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Sale-Leaseback Due Diligence Considerations

This is the fourth installment in our series on sale-leaseback transactions, a real estate financing mechanism growing in popularity. For a recap, check out part one on [sale-leaseback fundamentals](#), part two on [reverse built-to-suit transactions](#), and part three on [1031 exchanges](#) in the sale-leaseback context.

Sale-Leaseback Diligence

Sale-leaseback transactions offer many benefits to investors. Yet undertaking such transactions requires careful due diligence for investors prior to acquiring the property and entering into a long-term lease with the prospective tenant. This article delves into two critical aspects of sale-leaseback due diligence:

- The financial outlook of the tenant, which directly impacts the viability of the rental payments used to justify the purchase price
- The comprehensive property due diligence required to safeguard the investment for the long term

Underwriting of Tenant

Given that the tenant is responsible for making rental payments throughout the lease term—and that those rental payments are typically calculated based on the purchase price for the property—the buyer may have heightened concerns regarding the tenant's viability and financial strength. Buyers are investing substantial capital into the business and will critically assess the seller/tenant's operations and financial metrics due to this increased risk.

Additionally, it is crucial to confirm the tenant's ability to fulfill their ongoing maintenance and expense responsibilities, including insurance, declaration expenses, property upkeep, and significant roof/HVAC repairs. If the tenant is a special purpose entity (SPE), which is usually a limited liability company formed for a specific

task such as managing a project or holding assets to limit financial risk, then buyers may require a more robust upper-tier parent entity with sufficient net worth and liquidity to guaranty the tenant's lease obligations. In such a scenario, the applicable parent entity will also be subject to underwriting. Basic financial underwriting may include the following:

- **Existing operating statements:** If the tenant has historically operated at the subject site, the buyer/landlord will want to review the current and historic operating statements of the tenant to confirm it can take on the liability under the lease. The buyer/landlord may also perform an examination of tenant's existing operations at other locations as a "proof of concept" for the proposed transaction.
- **Financial projections:** Buyers/landlords may review and analyze projections of future cash flow, operating costs and other financial metrics created in accordance with the tenant's business plan, particularly if there is limited operating history at the subject site.
- **Net worth and liquidity:** The buyer/landlord may also conduct financial underwriting that includes net worth and liquidity investigations, as well as other investigations to confirm that the tenant and/or any parent company providing a guaranty are properly capitalized.

In addition to pure financial metrics, buyer/landlords will perform other investigations to verify the suitability of the tenant and its parent company. This diligence may include the following:

- **Searches:** Bankruptcy, judgment, tax lien, litigation and other searches may be required to confirm the tenant's viability. These searches may identify items such as contingent liabilities, existing financing arrangements and pending litigation, as well as evidence of past practices that may have resulted in litigation, liens or judgments. Searches may even include an analysis of media attention given to a tenant or its principles.
- **Entity diligence:** It is important to ensure that tenant entities are properly formed, in good standing, and registered to

conduct business in the state. Resolutions confirming the sale should be appropriately approved by the relevant seller parties.

Real Property Diligence

In addition to underwriting the tenant and its business, it is important to perform adequate diligence of the property itself. Even where certain property risks and obligations will be allocated to the tenant under the lease, the buyer/landlord should understand those risks, as they may fall back to the buyer/landlord if the lease is ever terminated or for certain items where strict liability against the property owner exists. The following factors should also be part of buyers/landlords' due diligence considerations:

- **Title and survey:** Buyers will want to assess any easements and encumbrances that could impact the property's use, while also checking for encroachments or other potential risks of legal disputes or code violations. These investigations may reveal issues that should be resolved prior to acquiring the property, issues that should be investigated further, as well as items that need to be specifically addressed in the lease. Buyers will typically look to acquire a [title insurance policy](#) in connection with their acquisition as well.
- **Reciprocal easement agreements (REAs) and declarations:** Buyers should be aware of any use restrictions that could potentially hinder continued or alternative use of the property after the lease terminates. They should determine whether certain uses are prohibited and whether redevelopment requires counterparty approvals. Although the tenant is typically responsible for shared maintenance costs and obligations under any REA or declaration, the buyer must understand these obligations fully. The buyer may seek estoppels from counterparties to ensure that the property complies with all obligations at the time of purchase.
- **Property configuration and long-term property value:** Since the tenant bears the risk of rent payment during the term of the lease, the buyer/landlord should evaluate the property's potential use and profit following the Lease

expiration. This analysis might include assessing how easily the property can be reconfigured for alternative uses and identifying any existing financing or encumbrances that must be resolved by or before closing.

- **Zoning code compliance:** Buyers should consider zoning requirements and determine whether existing structures are legal conforming, and if not, whether such structures can be rebuilt following a casualty event. Buyers should verify that valid certificates of occupancy for the current use exist, along with compliance with parking requirements, while also exploring other permitted uses for future options following the expiration or termination of the lease.
- **Property condition assessments:** Buyers may choose to conduct a property condition assessment. Even when the tenant is responsible for all maintenance costs, any imminent issues may need specific attention, including compliance with the Americans with Disabilities Act (ADA) and other items that may need to be addressed promptly. Additionally, the buyer may require transfer of roof and other construction warranties.
- **Environmental site assessment (ESA):** Obtaining a Phase I ESA and conducting related environmental diligence is particularly key given that (1) environmental liability is often strict liability on the owner, and (2) even in a sale-leaseback, tenants often want to negotiate environmental liability issues because they may still be held responsible for contamination or regulatory compliance during their occupancy, even if they no longer own the property. However, certain statutory protections may be available to a purchaser who performs [appropriate diligence](#).

Due diligence is crucial in sale-leaseback transactions as it provides buyers/landlords with a comprehensive understanding of the property and the tenant's financial stability. Further, it mitigates risks by ensuring the property is free of any problematic encumbrances and the tenant is capable of meeting lease obligations. This careful review helps both parties move forward with confidence, knowing they've tackled any potential issues and

made sure the property and tenant are a good fit for the deal. To learn more, please reach out to the authors or any attorney with our [Retail and Shopping Center Finance](#) team.

Visit our [Triple Net Blog](#) for future updates as we explore other issues affecting [sale-leaseback transactions](#), including commonly negotiated provisions, compliance challenges specific to transactions involving institutional capital, such as private equity and real estate investment trusts (REITs), as well as M&A and lender-related considerations.

Check out other articles in our sale-leaseback series:

- [Breaking Down Sale-Leaseback Transactions | Part 1](#)
- [Reverse Build-to-Suit: Sale Leaseback Transaction with a Twist | Part 2](#)
- [How Investors Use 1031 Exchanges and Sale-Leasebacks to Maximize Returns and Preserve Capital | Part 3](#)
- [Integrating Sale-Leaseback Transactions with Mergers and Acquisitions: A Value-Maximization Strategy | Part 5](#)

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