



**METRO BROKERS**



## **Checklist for Commercial Real Estate Professionals**

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## WHAT “DUE DILIGENCE” IS DUE?

The scope, intensity and focus of any due diligence investigation of commercial real estate depends upon the objectives of the party for whom the investigation is conducted.

1. **STRATEGIC BUYER** (or long-term lessee) is acquiring the property for its own use and must verify that the property is suitable for that intended use.
2. **FINANCIAL BUYER** is acquiring the property for the expected return on investment generated by the property’s anticipated revenue stream, and must determine the amount, velocity and durability of the revenue stream. A sophisticated Financial Buyer will likely calculate its yield based upon discounted cash-flows rather than the much less precise capitalization rate, and will need adequate financial information to do so.
3. **DEVELOPER** is seeking to add value by changing the character or use of the property – usually with a short-term to intermediate-term exit strategy to dispose of the property (although, a Developer might plan to hold the property long term as a Financial Buyer after development or redevelopment).
4. **LENDER** is seeking to establish two basic lending criteria:
  - Ability to Repay – The ability of the property to generate sufficient revenue to repay the loan on a timely basis.
  - Sufficiency of Collateral – The objective disposal value of the collateral in the event of a loan default, to assure adequate funds to repay the loan, carrying costs and costs of collection in the event forced collection becomes necessary.

## **DUE DILIGENCE REVIEW**

### **1. THE SELLER**

- Who is the Seller?
  - Individual?
  - Trust?
  - Partnership?
  - Corporation?
  - Limited Liability Company?
  - Other legally existing entity?
- If other than natural person, does Seller validly exist and is Seller in good standing?
- Does the Seller own the Property?
- Does Seller have authority to convey the Property?
  - Board of Director Approvals?
  - Shareholder or Member approval?
  - Other consents?
  - If foreign individual or entity, are any special requirements applicable?
  - Qualification to do business in jurisdiction of Property?
  - Federal Tax Withholding?
  - US Patriot Act compliance?
- Who has authority to bind Seller?
- Are sale proceeds sufficient to pay off all liens?

### **2. THE PURCHASER**

- Who is the purchaser?
- What is the purchaser/grantee's exact legal name?
- If purchaser/grantee is an entity, has it been validly created and is it in good standing?
- Articles of Incorporation – Articles of Organization
- Certificate of Good Standing
- Is purchaser/grantee authorized to own and operate the property and, if applicable, finance acquisition of the property?
  - Board of Director approvals
  - Shareholder or Member approval?
  - If foreign individual or entity, are any special requirements applicable?
  - Qualification to do business in jurisdiction of the property
  - US Patriot Act compliance
  - Bank Secrecy Act/Anti-Money Laundering compliance?
- Who is authorized to bind the purchaser/grantee?

### 3. THE PROPERTY

- Exactly what PROPERTY does purchaser believe it is acquiring?
  - Land
  - Building
  - Fixtures
  - Other improvements
  - Other rights
  - The entire fee title interest including all air rights and subterranean rights
  - All development rights
  
- What is Purchaser's planned use of the property?
  
- Does the physical condition of the property permit use as planned?
  - Commercially adequate access to public streets and ways
  - Sufficient parking
  - Structural condition of improvements
  - Environmental contamination
  - Innocent Purchaser defense vs. exemption from liability
  
- Is there any legal restriction to purchaser's use of the property as planned?
  - Zoning
  - Private land use controls
  - Americans with Disabilities Act
  - Availability of licenses
  - Liquor license
  - Entertainment license
  - Outdoor dining license
  - Drive through windows permitted
  - Other impediments
  
- If new construction:
  - Availability of construction permits
  - Soil conditions
  - Utilities
  - NPDES (National Pollutant Discharge Elimination System) permit
  - Permit required if earth is disturbed on one acre or more of land
  - If applicable, Storm Water Pollution Prevention Plan is required

#### 4. PURCHASE PRICE & OTHER CONSIDERATION

- How much does purchaser expect to pay for the property?
- Is there any condition on or within the property that is likely to increase purchaser's effective cost to acquire or use the property?
- Property owner's assessments
  - Real estate tax in line with value
  - Special Assessment
  - Required user fees for necessary amenities
  - Drainage
  - Access
  - Parking
  - Other

#### 5. TITLE

- Must be "good and marketable."
- Best resource will be the title report.
- Listed "exceptions" and "defects" should be reviewed in detail.
- Any encroachments onto the property, or from the property onto other lands?
- Any encumbrances on the Property that will not be cleared at Closing?
  - Easements
  - Covenants running with the land
  - Liens or other financial servitudes
  - Leases
- Consideration of the type and extent of proposed title insurance can be an important decision -- standard coverage or extended? Are special endorsements necessary? These will all depend on the type of property being purchased.

6. **SURVEY:** An up-to-date survey of the property allows you to visually understand where any easements or licenses burdening the real estate are actually located and whether the scope of use set forth in the recorded document is acceptable based on its location. The survey will also identify encroachments or physical uses not shown by the title commitment. Should ALTA standards be followed, or are the local/regional government agencies' standards sufficient? Is an improvement location certificate sufficient or should you get a land survey plat? These will depend on the type of property and nature of the transaction.

7. **BUILDING INSPECTION:** Inspection of buildings on the property is essential to ensure sufficiency of construction considering the intended uses of current occupants, proposed re-use by the buyer, and the surrounding geography and climate. Seller’s provision of “as-built” plans and specifications should be helpful here, but should not end the investigation.
  - Ensure access to the premises and any records or documents to complete due diligence.
  - Employ properly licensed and qualified inspectors, engineers, surveyors, and other experts to conduct structural, mechanical, environmental inspections, geological (or other) testing or inspections in order to ensure the fitness of the property for the intended use. Focus of inspections should be primarily on structural components such as the walls, roof, HVAC units and the fire suppression system. Certain climates/regions will require more exacting inspections, so hiring a local inspector is a good idea. The inspector should also independently look for any regulatory or statutory violations.
  - Conduct architectural evaluation and cost estimates for planned construction or renovation.
8. **THIRD PARTY SERVICE AGREEMENTS:** Include pest control, building and outside maintenance, property management, and others. Are they assignable or cancellable?
9. **ZONING:** The zoning, subdivision and land use matters are an often overlooked, but critical, aspect of the investigation. Zoning designation should be confirmed and uses at the property verified to conform to the allowed uses. In addition to current violations (or potential violations considering purchaser’s intended use), it is important to look at all of the current agreements affecting the property such as growth management agreements, covenants or public facilities agreements, as well as any current or proposed fees (impact fees or linkage fees), exactions or assessments. Also, look for a pending zoning change.

10. **EXISTING LEASES:** If assuming existing leases, extended analysis is necessary.

- Security Deposits
- Options to Extend Term
- Options to Purchase
- Rights of First Refusal
- Rights of First Offer
- Maintenance obligations
- Duty of landlord to provide utilities
- Real estate tax or CAM escrows
- Delinquent rent
- Pre-Paid rent
- Tenant mix/use controls
- Tenant exclusives
- Tenant parking requirements
- Automatic subordination of lease to future mortgages
- Other material lease terms
  
- Do tenants have a right to sublet?
- Are there non-standard provisions that could impact purchaser's intended use of the property?
- All attendant documentation, including the leases, communications, operating budgets, as well as the creditworthiness of each tenant, should be scrutinized.
- You should conduct actual interviews with each of the tenants to determine the condition of the property in the Tenant's opinion.

## 11. PURCHASER FINANCING

Lender financing is often required to purchase commercial real estate. In the context of due diligence, the lender can be somewhat of an experienced ally.

- What loan terms have the borrower and lender agreed to?
  - Amount of the loan
  - Interest rate
  - Repayment terms
  - What is the collateral?
  - Real estate and personal property together?
  - Liens and their priority
  - Single advance loan or multiple advance loan?
  - If it is a multiple advance loan, can the principal be re-borrowed once repaid prior to maturity of the loan; making it, in effect, a revolving line of credit
  - A construction loan?
- Reserve requirements?
  - Interest reserves
  - Repair reserves
  - Real estate tax reserves
  - Insurance reserves
  - Environmental remediation reserves
  - Other reserves
- Are there requirements for borrower to open business operating accounts with the lender? If so, is the borrower obligated to maintain minimum compensating balances?
- Is the borrower required to pledge business accounts as additional collateral?
- Are there early repayment fees or yield maintenance requirements (each sometimes referred to as “pre-payment penalties”)?
- Are there repayment blackout periods during which Borrower is not permitted to repay the loan?
- Is a profit participation payment to Lender required upon disposition?
- Is there a loan commitment fee or “good faith deposit” due upon Borrower’s acceptance of the loan commitment?
- Is there a loan funding fee or loan brokerage fee or other loan fee due Lender or a loan broker at closing?
- What are the borrower’s expense reimbursement obligations to Lender? When due? What is the borrower’s obligation to pay lender’s expenses if the loan does not close?

## **ENVIRONMENTAL ISSUES & COMMERCIAL REAL ESTATE**

Almost every commercial transaction today involves potential environmental issues. Disclosure of these issues by sellers of commercial real estate is required under state and federal environmental regulations. Several states have codified pre-sale environmental assessment obligations in property transfer statutes.

For Example:

- Georgia's Condominium Act
- Erosion and Sedimentation Act of 1975
- Coastal Marshlands Protection Act of 1970
- Georgia's Brownfield Act
- Uniform Environmental Covenants Act
- Georgia's Hazardous Site Response Act
- Agricultural Land Disclosure

Sellers must disclose material facts involving the environmental condition of the property if known. Facts should be supported by environmental records and documentation. Sellers can minimize environmental liability by allowing prospective purchasers sufficient time for a full environmental investigation, including soil and groundwater sampling.

As this area of law is changing rapidly, you may want to consult an environmental lawyer about these issues and review disclosure obligations in jurisdictions where properties are located.