

Legal Briefs

Buyer Beware

Today's distressed market puts a premium on due diligence.

By Sidney S. Fohrman and Kristina Daniel Lawson

Despite the current economy, the long-term outlook for commercial real estate investments remains strong. In this market, foreclosing lenders, equity investors, and other bargain hunters have numerous attractive opportunities to acquire defaulting and distressed commercial real estate assets.

That said, the age-old adage "buyer beware" has never had more relevance. While due diligence is always important, thorough and comprehensive due diligence is absolutely mandatory in down markets where opportunities are presented as bargains, and sellers are in a rush to close deals.

In addition to traditional legal due diligence such as evaluating existing disputes and advising on debt structure and other legal matters, prospective buyers should supplement due diligence efforts to ensure that their properties are legally suitable for their intended use.

Understanding Zoning and Use Issues

Upon identifying a property, prospective buyers should immediately determine whether a property's intended use is lawful under all applicable land-use laws, including zoning ordinances. While the scope and nature of land-use regulation varies nationwide, most local jurisdictions have established zoning districts that provide detailed rules and regulations related to property use and development.

Zoning ordinances generally prescribe permissible uses of property, including uses for which a special permit is required. In addition to verifying the property's current permitted uses, prospective buyers also should review local agency records to determine whether the agency has future plans to change the property's permitted uses. Because zoning ordinances may be amended by a local government without property owner input or consent, prospective buyers should evaluate the agency's future plans and policies.

Detailed review of the applicable zoning ordinance also provides insight into the relative difficulty of obtaining entitlements or permit modifications from a particular agency, which is critical information for any buyer. Additionally, many local agencies now review and require approval of architectural and design plans as well as proposed tenant mixes. Overall, it is essential to carefully review the applicable zoning ordinance to determine whether such requirements apply.

Subdivision Issues

Prospective buyers also must be aware of local subdivision requirements and previously imposed conditions of approval. Most local governments impose conditions in connection with granted subdivision approvals. For example, jurisdictions often condition a subdivision approval on the provision of certain public improvements.

It is particularly important to evaluate whether prior agreements with the local government granted the original sub-divider a right to defer the installation or construction of public improvements or deferred the payment of fees. Overlooking these deferral arrangements could cost a buyer millions of dollars in future public improvements or deferred fees.

Depending upon a buyer's goals, further property subdivision may be necessary. If it is desired, buyers must evaluate local subdivision requirements to determine whether subdivision is possible. In many cases, the original subdivision approval precludes further subdivision of the property, thus limiting future opportunities at a particular site.

Buyers also should examine whether the subject property is located in a special financing zone or redevelopment area. Although jurisdictions normally establish these areas solely to provide financing for revitalization and redevelopment projects, most implementing plans include land-use restrictions. This is often the case when public funds have partially financed a development project.

Finally, because most development projects require the approval of multiple local, regional, state, and federal agencies, due diligence at each of these levels is critical. Each agency has the authority to impose use conditions and restrictions, and therefore, buyers must obtain and carefully review all approvals. Otherwise, a buyer could end up purchasing a property for a particular use, such as a retail development, only to discover that the intended use is not permitted.

Contractual Obligations

When acquiring improved property, buyers should review all construction contracts relating to the initial construction. In particular, buyers should determine the assignability of warranties, guarantees, indemnities, and rights, if any, under

additional insured endorsements. To be prudent, a buyer should obtain assignments of such rights and determine whether the original contract required completed operations insurance coverage.

Because most purchase agreements release the seller from any obligations, buyers should ensure they have recourse against third-party contractors. For raw land acquisitions, buyers should review any grading contracts and related insurance coverage.

To ensure the subject property is suitable for the intended use, buyers also should review private restrictions, such as reciprocal easement agreements and covenants, conditions, and restrictions, which often include use restrictions similar to local government approvals that can preclude a desired property use. Prospective buyers should evaluate whether full access is available to all parcels and pads. Additionally, private restrictions often include provisions allocating maintenance costs, which if unchecked, could result in substantial future expense to the buyer.

Tenant Status

Tenant defaults are one of the primary issues landlords face in the current market. In addition to the obvious economic factors, retail investments are particularly risky because the entitlements associated with a specific development may be conditioned upon the continued operation of key anchor tenants.

Aside from revenue loss, necessary permits and approvals may be in jeopardy if a tenant defaults. Accordingly, in addition to obtaining and reviewing a summary of the leases associated with a particular property, those seeking to acquire distressed assets also should evaluate the financial status of individual tenants.

Environmental Issues

Prospective buyers also must conduct comprehensive environmental due diligence to determine the potential presence of hazardous materials. Such research generally requires the use of outside consultants experienced in environmental analysis and engineering. In addition, prospective buyers also should review applicable environmental regulations — particularly new regulations related to storm-water management — as these regulations may limit future proposed uses or may result in substantial costs and potential liabilities for property owners.

Due to the numerous issues evaluated during the due diligence period, a purchase agreement must clearly specify the permitted time period during which a buyer may evaluate the property and also should provide a buyer's right to terminate the agreement if the property is unsatisfactory for any reason.

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