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Questions to ask for any commercial real estate acquisition or financing: Expectations and practices in New York

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Abstract

What are the questions that any investor needs to ask about any commercial real estate before buying it or financing it? This paper lists and summarises those questions as a starting point for any investor's due diligence. The discussion first considers potential showstoppers such as development and approvals. It then turns to legal issues, leasing, title and other searches, financial matters, physical due diligence, a range of tax-related concerns, contract negotiations and some other issues. Armed with this list, an investor can decide which issues it cares about, and which to disregard, and plan its due diligence accordingly.

When a purchaser considers acquiring a commercial real estate asset, or a lender considers making a commercial mortgage loan, either of them (henceforth, 'the investor') needs to obtain a wide range of information about the real estate. The process of asking the right questions, obtaining the answers and thinking about what those answers mean is often called 'due diligence'.

Due diligence serves several purposes, depending on the circumstances and the timing. It will affect the investor's initial decision on whether to enter into a contract or loan commitment at all. Later, it will affect whether the investor decides to proceed with the transaction on the terms negotiated, or tries to renegotiate those terms — for example, if the investor cannot confirm the assumptions that supported the original deal.

Due diligence will also identify matters that require representations or indemnities from the seller or borrower and, later, identify possible breaches of those representations and warranties. Finally, it will help the investor to control the 'costs of the deal' and obtain information the investor may need to operate the property after closing.

In developing any due diligence plan for an acquisition or financing, the investor will identify the categories of relevant information, and then set priorities. As a starting point for

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developing the due diligence plan, this paper identifies the usual and not so usual categories and elements of due diligence for commercial real estate. Each is summarised, with only the briefest description. Little effort is made to explain why, whether, when, or how each item might matter or how an investor should analyse it or how the various issues interact. The paper is simply a practical reference tool, a cross-check, for investors when they structure their due diligence.

In each case, the investor's overall goal is to understand, value and define (and ideally quantify) any risks and opportunities relating to the property. To the extent that any particular due diligence will substantially help the investor to achieve one of these goals, they will want to emphasise that part of the process. Conversely, to the extent that the answer to a particular question cannot materially help the investor understand, value and define risks of the property — in other words, to the extent that the outcome of such due diligence does not matter — any such due diligence is a waste of time and money.

Control of due diligence, risks, opportunities

It is always possible to identify more questions to ask, more areas to investigate and more rocks to turn over. If the decision is left strictly to the people doing the due diligence — and if those people are instructed simply to 'protect' the investor — the due diligence could go on forever. A strategic investor will instead decide, as a business matter, where its due diligence programme should fall on the continuum between 'paying your money and taking your chances' and 'finding out everything there possibly is to know.'

A lender may take a somewhat different approach to some of these issues. A lender may, for example, care more about confirming value and preventing unpleasant surprises than understanding upside potential. Those differences are outside the scope of this paper, as are some issues unique to lenders, such as regulatory considerations and background investigations on the borrower and its principals. Among other things, many of these issues vary widely among lenders.

In a typical transaction, an investor's principals and staff would handle many of the due diligence items listed here. Outside counsel and other real estate advisers could handle these and other more complex matters. Defining and coordinating those responsibilities early in the process can be just as important as defining the scope of the work to be done. Planning and managing the due diligence process are just as important as completing it. The investor needs to manage and supervise its team so that it collects, organises, exchanges and understands information in a timely and efficient way.

Any investor will try strategically to break the process into stages, answering major threshold questions first and postponing or skipping low-value but high-cost due diligence activities, always depending on circumstances. Some information will be critical even when the investor makes its initial offer or deal proposal; other information can wait.

Typically an investor will not want to undertake extensive (ie expensive) due diligence until the basic deal terms have been resolved and, ideally, the investor has legal control of the property — enough control to assure that if the investor likes what the due diligence shows, the investor cannot 'lose the deal'.

The goal at all stages: if the transaction dies, the due diligence bill should be as manageable and defensible as possible under the circumstances.

Although this paper focuses strictly on due diligence, investors cannot treat due diligence as if it were a separate machine that grinds away in a hermetically sealed black box. The scope and nature of due diligence will depend very much on how the investor negotiates the business terms of the larger transaction, and particularly on how the parties agree to allocate risks arising from lack of knowledge. The information obtained through due diligence will in turn affect the same negotiations, as well as the closing process. Thus, investors must treat due diligence, and the process of defining its scope, as a dynamic and essential part of the larger transaction.

New York city

This paper reflects the expectations and practices of the New York city commercial real estate market. Expectations and practices in other markets, and even within the New York city market, will vary widely with the circumstances of any particular transaction, including its pricing, the investor's tolerance for uncertainty and risk, the investor's financial structure and participants and the seller's reputation.

The type of property will also be crucial. Due diligence for a fully tenanted office or retail project will vary greatly from due diligence for a vacant parcel of land or a development project. Residential, commercial, office, industrial and hotel properties each raise their own issues.

DEVELOPMENT AND GOVERNMENTAL ISSUES

Depending on the nature and location of the property, the plans for the property and the governmental climate, the investor may want to seek answers to the following questions, as well as others driven by local issues and concerns. If the transaction contemplates any development or redevelopment at all, the matters listed here are often potential 'showstoppers'.

'Showstoppers'

— *Approvals* Requirements to obtain governmental approvals, or at least to make filings, under a wide range of laws. Development approvals are only the tip of the iceberg. A transaction may require approvals under laws governing such matters as antitrust, health care, housing, alcohol licensing, or operating matters generally. These requirements are particularly likely for multisite quasi operating-company transactions. They will vary widely depending on the existing and intended use of the property, as well as the size of the transaction and of the parties.

— *Landmarks* Landmark status of the property, and other similar restrictions on development or redevelopment, such as historic preservation issues and recorded development restrictions (also part of the title review process).

Property information

— *Licensing* Requirements for licences and permits, and resolution of any missing items. Are there any changes in such requirements that might result from the transaction? Are the licences transferable? Operating licences, such as those for alcohol, health care facilities, gaming, and the like, may raise issues that go beyond the property to be acquired. Because they often involve some degree of governmental discretion, transfers of these licences introduce an element of randomness, unpredictability, and hence risk, that the contract must allocate between the parties.

— *Miscellaneous agreements* Any agreements with governmental authorities, whether or not recorded.

— *Plaza agreements* Public plaza agreements, particularly for issues relating to income, maintenance, operations and repairs.

— *Public areas* To the extent that the seller owns any areas that are open to the public generally, these are any measures that the seller has taken to prevent the public from obtaining a 'prescriptive easement' or other impairment of the seller's title.

— *Transportation* Agreements and arrangements relating to transportation, either benefiting the property or restricting its use. These might involve, for example, subway tracks and stations, rail spurs, pipelines and tunnels.

— *Zoning* Zoning analysis, including compliance, appeal rights and availability of unused development rights, possibly culminating in a zoning opinion or advice memo. Necessity for any variance, special permit or other dispensation. Any restrictions on the transferability of these benefits.

LEGAL DUE DILIGENCE (GENERAL)

At the beginning of any transaction, the investor may want to have its counsel receive and review copies of at least the following documents regarding the property.

— *Brokerage* Any agreements or understandings regarding payment of brokerage commissions for the transaction now contemplated.

— *Condominium or REA* If the project is structured as a condominium or under a reciprocal easement agreement structure, then copies of all relevant documents, including minutes of Board of Managers or other board meetings.

Contracts

— *Contracts* Service contracts (lifts, security, alarms etc). The level of review will vary depending on whether the contracts are cancellable, require termination payments, or are particularly important, unusual or hard to replace.

Employees

— *Employees* List of employees, length of employment, salary, fringe benefits and holiday entitlement, together with any labour union contracts and agreements with any non-union building employees.

Leases

— *Ground leases* If the property is held as a leasehold, copies of the lease, any amendments, previously issued estoppel certificates, and any correspondence with the lessor.
— *Leases* Space leases, including any leases and lease amendments under negotiation or to be signed during the closing process. Scope of review will vary depending on the size and composition of the leases and the transaction structure. (See 'Legal Due Diligence (Lease-Related)' below.)

Litigation

— *Litigation* Pending litigation may affect seller, any of its constituent entities, or the property itself — but the inquiry may need to go beyond those three obvious categories. For example, litigation concerning nearby environmental matters, entitlements, governmental disputes, Native American land claims, or other similar matters may indirectly affect a large development project being acquired. Any such litigation might not name the seller as a party and might not specifically relate to the property. Discovery of problems like this often requires local advisers at ground level.

Possessory interests, occupancy

— *Management agreement* Management agreements.
— *Other buildings* Agreements with neighbouring property owners that tie this real property to any other real property for utilities, infrastructure, services, access, support, parking, roadways, operations and maintenance or any other purpose.
— *Pending construction* Description of pending construction for both tenant improvements and any building-wide capital improvements, including contracts, budget, status and anticipated timing.
— *Telecommunications* Agreements with telecommunications or Internet service providers.
— *Utilities* Utilities agreements.

LEGAL DUE DILIGENCE (LEASE-RELATED)

Because rental income usually drives real estate value, and because leases and tenancies often conceal surprises, it is not enough for the investor or its counsel merely to read the leases, as suggested above. One must look behind the leases, by asking for information such as the following.

— *Abstracts* Abstracts of the existing leases, including any in the seller's possession or prepared by its advisers.
— *Antenna leases* Antenna and other telecommunications leases, particularly to review for termination rights and non-exclusivity.
— *Brokerage* Any leasing brokerage agreements that will stay in

place after the closing. Amount and timing of any outstanding commission obligations for any leases previously signed or now being negotiated.
— *Correspondence* Correspondence with tenants regarding defaults, administration etc.
— *Disputes* Pending disputes with tenants and eviction actions.
— *Estoppel certificates* Although primarily an issue for the closing, investor's due diligence may help to identify timing problems with obtaining estoppels and any terms of tenants' leases that relate to or limit the delivery of estoppel certificates. When estoppel certificates are delivered for the closing, investor's due diligence would also include review of those estoppel certificates to identify and understand any problems or issues they disclose.

Guarantees

— *Guarantees* Existence, status and strength of guarantors.

Rent roll

— *Rent roll(s)* Spreadsheets showing all tenants, rents, escalations, commencement dates/expiration dates, option terms, security deposits and tenant status.
— *Security deposits* Security deposits, including letters of credit or other forms of cash and cash equivalents. Transition arrangements.
— *Stacking and options* Stacking plan, now and in the future, including future interaction of all expansion, contraction and renewal options.
— *Standard lease* Standard form of lease, on paper and possibly in computer readable format, including all exhibits (such as alteration rules, building rules and design criteria).
— *Tenant financing* If the landlord gave any tenants financing for their tenant improvements, then copies of all loan documents and information about the status of these loans.
— *Transfers* Any assignments, assumptions and sub-leases.

SEARCHES AND SURVEY

Public records and other sources will provide a great deal of crucial information about the property. The investor or its counsel may want to investigate and review at least the following items.

— *Certificate of occupancy* Certificates of occupancy covering the entire building, or an explanation. Status and expiration dates for any temporary certificates of occupancy.
— *Designated areas* Status of property regarding 'flood plain', 'wetlands', and other designated areas.
— *Miscellaneous* Liens, judgments, litigation bankruptcies — both for seller and for any major tenants.
— *Municipals* Searches of municipal departments for violations, fines, licensing problems, unpaid utility charges and similar matters.

Survey

— *Survey* New survey or update of existing survey, and certification to all necessary parties. Compliance with lender's survey criteria. Comparison of the survey against the appraisal or the larger transaction, if any uncertainty or difficulty exists regarding the scope of the property (such as future development parcels or a vertical subdivision).

Title

Use

— *Title* Opening of title insurance orders, including strategic placement of title work. Title search, including obtaining and reviewing copies of all underlying documents and assessing how each will affect future use and development of the property.
— *UCC* Uniform Commercial Code and similar filings against seller and potentially other parties.

FINANCIAL DUE DILIGENCE

Audits

To check out the financial strength of the property, investors should not only look at the leases and lease-related information as described above, but also several other categories of information, including those listed below and the tax-related issues covered later in this paper.

Appraisal

— *Appraisal* Third-party analysis and valuation reflecting the current market.
— *Audit* Audit of operating and other expenses. The intensity and nature of this audit may vary with circumstances.
— *Brokerage commissions due* Future payments of brokerage commission for existing leases already in place.

Budgets (operating and capital)

— *Budgets* Operating budget for the current year. Seller's budget for capital projects, or anticipated schedule of requirements.
— *Financial reports* Property financial statements for the last several years.
— *Insurance* Analysis of future insurance coverage requirements and likely cost, including a comparison with seller's cost of insurance.
— *Operating expense changes* Possible changes in operating expenses after the change of ownership.
— *Percentage rent* Sales reports from percentage rent tenants.
— *Receivables* Amount, composition and implications of seller's receivables from tenants (part of rent roll analysis).
— *Service contract costs* Analysis of the cost of service contracts and possible alternatives after the change of ownership.
— *Staffing* Employee roster and compensation. Future staffing changes for building. Impact of union contracts, if any.
— *Tax returns* Review of seller's tax returns and underlying schedules; comparison against other financial reports and information.
— *Tenants* Analysis of financial condition of tenants (particularly major tenants) and their financial statements, if available.

PHYSICAL DUE DILIGENCE

Structural

Investors will typically retain outside engineers and other consultants to examine the physical condition of the property, including the following characteristics.

— *Archeological* Prior uses or ownership that may create archeological issues and interfere with or delay future development.

— *Artwork* Existence of any murals or other built-in sculpture or artwork, triggering possible artists' rights restrictions under applicable law. Scope of any artwork included in the transaction. Ownership of that artwork.
— *Code* Compliance with building, fire, zoning and other codes (including Americans with Disabilities Act). Particular focus on issues of parking; the possibility of new environmental or energy conservation requirements; life and fire safety systems; earthquake compliance and seismic safety; and retrofitting requirements.

Environmental, utilities, engineering

— *Engineering* Engineering issues, particularly for the structure and major systems of the building. Analysis of the age and condition of building systems, façade, windows and other components.
— *Environmental* Environmental and asbestos analysis, including 'Phase I' report and, where indicated, 'Phase II' report. Updating of any existing reports as necessary. Identification and status of any underground storage tanks. Investigation of any new environmental concerns of the moment, such as 'sick building', electromagnetic fields, poisonous insulation and other 'problem' building materials. Notices or claims regarding environmental matters. Application of any state-specific environmental review procedures (eg New York State Environmental Quality Review Act).
— *Geotechnical* Soils analysis and report.
— *Local neighbourhood* Compatibility with nearby uses and likelihood of objections to any future operations at the property or potential change of use.
— *Measurement* Measurement of actual usable and rentable size of the building.
— *Operational audit* Complete audit of building operations.
— *Pending construction* Identify and deal with any pending construction work (capital or tenant related). Identify status of job and cost to complete.
— *Plans and specifications* As-built plans and specifications.
— *Power* Adequacy of electrical service and availability of more power and/or competitive power. Availability of space for any new equipment that may be needed.
— *Telecommunications* Access to and availability of additional telecommunications services, such as fibre optics and other data links.
— *Tour* Building tour, including mechanical areas.
— *Upgrades* Identify any necessary building system upgrades (more telecommunications, generators, fuel tanks, rooftop facilities etc) and their feasibility.
— *Utilities* Adequacy of utilities, availability of any desired upgrades, physical connection arrangements and any necessary changes.

TAX ISSUES

Like any other business transaction, any real estate transaction may require consideration of a wide range of taxes, affecting both the asset and the structuring and closing of the transaction. Those taxes and related issues may include the following.

- *Local variations* Tax issues are particularly likely to vary from place to place. Investors may require local advisers even at the earliest stages of the transaction.
- *Mortgage recording tax savings* Availability of existing mortgages (including from any other property) for assignment to new lender to save mortgage recording tax in any jurisdiction with such a tax.

Real estate taxes, income taxes

- *Real estate taxes, generally* Status of real estate tax protests and any likely or built-in increases in real estate taxes during the coming years. Copies of actual real estate tax bills for the entire property for the last three years. Agreements with attorneys hired to prosecute any real estate tax protests.
- *Real estate tax assessments* Likelihood of forthcoming reassessments.
- *Subsidised financing* Existence and terms of any tax-exempt or other government-subsidised financing affecting the property; any restrictions on the proposed transaction.
- *Tax abatements* Availability (or continued availability) of any tax abatement or incentive programmes and requirements to qualify, including timing.
- *Tax lots* Alignment of tax lot lines with property lines.
- *Tax planning* Tax planning, both for acquisition and initial structuring to facilitate favourable future operation and disposition.
- *Transfer taxes* Calculate, minimise and allocate, taking into account local law and practice.

CONTRACT ISSUES

Negotiations

As the due diligence discloses the exact scope of the asset and any problems with it, each piece of information will affect what the larger transaction should require of other parties both before and at the closing, and the investor's negotiation of the documents that will govern the transaction. That process, and negotiations generally, will force the investor to consider at least the following issues.

- *Amenities* Identify any facilities or services benefiting the property, understand ownership structure.
- *Attachments* Identify exhibits and schedules to be attached, both schedules to better describe the asset (lists of contracts, leases etc) and exhibits setting forth the form of closing documents. Develop and review all such attachments.

Closing

- *Closing arrangements* Plan ahead for closing documents, deliveries and events, including such matters as requirements for estoppel certificates and non-disturbance agreements; termination of service contracts; satisfying lender's closing requirements.

— *Contract issues generally* Wide range of contract issues, including the due diligence process itself; amount of contract deposit and use of letter of credit; representations and warranties and their survival and credit support; assignment of any existing mortgages to new lender; responsibility for costs arising from the transaction (termination fees under service contracts, severance, transaction costs, etc); allocation of transfer taxes; interim operations between contract and closing; responsibility for pending construction; prorations (including timing and seasonality of percentage rent); and numerous other issues, including any that arise from the due diligence process.

— *Coordination* If this transaction involves other transactions, coordination of multiple simultaneous closings, exchange arrangements or other linkages.

— *Memorandum of contract* Record memorandum of contract?

— *Publicity etc* Publicity and confidentiality.

— *Recognition* If the property is subject to any existing mortgages, possible agreements with the holders of those mortgages to protect a purchaser's rights.

OTHER

Business strategy, coordination, insurance

The specific investor's agenda and plans for the building may produce another set of issues, many of a very practical nature.

— *Approvals* Internal approval requirements and timing for each investor in the transaction, including any indirect participants. Third-party approval requirements for the proposed transaction and investor's subsequent plans for the asset.

— *Broader picture* Any broader trends — not tied to the particular property — that may indirectly affect the success of this property. Demographics, the local economy, political trends, labour problems and other background issues that may be difficult to identify, particularly for an investor who does not team up with a local partner, adviser, or consultant. What local changes are likely in coming years? Growth restrictions? Rezoning? New development?

— *Business strategy and flexibility* Identify the purchaser's business strategy for any changes in the building — physical reconfiguration or renovation, legal structure, new amenities, circulation patterns, parking, change of use, operational, name of building etc. Determine whether any impediments exist to those changes (see above). Analysis of cost, timing, financing and feasibility for any changes.

— *Engagement letters* If the investor hires outside contractors for due diligence or other pre-closing work, engagement letters with those contractors. Reliance letters in favour of lender.

Closing arrangements, Feng Shui, market, management

— *Insurance recommendations* Correspondence and recommendations from insurance carriers.
— *Management files* Review of management files for possible claims, disputes, physical issues and other problems. Copies of any reports, recommendations or projections made by the management company or department.
— *Management transition* Plan for transition of management, including obtaining files and machine-readable databases and project management information. Possible retention of building management team or selected employees.
— *Market* Market study, including projection of rents and vacancy, pending construction, likely future construction.
— *Marketing materials* Brochures, plans and marketing materials.
— *New entities* Naming and formation of new entities; name reservations and availability.
— *New loan* Closing documents, deliveries, planning and negotiation for new financing.
— *New ownership/debt structure* Establish, structure and negotiate debt and equity structure for new ownership. Consider business terms, regulatory and tax structure, exit strategy, internal flexibility, agenda of multiple partners, control, ownership, management etc. (These structuring issues and possible ways to approach them are outside the scope of this paper.)
— *Publicity* Press release (if any) and publicity, or prevention of same.
— *Research* Research the seller's acquisition cost. General research in Nexis or the Internet regarding publicity on the building and seller.
— *Unique concerns* Any special non-standard considerations or agenda items of a particular investor ('earth friendliness', 'feng shui', workforce requirements etc).

If investor starts from the preceding list of 'due diligence' items, the investor can tailor its requirements for any particular transaction to reflect that transaction's unique circumstances and issues that are important to that particular investor. By taking this approach the investor should be reasonably comfortable that nothing will fall between the cracks, except through a deliberate decision to disregard it.

With the 'due diligence' process on track and built on a sound structure, the investor can also turn its attention to broader issues: identifying how to create value in the property in ways that the seller and other investors may have missed; raising (or allocating) the money to close the deal on attractive terms; and negotiating the business terms of the acquisition or loan, taking into account, among other things, any information that the due diligence discloses.