THE USE OF REPS & WARRANTIES INSURANCE IN REIT TRANSACTIONS

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Reps and warranties insurance (RWI) has become a popular tool in M&A transactions and is increasingly being considered in REITs and complex real estate transactions.

Environmental liability continues to be a top risk factor for REIT transactions. Single property or small portfolio real estate buyers have historically relied on third-party reports, governmental searches, title insurance and estoppels, and other due diligence to protect themselves. However, in complex transactions involving large property portfolios or the sale of interests in a REIT or other entity, it can be more difficult to make or verify factual statements.

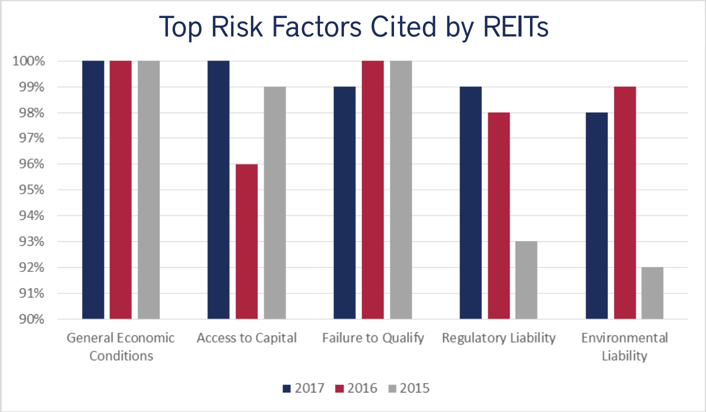
REIT transactions can include significant liability risks due to the litany of reps and warranties involved, including rent rolls, tenant concessions, environmental exposure, construction, tax and zoning restrictions, and compliance. Additionally, environmental exposure is increasingly becoming a significant risk factor in REIT transactions, specifically in the buying and refinancing of commercial, office, retail, and industrial properties. While pollution liability insurance has typically been the solution for managing M&A environmental risks, RWI has emerged to cover some transactional environmental issues. Therefore, RWI is increasingly being used in real estate transactions structured as entity-level acquisitions and/or involving large portfolios.

The size of the portfolio or pressure to close the deal often leads to an underdeveloped historical evaluation of the properties' uses and tenant operations. This can lead to extensive subsequent pollution liability, remediation expense, and environmental exposure. Further, REITs have shifted some of their acquisition strategies to include zoning use changes, converting previous commercial and light industrial properties to residential. A heightened level of due diligence is required for zoning or use changes, particularly when the plans consist of conversion to residential use. Off-site or adjacent property contamination can also affect the REIT value and/or acquisition plans if overlooked. The trend of converting light industrial or commercial properties for residential use continues, and RWI can be useful to offset unknown liabilities or inadequate disclosures, including issues that may arise when companies refinance a loan or use equity from properties that were acquired prior to the environmental due diligence required today.

For instance, depending on the type of policy, RWI could potentially cover a pollution or environmental condition that was unknown to the buyer and the seller at the time the transaction closed. Keep in mind that for coverage to be triggered, there must be a loss associated with a breach of an underlying representation and warranty. Therefore, coverage could extend to the clean-up of an unknown pre-existing condition and/or permitting/zoning issues associated with the same, so long as the deal-specific exclusions do not preclude coverage.

Typically, existing or new conditions would not be covered under a RWI policy, nor would changes in environmental laws going forward from the time the deal is closed. Further, if a REIT transaction involves high-risk industries such as chemical, petrochemical, and heavy manufacturing, the deal would not be a target for environmental coverage under a RWI policy, which would call for a customized environmental insurance policy designed specifically to cover the environmental exposure at issue, with a concurrent RWI policy to cover the remaining reps and warranties. REIT transactions are complex and require specialized insurance knowledge that your broker can provide. The major factors determining whether underwriters will cover environmental reps are potential exposure, size of the retention, and the due diligence around environmental exposures.

The chart below shows the five largest risk factors highlighted by REITs from the 2017 BDO Riskfactor Report for REITs by BDO.



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