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The "diligence" in due diligence: How the process has evolved in commercial real estate - Part 1

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On August 23rd, I was asked by the New England Real Estate Journal for their Professional Services Edition to be published on September 14th to write this article on due diligence. The special edition was to highlight special services in commercial real estate and due diligence was thought to be an important subject.

Due diligence in real estate has been in place for well over a century and has been executed by buyers, sellers and lenders alike. Due diligence is used in a variety of contexts including post contract, pre-closing investigation of either a seller or buyer in a business transaction. I was involved with due diligence in the closing of loans and property acquisitions when at John Hancock many years ago. Due diligence was in place when completing the land assemblage for creation of the John Hancock Tower.

When I was involved with the Nation's founding REIT, Real Estate Investment Trust of America, a similar process was followed. From time to time that experience extends through to today. It was not until the 1990's that the process and importance changed which is why the Journal asked that I apply my special experience in due diligence and address herein this issue. This article will start with recent history, address the standards now found in the market and conclude with responsibilities that apply.

Recent History: Due diligence became a buzz word in commercial real estate and was brought about by the two most severe recessions in the U.S. since the 1930's depression. The banking collapse leading to the 1990-1992 recession and what is styled as "The Great Recession" of 2007-2011, with the book still open. In the 1990's, buyers of assets used due diligence to protect their purchase position. I went back to Webster's 9th Collegiate Dictionary published in 1991-1992 to look for definitions. The term I could find was "due process" with the word diligence having its own definition:

"The attention and care legally expected or required of a person (as a party to a contract)"

As suggested by the definition above, due diligence requires careful investigation to detect problems that may have been deleted by accident or deliberately hidden by the other side. Due diligence should not rely on unsubstantiated information. Due diligence should be based on a number of steps; review of original documents, public records review, inspection of the physical assets at issue, independent communication with third parties, and other sources separate from the opposing parties.

In the 1990's falling market, troubled assets were frequently impacted by incomplete files lacking in information. Terms of leases, owner obligations and general property data was often sketchy. The due diligence process could produce different information to that which was believed to exist which is why deeds often contained non-round numbers and pennies at the end of the reported price. Little capital was available for real estate and it was the buyers who were in control.

Leading into the 2007-2011 recession, it was just the opposite. Sellers were in control. During the 2004 to 2006 era, a huge supply of capital was seeking real estate. After the 2000 stock market collapse, investors wanted something they could touch and feel. Capital looked for solid deals and would enter into forward purchase and sale agreements to buy upon completion what are now called "core" assets. A core asset is a new, well leased, prime parcel of commercial real estate in a key location. Legal documents of the 1990's, 2000's time frame contain special due diligence wording to be followed. While sellers might be in control in rising markets, buyers wanted the right to walk away from a transaction if the property did not meet the standards expected upon entering into a contract. The types of due diligence they would follow included: Financial analysis; environmental studies and physical property and infrastructure reports.

The levels of due diligence typically vary by property size; the larger the property the higher the level of due diligence expected.

Standards of Practice: As the importance of due diligence has grown, methodology on how to conduct due diligence has evolved. The methodology in place today for major properties consists of defined steps represented by checklists. Each company will typically have their own checklist. In the case of CBRE Global Investors (CBREI), there is a three page "Pre- Investment Committee" due diligence program and in the event of a vote to buy, a subsequent ten page due diligence program.

Part two will appear in the September 28th edition of NEREJ.

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