when: 1) the particular sale structure is defined in the lease to be an assignment; 2) there is no safe harbor applicable in the lease, and/or; 3) there is a safe harbor but the buyer entity is unable to satisfy the condition for no consent to be required. The parties should then analyze whether the buyer entity will meet the requirements for obtaining consent, if the lease delineates requirements (e.g., financial responsibility; reputation, etc.). In some jurisdictions, unless the lease requires the landlord to act reasonably in determining whether to consent, the landlord may withhold consent arbitrarily in its sole discretion. Even if the lease requires consent not to be

unreasonably withheld, the consent could nonetheless be wrongfully withheld, so the reasonableness standard cannot necessarily be assumed to achieve the goal for consummating the sale.

SALE AGREEMENT PROCESS

Therefore, based on the deal structure in the sale agreement, the parties should agree as to each lease whether consent is required at all, what conditions to a transfer with or without consent need to be satisfied, and recognize whether there are problems in satisfying any conditions. Commonly, a sale agreement provides that the seller must use commercially reasonable efforts to obtain any required third-party consents to the assignment. A seller will not want to be required to commence litigation or incur any material expense to obtain consent, and the sale agreement may so provide. As most real estate leases provide for the landlord to be paid a fee or to be reimbursed for its legal fees in connection with the consent, the sale agreement should provide which of seller or buyer is responsible for payment.

It is important to consider whether the lease has a time period by which the landlord must grant or deny consent and how that time frame fits with the anticipated closing date under the sale agreement. The buyer should require the seller to provide it with all correspondence or material communications with the counterparty in the course of seeking the consent, and of course the consent itself. Some landlords grant consent pursuant to an elaborate agreement, which could even modify provisions of the lease for the future, by onerous clauses such as: *"The Lease may not be further assigned without the consent of the Landlord which may be granted in its sole discretion."* While this consent document is negotiable, the sale agreement should provide for what "consent" will actually qualify, such as *"The consent shall be on a commercially reasonable form but shall not vary in any material respect the provisions of the Lease."* Some leases provide that consent is *deemed* granted if, after properly notifying the landlord, consent is not actually granted or denied in a certain time (or if that time expired, after a second notice). The parties should decide whether for purposes of the sale agreement, a deemed consent will constitute consent.

If a deemed consent is not in the picture, and depending on the relationship between the parties to the agreement, it may be beneficial to reach out informally early on in the negotiation of the sale transaction to ask the landlord to confirm that no consent is required for the transfer or that the safe harbor conditions have been satisfied, or when consent is required to get a sense of whether consent will be granted. However, sometimes the negotiations and existence of the deal are highly confidential and sellers may be extremely sensitive to alerting their customers or major suppliers that they are considering a deal. Also prior notice to the landlord of the transaction might be of legal concern in the case of a public company. It might be helpful in these situations to ask the landlord to first sign a confidentiality agreement.

SALE AGREEMENT CONTINGENCIES

A well-drafted sale agreement should anticipate the possibility of:

- the landlord's consent being required and the landlord withholding consent to the proposed assignment;
- or, the landlord not granting consent in the time required for the closing under the sale agreement.

In analyzing the implications of these contingencies to the deal, the parties should determine how important the leased location is to the prospective buyer—does the business transaction hinge on the lease at this location? Is it the main business headquarters or asset? Is relocating a viable option if landlord consent is not obtained? Would the purchase price have been different if this location was not available? Based on this analysis, the parties should decide whether obtaining the consent is a condition of the closing.

ASSIGNING THE LEASE WITHOUT CONSENT

If the landlord properly withholds its consent to the proposed assignment or does not grant consent in the time required under the sale agreement, and the parties have agreed that the sale shall nevertheless close with the lease nevertheless being transferred, an assignment without consent constitutes a default under the lease and the landlord may exercise its remedies under the lease of eviction and/or damages. In an equity sale, the lease default occurring by failure to obtain the required consent practically becomes the buyer's problem because the tenant may incur damages, or the lease may be terminated, but the equity seller has no liability for that under the lease. In an asset sale in which the selling entity survives the transaction, the seller would remain liable under the lease for the damages. Quite possibly neither party has breached the sale agreement if there was no misrepresentation made by seller and if each party used

reasonable commercial efforts to try to obtain the consent. However, the sale agreement should provide which of the seller or buyer assumes liability caused by the lease being assigned upon closing without consent.

CLOSING WITHOUT ASSIGNING THE LEASE

If consent is not granted, but the parties decide to close the transaction without assigning the lease, they should provide for some sort of work-around. (Note, in an equity sale or a merger, it may be necessary to assign the lease pre-closing to a seller affiliate in order to avoid its automatic transfer.) A sale agreement often contains a clause such as:

> *If, on the Closing Date, any consent of another Person that is required for the assignment to Buyer of Seller's rights under any contract constituting a Purchased Asset is not obtained, so that the Buyer would not in fact receive all rights of Seller under such contract, Seller and the Buyer shall, consistent with any other legal or fiduciary obligation under applicable law, use reasonable best efforts to cooperate in a mutually agreeable arrangement under which the Buyer would obtain the benefits and assume the obligations and bear the economic burdens associated with such Purchased Asset, claim, right or benefit, in accordance with this Agreement, including subcontracting, sublicensing or subleasing to the Buyer, engaging the Buyer to provide research or other services, or another arrangement under which Seller would, subject to the Buyer performing the obligations thereunder, enforce for the benefit (and at the expense) of the Buyer any and all their rights against a third party associated with such Purchased Asset, claim, right or benefit, and Sellers would promptly pay to the Buyer all monies received by them under any such Purchased Asset, claim, right or benefit.*

Here it is vaguely contemplated that, by some unidentified means, the parties will achieve the same result as if the lease had been assigned. But, this clause really is just an unenforceable agreement to agree, which the parties use because they have not negotiated exactly how they would resolve this problem.

Therefore, each party should more specifically focus in the sale agreement on what happens after the closing occurs without assigning the lease, which could include:

- which party should be responsible for paying for the cost and liabilities. If one party did breach the sale agreement, will the claim be preserved under the sale agreement, or will the operative provisions of that agreement prohibit the claim from surviving? If it is believed that the landlord wrongfully withheld consent, the sale agreement could allocate to seller or buyer the right or obligation to pursue the claim and the benefit resulting from the claim;
- the buyer and all employees of the business at the leased property could be required to vacate and cease to use the premises to conduct business within a specified time after the closing or within such shorter period thereafter as may be required by the landlord, but in this interim period the buyer should comply with the terms and provisions of the lease including paying the rent;
- as the seller will no longer need the space, if the landlord has not recaptured, the seller will need to relet and perhaps would be left with any loss upon such reletting but may retain any profits;
- the buyer will need to identify an alternative comparable location to the leased property; then the seller might bear the costs associated with the build-out and relocation to such alternative location, but, the buyer would pay the rent under the new lease. To be a comparable, the alternative location would be within a certain radius of the leased property and be of equivalent size and build-out to such leased property, or the parties may agree on what the relocation cost would be for an alternative location;
- as it takes some time to lease and build out an alternative location, the parties may not want to wait until closing to initiate the process, but may allow the buyer this right commencing some time prior to the anticipated closing date;
- the seller might indemnify and hold harmless the buyer against losses arising out of such inability to obtain such lease consent.

However, the allocation of responsibility can be varied. For example, if the inability to obtain a lease consent relates to any condition or requirement to be satisfied by the buyer under the sale agreement and the buyer wrongfully failed to comply, or is caused by the buyer's failure to cooperate to obtain the consent, then more of these liabilities and costs should be the buyer's responsibility. If, alternatively, such failure related to the seller's being in breach under the lease, or its failure to use commercially reasonable efforts to obtain the consent, the seller might be responsible.

LEASE DEFAULT

If the seller was in default under a lease, that default could either:

- be an obstacle to the lease assignment because the absence of a default is often a condition to a permitted assignment of the lease; and
- create costs and liabilities to the buyer after the closing when the landlord seeks to enforce its rights because of the default.

Therefore the sale agreement often contains representations by the seller, such as: *"To Seller's knowledge, each Lease is in full force and effect, and Seller is not in material default of any of its obligations under any such Lease (and no event exists which upon the passage of time or the giving of notice would constitute a material default by Seller thereunder). To the knowledge of Seller, no landlord under any Lease is in material default of any of its obligations under such Lease (and no event exists which upon the passage of time or the giving of notice would constitute a material default by such party thereunder.")* To back up this representation, a buyer may require that the landlord provide an estoppel certificate prior to closing in essentially the same language so that the certificate will reveal whether there are actually default concerns under the lease.

RECAPTURE

In some leases, if an assignment is proposed, the landlord may have the right to terminate the lease in lieu of consenting. This enables the landlord to control the leasehold without having to be reasonable about consenting to the assignment where, for example, the lease is significantly below market rent, or if the landlord has a better prospective tenant. If the landlord exercised this right, there is no lease to transfer. An exercise by the landlord of its recapture right creates similar issues to the buyer and seller as not consenting at all. Therefore, the buyer and seller should be aware of whether leases contain a recapture right and, in the sale agreement, provide for the possible exercise of that right. However, often this right is made inapplicable to a business transfer when no consent is required under the safe harbors.

LOSS OF RIGHTS

Some leases provide that certain rights are personal to the original tenant, and if the landlord's consent is required for the assignment, such rights will be lost (e.g., renewal rights, expansion rights, early termination rights and signage). The buyer should carefully examine the lease for such provisions and determine how important these rights are to the buyer. Even if the assignment of the lease was permitted without consent, or a required consent was obtained, the fact that the sale closed could nevertheless trigger the loss of a lease right in the buyer's hands. If the loss of rights would be crucial, perhaps the transaction could be structured so as not to trigger a loss (e.g., a clause making renewal *"personal to the named Tenant"* might be inapplicable in a stock sale or a merger where the original tenant was the survivor).

PROFIT SHARING

A lease may require that all or part of the consideration received by the tenant/seller for the lease interest in excess of the rent payable under the lease and certain transaction costs (i.e., "profits") must be paid to the landlord. Often this right is made inapplicable as to a business transaction for which no consent is required under the safe harbors. If profit sharing did apply, however, consider a provision in the sale agreement that no part of the purchase price is allocated to the lease. However, since some leases do have independent economic value (e.g., the rent is below market for comparable space), the landlord might challenge a provision that does not allocate any part of the purchase price to the lease. Some deal structures could arguably not run afoul of profit sharing. For example, a clause requiring the landlord to be paid a share of "*rent or other consideration paid to tenant"* might not apply to a stock sale or merger where the consideration is paid to the tenant's shareholders.

CONTINUING LIABILITY OF SELLER AND ITS PRINCIPALS

In an asset sale in which the seller receives the sale proceeds and is a continuing entity (or liquidates and distributes the proceeds to its owners), the seller and perhaps the owners receiving liquidation proceeds could have a continuing liability for the lease obligations. This is similar to situations in which the tenant's obligations under the lease are guaranteed by a parent entity of the business being sold, or by an individual principal. Therefore, in the sale agreement the buyer should indemnify the seller and any guarantor against those liabilities. Of course, if the buyer does default, then most likely it will not be able to make good on its indemnity either.

In such a case, if after the transfer the seller or guarantor is forced to cure lease defaults of the buyer and the buyer does not make good on the indemnity, the obligor will be paying the rent but no longer will have any rights to the leased property. The seller may thus want to make the closing contingent on the landlord's agreeing to release the seller or guarantor, and may want the buyer to agree to substitute an equivalent credit guarantor so as to induce the landlord to agree to the release. Or the parties may instead have a creditworthy entity of the buyer back up the indemnity in favor of the obligor.

If none of the above can be accomplished, the parties might try to obtain an agreement of the landlord that, should the buyer default, the landlord will recognize the obligor as the tenant and evict the buyer, entering into a new lease with the obligor. Moreover, when the seller or guarantor will have continuing personal liability after the sale, perhaps they will want to preclude the buyer from exercising a future renewal or expansion option, as that would increase their exposure.

PARTIAL LEASE ASSIGNMENTS

If the business being sold is a division or subsidiary of an entity that occupies a part of the leased premises along with other divisions or subsidiaries not being sold, an assignment of the lease must deal with the need for both the seller and buyer to separately use the space after the closing. Either the lease will be assigned to the buyer which will sublet a portion of the space to the seller, or in place of an assignment, the seller could sublet to the buyer the portion of the space used by the business being sold. A sublet involves similar concerns with respect to landlord consent and recapture that must be considered by the parties. Often, leases do not have a safe harbor for sublets in the same way as for business transactions that take the form of an assignment.

If it is not intended to assign the lease or sublet space to the buyer, the buyer will have to arrange for its own space in which to house the business being sold. As locating, leasing and building out space will take time and often cannot be accomplished prior to closing, the parties may need to enter into a transitional services agreement. Under such an agreement, for a temporary period the buyer is given a license to use the leased premises and the seller provides additional business services there such as telecom, IT, etc. The license probably is considered under the lease to be a sublease triggering similar concerns as to landlord consent and recapture.

CLOSING ALLOCATIONS

Since rent is typically prepaid, a purchase price adjustment should be made under the sale agreement if the closing occurs in the middle of the month. Also, a lease often has annual reconciliation rent adjustment for payment on account of operating expenses which, after the closing, can require the tenant to either make an additional payment or allow the tenant a reimbursement. The sale agreement could provide for this possibility, allocating the seller's obligation or right as to the period prior to the closing.

TRANSFER TAXES

An assignment of a lease may trigger a real property transfer tax liability even in the context of a corporate transaction. This is true for New York, where a transfer tax of almost three percent of gross consideration (in New York City) applies when there is an asset sale or merger or a transfer (50 percent or more) of equity in an entity that owns a New York City lease. The consideration subject to tax is the fair market value of the lease (i.e., the amount that would be paid for the lease over and above the rent). Customarily the seller or assignor pays the transfer tax, but if it fails to do, the buyer is liable. Therefore, in the transfer of a business that owns real estate or real estate leases, the real property transfer tax provisions of the jurisdiction in which the real property is located must be considered, and if a tax is due, provision made in the agreement for payment of the tax.

CONCLUSION

When selling or buying a business, there will likely be real estate leases that are part of the business assets. In that case, both the buyer and seller need to determine how the leases may be assigned in the context of the sale of the business or else determine what could be done if a lease cannot be assigned. If there are serious issues about assignability, the sale agreement should deal with the possibility that when the closing is to occur an assignment has not been accomplished. Even though the lease may be successfully assigned, the sale itself may trigger loss of rights to the buyer and unwanted contingent liabilities to the seller. Hopefully this article delineated the issues to consider so that both parties may smoothly structure, document and conclude the sale without letting a lease assignment problem constitute a ticking time bomb in the transaction. ■

ENDNOTES

1. Italicized material throughout are provisions of leases or sale agreements which are examples of the concept being discussed.