



Issue Spotting in Real Estate Due Diligence

By Leslie D. Reed, Associate, Pircher, Nichols & Meeks, the Real Estate Law Firm and Alexis R. Alonzo, Sr. VP and General Counsel, Bentley Forbes

This article is an introduction to (or a refresher course in) why attorneys do due diligence, who we do diligence for (in other words, the focus and perspective during the diligence process that will add value for our clients), and what we and our clients (for general counsels, that's the company) are trying to spot.

Who: The Client.

The type of client and the size and type of transaction all frame the appropriate diligence strategy. Is your client a buyer, seller, lender, tenant, or an agency or other governmental entity? If your client is a lender, is the deal a financing, a foreclosure or deed in lieu or the sale of an acquired property or the promissory note? What's the dollar value of the deal? Is your client a sophisticated commercial real estate investor or developer, or a mom-and-pop owner? Your client's role, experience, and risk tolerance will inform the nature and scope of your due diligence. Deal size and client identity can help you assess which risks your time (and their budget) are well spent on, versus those which might be most cost-effectively handled in house, or those which are simply not cost-effective to fully evaluate. Diligence may be initially handled by the client's business person or its general counsel; they may turn to you to for the close-up look at the problems they spotted from 30,000 feet or the legal issues or concepts they are unfamiliar with.

When and Where: The Subject Property.

Generally speaking, the income stream is the main pricing mechanism for the investment. Whether your client is obtaining or providing financing, or just buying to flip later, evaluating the property's income stream is key in the diligence process. Due diligence usually happens during or after the purchase agreement, loan agreement or lease is negotiated, up until a specified date after which the parties agree to go forward. Occasionally, in a bid situation or a "sign and close" transaction, it could happen before any documents are signed.

For retail and office properties, buyer and lender want to know how much space is leased up, at what rates, and for how long, but also whether and how any of the rents

can be put in jeopardy or terminated. For instance, are any leases expiring? Have any been recently renewed? Do any tenants have rights to expansion space and, if so, where and on what conditions? Are there any defaults by either tenant or landlord? What about rights to vacate or to "go dark" upon some triggering event – for instance, failure of a co-tenancy provision or occupancy threshold? What are the landlord's and tenant's tenant improvement allowance obligations and construction obligations? Are they completed? Is parking sufficient? Your task may be to analyze and answer these questions quickly and succinctly in a lease abstract.

For property such as a hotel, other items such as licenses, use permits, parking, occupancy rates and alcohol permits might affect the income stream and often require legal review to understand. Where the subject property is raw or partially-entitled land or is to be repurposed, then zoning, public and private restrictions, entitlements, permits and other land use and environmental diligence may prove critical. Zoning will dictate whether the property's intended use is permitted, and whether any discretionary approvals are needed to expand, modify or change the property's current use. Timing is also key – can development commence within the time period granted under the entitlements? If not, will your client be able to obtain necessary extensions, and at what cost? These in turn affect whether the deal ultimately "pencils out" for the client.

Sometimes, the diligence is on the income stream or transaction's structure itself, rather than the property. For instance, some income types (i.e., parking lots and certain services) may present problems for clients with certain tax-exempt structures, such as a REIT, the rules for which may preclude some types or amounts of income from being held in those entities or their subsidiaries. Local tax rules may make an entity membership sale more advantageous than a property transfer. Such information can importantly affect the deal structure for your client. There may also be peculiar local issues that a general counsel or you may not be aware of or able to address that local counsel should weigh in on. A diligent attorney must raise these issues or suggest that tax counsel and local counsel (and any other specialized counsel that your initial

diligence suggests may be needed) review the transaction for such issues.

Why: Reveal Problems and Confirm Assumptions.

Often, you are hired to help reveal the issues at the property or confirm the assumptions that underlie the parties' underwriting process. In other words, your work helps the client determine if the property is worth its asking price – or is there some hidden cost (or benefit) your client did not anticipate? You may be asked to identify or consider the risks for hazardous substance issues; zoning restrictions, necessary development permissions or land use violations that affect the desired development (including rebuilding rights for legal but non-conforming uses); the effect (and costs) of certain public or private use restrictions (i.e., REAs, CC&Rs, exclusive easements, development agreements, etc.); quality issues arising in the improvements (i.e., mold, hazardous substances, roofing warranty and ADA issues); and unusual situations with potentially expensive or time consuming solutions (i.e., a building extends into restricted airspace and the top floor has to be removed; a city inadvertently rezones private property for public use incompatible with the existing (and otherwise permissible) use, but the city's zoning code contains no process to reverse such mistake). One of the author's firms, for example, once assisted a client who found that local zoning had been specially created for the prior owner, but the zone was so specialized that it precluded the potential new owner's almost identical intended use! The City could not amend the zoning during the diligence period allotted, and would not commit in writing to make such change, and the deal did not proceed.

You may also be engaged to affirm information provided by a seller to your buyer client, or to confirm for a seller before it sells a property, that there are no major issues, to confirm the benefit and burden of any easements or other restrictions, to identify and verify existing entitlements or their vesting status. The information you find during this period can shape the asking price for the property or the structure of the transaction.

The common thread in due diligence is that you are assisting your client with a cost-

benefit analysis, and so you must be cognizant of the cost involved in your diligence review. The client isn't likely to want you to spend 40 hours of legal time on a detailed memorandum to solve a \$1,000 problem. Conversely, a \$600 zoning report probably won't cut it if a property's development potential (or potentially the incredibly expensive option of tearing down or reconfiguring an existing structure which violates current zoning) is in the millions. Communicate early and often with the client as to their needs, and as to the potential risks; educate them as to where they should invest time and energy to understand a property more fully, and where the risk exists, but is too small to be cost effective to spend legal dollars fleshing it out. Effective counsel understands when a phone call, an e-mail or a full memo is appropriate and, if they are not sure, they know to ask the client.

What: Common Types of Real Estate Due Diligence.

Here's a short list of common types of diligence an attorney may be asked to perform (or should suggest to the client) along with some of the most important items to spot. Note: this list is not exhaustive and serves only as an example of various common diligence areas in which attorneys can add value for their clients.

Title and Survey. The legal description of the property needs to be confirmed; easements should be identified and those that benefit the property should be insured. All CC&Rs and other private restrictions should be identified and any monetary obligations (i.e., outstanding taxes, loans, liens and other assessments), significant ongoing responsibilities (and the remedies for failure to observe same) and repurchase rights or reversionary rights noted to your client. Leases and any observable instances of possession for which a title company may take exception must be identified and understood. Finally, certain coverage requires an ALTA survey; any encroachments and the zoning setback, parking, height and other elements should appear and be evaluated. The certified-to parties must also be confirmed, particularly the lender.

Environmental. If hazardous materials are in use at the property (or an existing/ prospective tenant's operations will use them), an analysis of the various processes to handle these and appropriate indemnities (and backstops) in the documents are necessary. The diligence team may discover ongoing remediation of previous conditions at the property, or a Phase I report may warrant additional testing. A survey or recorded documents may show groundwater monitoring wells. The diligent attorney should raise these

with the client to ensure proper review is undertaken or, if refused, intelligently refused. A client may desire review for or assistance with the decommissioning of a plant, or to handle the inspection, removal or closure of underground storage tanks. The presence of auto repair businesses, hydraulic lifts, painting facilities, gasoline stations, dry cleaners, manufacturing facilities and the like should prompt you to confer with your client about environmental review or disclosures.

Land Use and Project Entitlements. A project that is not fully built out and completed may have outstanding entitlements, requiring confirmation of expirations, extensions, vesting of rights, and status of outstanding obligations. Similarly, a newly-completed project may have conditions which must be completed once certain development intensity is reached or within a certain time period after the certificate of occupancy is issued or final map recorded. If there is a tentative map, a final map, a development agreement or another discretionary approval, you may be asked to check for outstanding conditions of approval. Such conditions often include significant development obligations and costs (offramps, traffic signals, roads and sidewalks) or expensive fees for schools, parks or affordable housing, each of which may run with the land to successive (and unsuspecting) owners. Note that the issuance of building permits and/or certificates of occupancy or the recording of a tentative map or final map often trigger these required conditions. Lapsed or soon-to-be-lapsed entitlements must be identified or monitored, and extensions obtained or the re-entitlement process assessed. If an unusual use is proposed, such as wind farming, solar array placement, drilling, 24 hour operations, alcohol sales, or even a hospital, zoning will need to be checked to determine whether it is permitted (see below) and conditional use permits may be required.

Zoning. Zoning review is often handled by a third party zoning report, but these must be carefully reviewed for accuracy. These reports (and local zoning codes and planning department files) indicate use, height, setback requirements, parking requirements, permitted development intensity (i.e., floor area ratios and lot coverage) and the project's conformance with existing codes or with codes in effect at the time of construction (i.e., legal non-conforming uses). You may be asked to review a municipality's "grandfathering" processes for what can be rebuilt following damage or destruction of all or some threshold portion of the structure. You may be asked to evaluate ADA compliance, which is a specialty area but which could be implicated in rebuilding older structures and

can be triggered by tenant improvements.

Leases. In addition to the leasing items mentioned above, options to purchase or first rights of refusal for more space are also important items to spot and note. The determination of the subordinate or superior status of a given lease with respect to an existing or subsequent mortgage may be needed, and whether the lease automatically handles this or has forms of pre-approved SNDA or estoppels that must be used. Remember to check with your client whether any desired leases will conflict with their existing loan documents in any way or require lender approval. In California, noting the guarantees, suretyship waivers and assignment provisions is also important, as well as any modifications made to a guaranteed lease in the absence of the standard waivers.

Loans. Certain loan provisions may conflict with various other transactions. Lender or servicer approvals may be hard to obtain, take months or be costly, yet violating such provisions could be a default and may trigger recourse to your client. Identification of subordination issues for leases, REAs, even easements on a property must be considered. Often, your role is limited to coordinating due diligence review, but always ask whether the client has reviewed its loan documents (or at least any loan summary) for red flags.

Reciprocal Easement Agreements (REAs). Restrictions should be highlighted to the client where onerous, where already violated, or where they conflict with the planned use or the existing or prospective leases to be entered at the property. Note that there may be related unrecorded supplemental cost agreements, and you should confirm whether these exist. Confirm assessments, costs, and obligations. Appropriate endorsements to the title policy regarding no violations of the REA should always be obtained. Some REAs are drafted to expire without automatic extension provisions and without simple amendment processes, and this must be addressed or the consequences examined carefully. Other issues include understanding the voting rights in any association, the parking rights and restrictions, and, in the event a common parking structure provides all the parking to the property affected by such REA, how that parking is insured or provided for in the event of damage, destruction or a taking, and how parking is allocated, reserved, and charged for (if at all). **CC**

About the authors:

Leslie D. Reed is an associate of the Los Angeles office of Pircher, Nichols & Meeks, a national real estate law firm. Alexis R. Alonzo is a Senior Vice President and General Counsel for Bentley Forbes. Their email addresses are lreed@pircher.com and aalonzo@bentleyforbes.com

Copyright © 2011 California Centers Magazine, Inc. Originally appeared in the May 2011 issue of California Centers. For more information on the publication, please visit <http://www.californiacenters.com>. Reprinted with permission.