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The more due diligence you conduct, the better protected you are from unanticipated problems

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As we are again starting to see increased buying opportunities in today's commercial real estate market, it is timely to review the extent of due diligence required to save a buyer from making costly mistakes in evaluating the investment potential of a property.

The type and extent of due diligence that is performed varies based upon the type of property and issues specific to that property. Increasingly complex legal and regulatory schemes governing the use of property, and the many complex issues often inherent in commercial properties, make it necessary to engage knowledgeable and experienced consultants who can vet a property fully before the buyer completes an acquisition. This is absolutely critical to the acquisition of any commercial property and essential to making an informed decision about a property's true potential to meet the buyer's investment goals.

Purchase Agreement Provisions

It is critical that the due diligence provisions of the purchase agreement be effectively negotiated to give the buyer the best opportunity to evaluate a property. Typically negotiated items in the purchase agreement are: a) the scope of inspections the buyer may conduct; b) documentation the seller must provide for the buyer's evaluation; and c) the length of the due diligence period, which can range from as little as a couple of weeks to as much as six months or more. Purchase agreements typically require the buyer to put a substantial deposit down at contract signing, and include a "free-look" period, the time that the buying entity has to conduct its due diligence and then still elect to terminate the agreement and receive its deposit back.

The due diligence provisions of the contract are often supplemented or supplanted by representations and warranties made by the seller in the contract. For instance, if the seller is willing to guarantee the environmental condition of the property through a warranty in the contract, the seller may seek to prohibit the buyer from having a termination right prior to closing for environmental conditions. On the other hand, if the contract is an "as-is" deal, which is the most typical, then the buyer will want the broadest due diligence rights possible. It is often necessary for the buyer to obtain certain reports or documents prior to the expiration of the free-look period before being able to analyze the property. Those contingencies also must be negotiated into the purchase agreement.

Purchase agreements usually (and should) have some type of mechanism for a buyer to make objections to problems found during the due diligence period and an opportunity for the seller to cure such problems. There are many ways in which problems can be cured, including through amendments to the purchase agreement; requiring title insurance endorsements or coverages; obtaining additional testing to verify conditions; obtaining lease or other contract amendments; and a wide variety of other cures based upon the issue involved. An astute buyer will always secure the

right to terminate a purchase agreement and receive its deposit back if, following the completion of its due diligence, it is not satisfied with the condition of the property or with the cures offered by a seller.

Scope of Due Diligence

The nature and scope of due diligence that is advisable will vary based upon a number of factors, including: the type and history of the property; what the property will be used for after acquisition; the location of the property and adjacent uses; specific development issues; types and identity of tenants; age of improvements; and many other factors. The buying entity and its attorney typically discuss the scope of due diligence during the contract negotiation phase and develop a due diligence checklist, following which additional consultants are engaged as needed.

Some of the more typical categories of due diligence required in commercial transactions are:

- * Financial analysis for prior years
- * On-site physical inspections
- * Review of leases
- * Permitting and zoning research
- * Review of third party contracts that will not be terminated prior to closing
- * Utilities
- * Environmental including only analyses that may be required after a Phase I environmental report prepared during the free-look period
- * Title report and analysis of encumbrances
- * ALTA/ASCM survey
- * Verification of real estate tax payments
- * Other due diligence for unique issues

Conclusion

The completion of thorough and effective due diligence using experienced consultants insures that a buyer can properly analyze the investment potential of a property with a clear picture of the flaws and risks inherent in the property. In short, due diligence is like buying insurance against surprises. The more due diligence you conduct prior to purchasing a property, the better protected you are from otherwise unanticipated problems and risks that could derail your future investment returns.

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