



A Checklist for Real Estate Due Diligence

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Conducting due diligence is standard protocol when considering whether to acquire or merge with another business. However, it is similarly important to perform such research on prospective business real estate purchases prior to closing. Many due diligence considerations are contingencies to the buyer's obligation to close on the purchase, and failure of a contingency gives the buyer a right to walk away from the deal and get their money back. The following considerations can help buyers get started:

1. Seller Authorization

Immediately identify who the seller is, especially if it is a corporation, limited liability company or other form of business entity with multiple owners. Make sure the seller actually exists and is authorized to sell the property by requesting and reviewing a resolution from the entity authorizing the sale. This will minimize the likelihood of any post-closing entanglements with rogue owners who might dispute the sale. Typically, the company issuing the title insurance policy will provide a satisfactory form of resolution.

2. Title Report

Obtain an updated title report from a reputable title company. This should list all relevant interests touching the property, along with links to the supporting documents for review. Examine those documents to determine the extent of any interests, encumbrances or even ownership by third parties related to the property. While owning the property, the seller may have voluntarily or involuntarily granted or created mortgages, deeds of trust or other liens, including judgments against the seller and government liens due to failure to pay taxes. Existing covenants, conditions, restrictions, easements and other agreements affecting the property could potentially limit (or even prohibit) a particular type of business operation on that property.

3. Surveys

Most people think surveys consist of boundary lines, lot size and property descriptions. However, surveys also include a determination of whether the property is in a flood zone and a detailed visualization of the specific locations of wetlands, setbacks, utilities and easements on the parcel, as well as other legal and contractual issues potentially affecting the occupation and operation of the property. An updated survey helps the buyer and the buyer's architect create an appropriate footprint design for the building that does not violate any of these interests.

4. Entitlements

The existence of certain federal, state or local entitlements impacts the ability to effectively run a business on any given property after closing.

For example, if the business is a product component manufacturer, it may only be able to operate within areas zoned for industrial use. Developing land to build such operations from the ground up requires permits and approvals from state and local agencies, resulting in months of applications and meetings prior to any final issuance. These meetings will likely include public hearings to give the public a chance to remonstrate against the proposed development, so have a plan ready to address any possible concerns.

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Many of these entitlements may already be in place, streamlining work on this front significantly, but this information is crucial to getting a handle on how long any additional entitlement processes could last. Consider incorporating a deadline extension option into the purchase agreement to account for any issues that the process may uncover.

5. Environmental Hazards

Determining or discovering issues with soil and groundwater is another crucial element of due diligence. Greenfield property with no prior industrial or commercial use should not be much of a concern, but if the property is a brownfield property that had significant prior industrial use, obtain all prior environmental assessments and reports to fully understand potential hazards. If there are no such reports, consider engaging a reputable inspector to conduct a Phase I environmental site assessment to determine the existence of recognized environmental conditions such as underground storage tanks. If the Phase I assessment determines the property has potential to contain hazardous substances, then perform a Phase II assessment to test the soil and water for the presence of contaminants.

6. Leases

If the tenants or landlords of the property recorded a memorandum of lease in the public property records, a title report would inform the buyer of the existence of that lease. However, the existence of a lease is usually not public information. It is imperative to know if a third-party tenant has the right to possess the property pursuant to a lease—it would be a costly surprise to close on the purchase of a property expecting to begin using it right away and then learn a tenant has a 10-year lease for the property. It is easier to address tenant issues proactively with the seller prior to signing a purchase agreement, and certainly prior to closing on the property, than it is to close on the property and then try to evict any difficult tenants, especially given pro-tenant eviction statutes in many states.

In the purchase agreement, include a representation from the seller that they have not leased the property with an option to buy and that no third parties are in possession of the property. It is also important to physically tour the property prior to closing to visually observe whether any persons other than the seller are using the property. If the property has residential tenants, consider researching local rent-control laws and require a tenant-estoppel certificate, which asks the tenant to make certain representations about obligations of the property owner.

7. Pending or Threatened Actions

On the subject of adversarial actions, it is also important to make sure there are no pending or threatened claims, lawsuits or other actions involving the property, since a buyer could inherit those as well. These actions may not appear on a title search, so proactively ask for items such as a notice of default by the seller's bank, a letter from a contractor to the seller demanding payment for work done on the property, a letter from the state notifying the seller that it will be taking some of the property by eminent domain proceedings to expand a highway, or an agency notice regarding discharge of hazardous materials at the property. In the purchase agreement, require the seller to provide copies of every letter, notice, demand and lawsuit involving a potential action against the property and meaningfully evaluate the significance of each such action.

8. Contracts, Insurance and Utilities

For a property with an existing structure, obtain copies of all agreements and contracts with all vendors currently servicing the property to determine if the business will be assuming any ongoing obligations of the current owner. Additionally, obtain copies of any insurance policies affecting the property to understand any risk-transfer issues, including enhanced or reduced coverage and premium spend.

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Some properties in geographic areas with increasing adverse weather events, such as hurricanes and wildfires, may not be insurable due to insurers pulling out of those areas. While not historically necessary, consider adding the ability to obtain satisfactory insurance on the property as a closing contingency, similar to the common contingency that a buyer will find satisfactory financing.

In addition, obtain a list of all utilities affecting the property, as well as any outstanding obligations. Undeveloped land may not have utilities nearby, so the analysis should include whether the municipality will extend utility services to the property and any additional costs associated with the extension.

9. Physical Inspection

Perform a thorough physical inspection of the property to determine the extent of any deferred maintenance and immediate repairs or replacements needed, such as to a building's roof or its electrical system. The purchase agreement should require the seller to provide all records of service and repairs to the property. The physical inspection should determine any code noncompliance, including with local fire and life safety requirements and federal laws like the Americans with Disabilities Act.

To avoid any adversarial situations with the seller regarding the scope and length of the due diligence, it is generally considered best practice to incorporate a letter of intent into the final purchase agreement that contains such agreed-upon terms. A reputable title company can help acquire some of these items, and any potential gaps can be patched through a standard or extended title insurance policy.

As with due diligence related to mergers and acquisitions, start with broad-stroke inquiries when purchasing real estate, then follow up with requests for supplemental information and documentation if there are any red flags or other items worthy of further exploration. The goal is to uncover and proactively address landmines that may exist to minimize the likelihood and impact of post-closing problems.

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