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Back to Basics Due Diligence: Ensuring Use and Minimizing Risk

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The economic downturn of the past year has inflicted a whirlwind of chaos and uncertainty upon California's commercial real estate industry. The market is volatile; financing is difficult to obtain; loan defaults and foreclosures continue to rise; and sophisticated investors conscientiously wait for the perfect moment to re-enter the market. While the present stagnation presents many challenges, it also provides a unique opportunity to plan for the market's inevitable rebound.

Industry observers speculate that the credit crunch and broader economic problems that have wreaked havoc on the commercial real estate industry will generate an industry-wide movement "back to basics." For lending institutions this means a return to traditional real estate underwriting principles. For prospective purchasers - from passive investors to developers - a key component of a transparent, back to basics approach means comprehensive acquisition-related due diligence.

Traditional pre-acquisition legal due diligence generally involves matters such as evaluating existing disputes, and analyzing the existing debt structure. In addition to this traditional due diligence, lenders, investors, and prospective buyers must also make certain a particular asset is suitable for its intended purposes. Because the value of a particular asset depends on many factors, including whether its use can continue or be modified, whether the owner will be faced with substantial costs and liabilities, and on the status of tenants, all relevant issues must be evaluated before any property is acquired. While these principles apply to any person or entity seeking to acquire property, this article focuses on the prospective buyer.

Entitlement and Zoning

Upon identifying a property, a prospective buyer must immediately determine whether the property lawfully may be used for its intended purposes. While the scope and nature of land use regulation varies by jurisdiction throughout California, all local jurisdictions have established zoning districts that provide detailed rules and regulations regarding the development and use of property within the district. In addition to verifying the permitted uses of the property, a prospective buyer should also review local agency records to determine whether the local agency has planned changes to the designation of the property.

Detailed review of the applicable zoning ordinance can also provide insight into how difficult a particular jurisdiction will be to work with if future entitlements are required. The trend throughout California has been to increase the level of local agency review - many local agencies now review architectural and design plans, and proposed tenant mixes. Agency cooperation is essential to the continued success of any development, and therefore must be carefully considered prior to any acquisition.

Prospective buyers also must be aware of local subdivision requirements and the need to comply with imposed conditions of approval. It is particularly important to evaluate whether the previous subdivider entered into any agreements whereby the subdivider was permitted to defer the installation or construction of public improvements, or was permitted to defer the payment of fees. If a purchaser misses these deferral arrangements during the due diligence process, it could potentially be on the hook for millions of dollars in future public improvements or deferred fees.

If further subdivision of the property is desired, local subdivision requirements - and previously imposed conditions of approval - must be evaluated to determine whether a further subdivision is possible.

Prospective buyers also should evaluate whether the property is located in a redevelopment area. Although these

areas are generally established in order to provide financing for revitalization and redevelopment-type projects, many of the implementing plans include use restrictions.

Comprehensive due diligence cannot stop with the local government agency. Many development projects today require the approval of multiple local, regional, state and federal agencies. Because each agency generally has the authority to impose conditions and restrictions on the use of a property through its individual approval process, these permits/approvals must be obtained and reviewed to ensure the intended use of the property is permitted.

Environmental

Prior to acquiring commercial real estate, it is imperative that a prospective buyer conduct comprehensive environmental due diligence. In California, complex and extensive environmental regulations apply to the use of real property, and environmental due diligence generally requires specialized environmental consultants. In addition to potential effects on the existing use of a particular asset, applicable environmental regulations may limit future proposed uses or may result in substantial costs to and potential liabilities for the property owner.

Contractual Obligations/Private Restrictions

For acquisitions of improved properties, prospective buyers must carefully review all construction contracts affecting the initial construction of the property. Specifically, prospective buyers should review these contracts to determine the assignability of warranties, guarantees, indemnities and rights, if any, under additional insured endorsements. Purchasers should obtain assignments of such rights, and should determine whether the original contract required completed operations insurance coverage. Because most purchase agreements will release the seller from any obligations, purchasers should contract for recourse against third-party contractors if a problem arises. For acquisitions of raw land, sound due diligence includes the review of any grading contracts and related insurance coverage.

To further ensure the acquired property is suitable for its intended purposes, prospective buyers must also review private restrictions, such as reciprocal easement agreements, or REAs, and covenants, conditions and restrictions, or CC&Rs. REAs and CC&Rs often include use restrictions - similar to local government approvals - that may preclude a desired modification in the use of a particular property. Prudent due diligence demands a full evaluation access rights to all parcels and pads. Additionally, these private restrictions often include provisions allocating maintenance costs, which if unchecked could result in substantial future expense to the purchaser.

Status of Tenants

Throughout California, the economic slump has resulted in tenant defaults. Some local jurisdictions condition the entitlements associated with a particular development on the continued operation of key anchor tenants. Banks customarily condition financing on the established health of tenants, and tie loan defaults to tenant defaults. Thus, in addition to the loss of revenue, tenant defaults may jeopardize the permits, approvals and financing necessary to continue operations. Accordingly, in addition to obtaining and reviewing a summary of the leases associated with a particular property, those seeking to acquire distressed assets must also consider and evaluate the financial status of each individual tenant.

This economic downturn has reminded real estate professionals of the value of long-term planning, conservative deal making and prudent risk management. The market will return - although perhaps with a different culture and mindset. It is likely that a "back to basics" approach will drive the deal-making process in the future. A key component of this approach is a comprehensive understanding of the target property.

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