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Workshop 25

Do the Due or Don't do the Deal: Diligence in an "AS IS" World

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Do the Due or Don't do the Deal: Diligence in an "AS IS" World

INTRODUCTION.

"Due diligence" is a term that can strike fear in the hearts of both clients and real estate lawyers. From the client's perspective, the due diligence process may seem tedious, time-consuming, and expensive, especially when faced with a tight closing timeline. However, clients who can overcome their reluctance and apprehension about the process can ultimately save significant costs in the future by avoiding complications and planning in advance for material issues.

This workshop is designed to equip real estate lawyers with the strategies, tools and insight to guide their clients through an effective and efficient due diligence process and to point out specific issues that should be examined and certain problems that may arise during the review. This paper is not intended to provide a comprehensive guide to due diligence – a paper of that nature could be *thousands* of pages. But we hope that this resource will provide a starting point for clients and counsel to use when preparing their due diligence strategy and serve as a checklist as they proceed through the process.

These materials are divided into different sections and include an extensive sample due diligence checklist that can be tailored for a specific deal and client. The first section explores preparing for due diligence by examining your client's strategy based on the type of transaction, type of client, and scope and timing of review. The second section focuses on the due diligence process, from the preparation and organization of the materials and data room, to document and information requests and specific issues to look for during the review. The third section focuses on the fundamental integration of due diligence with the transactional documents. In the fourth section we review some due diligence best practices, and the fifth section focuses on due diligence gone wrong.

It is important to note, as we discuss later in this paper, that effective due diligence of a transaction will involve much more than a legal review. Real estate lawyers should guide clients to focus on these other categories, such as financial and operational review, and clients should consider these topics equally essential to a successful due diligence review.

STRATEGY AND PREPARATION FOR DUE DILIGENCE.

Before embarking on due diligence, counsel should work with their clients to develop a strategy for the review, which strategy will drive preparation for and completion of the review. Most clients will have the same general goals for due diligence: using it to achieve business objectives, value the transaction appropriately, and avoid or minimize post-closing risk. Outside of these main points, the due diligence strategy will be driven by many factors, a non-exhaustive list of which is below.

<u>Type of Transaction</u>.

Purchase and Sale – Is it a single-asset purchase? Portfolio? Raw land or developed property? What is the amount of competition for the deal?

Lease – Amount of space to be leased and percentage of overall development (anchor or single tenant)? What is the client's leverage? Established retail chain or local business?

Financing – Lender's review will be driven by the underlying property and transaction and integrity of the borrower.

<u>Client and Client's Future Plans</u>.

Seller/Landlord – Is Seller selling its real property asset(s)? Or is the transaction a stock or membership interest purchase involving the seller entity? Seller's most important role in due diligence is preparation.

Buyer/Tenant – Is buyer buying to develop or redevelop (relet) the property? Does tenant need to customize the space?

Lender – what should lender be concerned about if it has to take over the property?

Timing for Review. One important consideration that will drive strategic decisions about due diligence is the timing for completion of the review. Will the purchaser be able to start due diligence prior to submitting a bid or a letter of intent? Or will diligence be driven strictly based on the time limits set forth in the negotiated contract?

Modern technology allows for the immediate accessibility of documents and information, which increases the speed of transactions, resulting in shorter timeframes for inspection or feasibility periods and closing. The speed of the transaction drives the need for a quicker due diligence review. Virtual data rooms may be made available to parties by brokers before there is an executed a letter of intent or a meeting of the minds of the terms of the deal.

A quick, early sweep of due diligence is especially important when the deal involves a competitive bidding process. In this scenario, interested parties (after signing a confidentiality agreement) are usually provided with access to the data room (and therefore have access to the exact same information about the property) and a proposed agreement on seller's form or drafted by seller's attorney, and the bid to be submitted by the buyer will include a markup of the draft agreement. Obviously, in such a competitive process, a light markup will be encouraged and preferred. After the bids and markups are considered, the seller and winning bidder will execute a letter of intent and proceed to negotiate an agreement, but the seller will undoubtedly pressure the buyer to stick as close to the markup as possible. Therefore, the buyer and its counsel will need to quickly confirm certain items that they can "give" on in the markup based on initial due diligence, knowing that they may not have the opportunity to claw back in the final negotiated agreement.

Scope of Review. Real estate lawyers and their clients should consider the client's business objectives and position in the transaction, risk tolerance, and compliance requirements when determining the scope of the due diligence review. It is important for the client and its counsel to agree on and define the terms and limits of the diligence review at the outset. Defining the scope is another time for the real estate lawyer to stress the importance of the client's monitoring of other aspects of diligence (financial, operational, etc.).

Due diligence for certain transactions may be limited to "fatal flaw" analysis, or reviewing for an issue that could cause a major problem, affect the valuation of the transaction, or frustrate the client's intended use of the property. However, the problem with a review for "fatal flaws" is that they may not be immediately apparent without conducting a broader review, since context is typically required in order to be able to identify what may constitute a major problem or "fatal flaw".

A broader scope of diligence can be broken down into more categories:

Identifying things the client should know about the property or do upon closing (e.g., filing paperwork or providing notice of transaction, administrative items, etc.) but that carry no or minimal risk.

Identifying things that carry a greater risk to or require advance planning by the client (e.g., securing third-party consents or completing certain tenant improvements, etc.).

Identifying red flag issues that may become "fatal flaws" if there are not mitigating factors or solutions (e.g., use restrictions that prohibit client's contemplated use of the property, a tenant's right of first refusal to buy the property, etc.).

It should be expected that the scope of due diligence review will evolve and expand over the course of the transaction. For example, when preparing for a competitive bid to buy a shopping center, the client may wish only to identify fatal flaws to the proposed transaction and may not care about a memorandum or formal work product before simply incorporating these points into the initial bid. However, once the client is under contract for the shopping center acquisition, and especially after it waives its inspection period, it may prefer to have comprehensive lease abstracts completed in order to assist with administration of the project after closing.

Client's Preferred Deliverable. As discussed above, clients may have different desires for the due diligence work project and summary deliverables. Certain clients, especially those who are very familiar with the attorneys on the team and/or have worked previously with the adverse party or on a similar deal, may not wish for legal time to be spent producing a formal written work product and prefer to communicate in person, over phone and via email as the review progresses. Other clients may prefer that attorneys "show their work" and summarize every document reviewed. In most transactions, the deliverable may be more of a "happy medium" – a broader scope of diligence

review with a formal deliverable that highlights potential red flags for the client and offers mitigating factors or solutions to these issues.

Similar to the scope of the review, the client's preferred deliverable may change over the course of the transaction or repeated dealings with the same parties. Regardless of the client's desire for a type of work project, real estate lawyers should develop their own method and records for keeping track of what was reviewed and what was discovered in the diligence process so that they will be able to refer back in the event of future questions or issues.

Taking into account the various drivers discussed above, lawyers should also discuss any budgetary constraints with the client at the beginning of the engagement. One of the quickest ways to perpetuate clients' negative feelings towards due diligence is to run up a bill based on a scope that was not well-defined.

DUE DILIGENCE PROCESS.

After the client and counsel have agreed upon the strategy, scope, and timing for the due diligence review, they will proceed into the review process. After careful consideration and planning, the process should be less daunting because the parties will generally know what they are looking to identify and confirm about the deal.

Preparing Materials. Proactive preparation is a seller's most effective due diligence strategy. Using the sample checklist attached to this paper, the client should anticipate what the other parties to the transaction are going to request and what questions are going to arise. Adequate preparation may require coordination among several business units and document custodians. With guidance from the real estate lawyer, the client should work to start gathering and preparing the diligence documents in advance of marketing the property or negotiating with potential buyers.

Organizing Data Room. Once the diligence materials have been identified and collected, the producing party should work to populate the data room in the most organized and intuitive way possible. As a lawyer, one of the most daunting things about due diligence is definitely logging into a data room to find a "document dump" lacking any semblance of order. An organized data room at the beginning of the diligence process will decrease additional requests and questions as the review progresses.

Document/information requests. A party often starts its due diligence review by submitting a comprehensive list of requests and questions to seller to make sure that seller is providing all of the materials in its possession that pertain to the property. An initial review of the documents will likely result in follow up questions and document requests to the seller regarding issues uncovered as due diligence proceeds.

Checklist. The checklist attached hereto as Exhibit A has been developed through working with various clients across many transactions to encompass a broad range of commonly requested documents in due diligence. This sample checklist can be used to develop a more specific document request list tailored to the client and/or transaction. It can also be used to help seller anticipate the documents it should identify and collect when preparing for production.

Cooperation with Internal Client Teams - Importance of Non-Legal Due Diligence. In addition to conducting legal due diligence, the real estate lawyer can assist the client with coordinating and monitoring its internal teams and other consultants conducting non-legal due diligence. It is crucial that both legal and non-legal reviewers work in tandem. Some of the important non-legal due diligence review items are as follows:

Operational – utilities, day-to-day operations, practical access and traffic issues, insurance claims, employees.

Property management – tenant relations, service contracts, billing.

Business team – current and historical financial review, budgets, capital expenditures, consideration of the transaction in the overall business of the client.

Specific Questions and Action Items. Below is a non-exhaustive list of questions and action items to consider when conducting diligence related to each of these categories. These points are designed to confirm certain information

for the deal and also identify areas that the parties may wish to examine further. The client and real estate counsel should use this list in conjunction with the document checklist to

Title and survey:

Order updated title commitment. Confirm record owner of property.

Review all encumbrances listed as exceptions to title and any conditions or requirements for issuance of policy.

Order updated survey, which should be coordinated with title work.

Review survey to note as-built improvements, flood information, encumbrances on property (easements, encroachments, unrecorded rights), legal description, certification to proper parties, etc.

Does the property have adequate access?

Are there encumbrances on the property that restrict proposed use or access by the buyer or tenant?

Are there encumbrances containing conditions and obligations that will need to be assumed by the buyer or tenant? Have these obligations previously been performed?

Leases:

Review leases and all amendments thereto. Abstract the lease or summarize certain terms for client.

Are there exclusivity restrictions?

Tenant's rent obligations (base, percentage, CAM, security deposit)?

Is there rent abatement?

Are these leases nearing expiration? Do tenants intend to renew or extend the term of the lease?

Do tenants have existing renewal options, rights of first offer, or rights of first refusal?

Are there outstanding landlord improvements to be completed or tenant allowance to be paid?

Are there unusual termination rights or other unfavorable tenant provisions?

What are landlord's maintenance obligations?

Are there leasing commissions owed?

What are tenant's assignment and subletting rights?

For merger and acquisition deals, will landlord consent be required for assignment of the lease? Does "assignment" include a change of control of tenant?

Subordination and issues for lenders

Financials:

What loans are in effect affecting property or parties to transaction?

Evaluate base rent, percentage rent, and tenant improvement allowances.

Review property bills (real estate taxes, utilities, insurance, CAM).

What equipment leases are there? Assumable? Terminable?

Consider transfer tax, title premium and other closing costs.

Consider creditworthiness of parties.

Environmental:

Review or order Phase I report.

Is Phase II necessary?

Are there environmental conditions?

Has remediation been performed in the past?

Physical condition:

Visit the property and walk the site.

Are there access issues? Traffic flow issues?

Is there material deterioration or obvious maintenance issues?

Site Visit. It may not always be possible for the real estate attorney(s) to visit a site in person, but it is best if someone from the client and/or consultant teams can physically visit the property at some point during the diligence process. There is only so much information that can be gleaned from poring over documents and looking at pictures and surveys of a property! The reality is that certain characteristics of or potential issues with the property, especially when it comes to the practical operation of the property, will only be apparent when physically present at the site. Walking the property will help the client understand if the site truly "works" for their proposed use and business goals.

INTEGRATION INTO TRANSACTION DOCUMENTS.

Regardless of when it is conducted, effective due diligence can be used as a tool and is fundamental to the negotiation of the overall deal. A thorough investigation of the property and any potential issues and associated risks will inform the prospective purchaser, tenant, or lender in negotiating the transaction documents. The due diligence process has several implications on such transaction documents, including:

Business terms, such as the duration of the diligence period, purchase price or credits (to address specific issues with the property).

Representations and warranties of seller, as buyer will use diligence to confirm the accuracy and completeness of seller's statements. Typically, sellers will be reluctant to represent things that can be independently investigated by buyer.

Survival periods and indemnities related to such representations and warranties, including caps and baskets.

Closing conditions, such as estoppels. Once buyer has identified key leases or encumbrances on the property, it will likely request that seller obtain estoppels from the tenants or third parties to confirm certain information as conditions to closing.

EXHIBIT A

DUE DILIGENCE CHECKLIST

GENERAL PROPERTY INFORMATION

- A current title report for the Property issued by a national title insurance company, together with complete legible copies of all documents referenced therein
- Owner's existing title policy
- As-built survey with wetlands designated and elevations noted
- Recorded plat of Property
- Deed to owner of Property
- Legal description of the Property
- Existing mortgage documents and other liens on the Property
- Development agreements and impact fees
- Conditions, covenants and restrictions
- Inventory of personal property (including cost and acquisition date)
- UCC lien search
- Recent third-party appraisal
- News reports or articles regarding Property
- Site plan

LEASE DOCUMENTS

- Full and complete copies of all leases and amendments thereto
- Ground lease documents, if applicable
- Standard lease form
- Lease commitments or offer letters
- Lease abstracts
- Past estoppel certificates
- Non-disturbance agreements given by property owners, lessors, mortgagees or other parties

FINANCIAL DATA

- Guarantees
- Current rent roll

- Current delinquency/accounts receivable report
- Detailed tenant profile, including tenant's financials and credit information
- Tenant sales reports for the last (3) years
- Capital expenditures budget
- A detailed listing of all capital expenditures incurred on the Property in the past five years, with dollar amounts
- Property operating statements for the previous three (3) to five (5) years detailing revenue and expenses
- Most recent annual budget
- Prior year's general ledger
- List of capital leases (with payoff balances)
- Information regarding association dues
- Utility bills for the Property
    - Water and sewer
    - Gas
    - Electric
    - Telephone
- Real estate tax bills for the Property for the previous three (3) years
- Complete filings on any pending certiorari proceedings, and any available information regarding future tax increases or special assessments
- List of all tenant improvement allowances
- Copies of lease commission agreements and any other brokerage commission agreements
- Current insurance certificates maintained by owner/landlord and tenant
- Insurance (liability and property) bills for the Property for the previous three (3) years
- Statement of monthly amounts paid by tenants for CAM, taxes, and insurance
- Reconciliations of CAM, taxes, and insurance
- Information relating to any CAM, taxes, and insurance audits
- List and copies of service contracts, equipment leases, warranties and other agreements relating to the operation of the Property or occupancy of real or personal property, including start date, end date, and notice/assignability/cancellation provisions.
    - Property management

- Advertising
- Antenna or satellite
- Cleaning/janitorial
- Extermination
- Landscaping
- Snow Removal
- Security/fire alarm
- Security service
- Elevator
- Uniform Rental
- Towing
- Any other contract not cancelable in sixty (60) days

PROPERTY OPERATIONS

- Certificate of occupancy (building shell)
- Certificate of occupancy (tenant improvements)
- List of property employees with date of hire, salaries, benefits, and bonuses
- Any leasing and management reports
- Building hours of operation
- Litigation reports (pending and threatened)
- Parking requirements (number, handicap spaces)
- Assignable warranties
- Schedule of historical insurance claims for the previous three (3) years

PHYSICAL ASSESSMENT

- Narrative description of improvements
- Original cost of construction, if available
- Site and building plans
- Floor plans (CAD if available)
- As-built drawings and engineering calculations including recent mechanical/electrical changes (CAD if available)

- Engineering reports
- Environmental reports (Phase I, Phase II, remediation?)
- Soils and geotechnical reports, if available
- Square footage measurements, calculations
- A schedule of all licenses, permits, certificates of occupancy for the Property currently in effect, together with copies thereof and of all amendments
- Architect's certificate of completion
- ADA Compliance Survey
- Information regarding governmental approvals
- Violations search
- Compliance letters (ADA, fire, zoning, health, building codes, etc.)
- ADA complaints
- Notices of violations
- Pest Control/Termite Report
- List of utilities vendors and evidence of utility availability
- Verification of Flood Zone and Existing Flood Insurance
- Description of the existing zoning on the Property
- Roof Warranties
- Flood Certificates
- Construction contract, architect's contract and other construction contracts (applicable to new construction only)

OTHER INFORMATION

- Current aerial photograph indicating subject site
- Photographs of Property, including exterior, interior, surrounding area
- Marketing information