No Holds Barred In Commercial Real Estate Acquisition

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If you've ever been hit square in the face then you know what it feels like to miss a critical diligence issue. It usually comes out of nowhere. When it lands it really stings. And you never want it to happen again. This we know because we've experienced both.

Due diligence is arguably the most important phase of any commercial real estate acquisition. It's sometimes a struggle, but also a necessary fight for the facts. The term "due diligence" is used by commercial real estate attorneys and others in the industry to describe the process of inspecting and investigating the to-be acquired real estate asset from a financial, operational and legal perspective. Or to put it another way, and more simply, it's studying your target's weaknesses before stepping into the ring.

Backdrop

Due diligence is especially critical in U.S. CRE acquisitions because sellers customarily transfer the real estate "as is" and "whereas" based on the maxim "caveat emptor" or buyer beware. This just means that when the buyer takes ownership and possession, it takes the property as it is with all of its good and bad qualities. In U.S. CRE there are no weight classes and no rules against biting, elbowing or punching below the belt.

Sellers are typically unwilling to make representations as to matters that can be uncovered through due diligence. As a result, essentially all risk shifts to the buyer post-closing. When you go toe-to-toe in this fight, it is usually no holds barred. The greatest protection against unwanted surprises post-closing is a thorough investigation and examination of the property pre-closing.

Due diligence is typically conducted during a due diligence period specified in the purchase contract. When the due diligence period expires, unless the buyer has elected to terminate beforehand, any earnest money (or security) deposited becomes nonrefundable and

payable to the seller if the purchase contract terminates by reason of a buyer default except in certain limited circumstances.

As an exception to this, sellers marketing a property for sale in a competitive bidding process or in a competitive primary market like NYC may not accept a diligence period contingency in the purchase contract — requiring the buyer to complete its due diligence and bear the significant cost of doing so even before the purchase contract is executed and the seller is committed to sell. Although buyers in this scenario often insist on an exclusivity period specified in the letter of intent or a separate letter agreement.

In either case, the period in which the buyer must complete its due diligence is usually time constrained and time pressured irrespective of its scope and importance. As a consequence, buyers must size up a property fast because the bell is quick to ring and a series of haymakers are usually on the way.

The Last Round

A knockout number of published works exist that describe in great detail the CRE due diligence process. This article is not meant to be one of those. It instead focuses on the round of the legal due diligence fray that most published works on the topic gloss over or whiff on entirely: the last round, which immediately follows the investigation and inspection of the property.

At this point you may have discovered a handful or more of material diligence issues. What do you do now? It depends. It depends on whether the issue is monetary and can adequately be satisfied through the payment of money. If it's a nonmonetary issue, it depends on whether it's capable of being resolved pre-closing. And it could also depend on a variety of other considerations. In the same way, if an opponent opens up their right side before attempting a left hook or leaves the jab hanging a millisecond too long, the counter is likely to be different for both.

Each issue should be separately analyzed for a tailored resolution. The client may still decide to just walk away or ignore your advice completely and continue to closing. Regardless, as trusted advisers to our clients we are expected to add value and do more than spot issues by also suggesting creative solutions and a path forward. Failing to do this is no different than identifying your opponent's weaknesses after watching hours of film

without then developing a strategy. It would make all the effort and work that came before totally meaningless.

Containment

When analyzing an issue, take note of the unknowns. What does this mean? The additional facts surrounding the issue that are not capable of being discovered through due diligence but if known and proven adverse could potentially make this issue even more significant and costly. In other words, what are the facts you need to assume to take comfort that this issue is not just the first hit before a flurry of punches. Now convert those facts into seller representations. And backstop those representations with a seller indemnity that survives the closing. As Muhammad Ali once said, “[t]he hands can’t hit what the eyes can’t see.”

Usually the seller’s indemnity relating to breaches of seller representations is limited by a deductible or basket and a maximum cap (i.e., a floor and a ceiling). The seller’s indemnity also typically survives the closing for a limited period. You need to ask yourself whether the specific indemnity for the representations relating to this issue should be excluded from these limitations or whether these limitations should be adjusted (e.g., raising the cap and extending the survival period). You also need to consider whether for this indemnity a creditworthy guarantor or a holdback of proceeds for the duration of the survival period is warranted.

And for any representations relating to a third party arrangement like a lease, a loan, a management agreement, a condominium, a government contract, etc., you may also consider whether it would be appropriate to require an estoppel certificate from the third party. An estoppel certificate where statements of the unknown facts are made directly from the source is always the preferred approach but it just may not be the practical one given the seller’s (or even the buyer’s) desire to close and to close by an outside date. And in that circumstance the seller should make the representations, but it is also reasonable to require the seller to try to obtain the third party estoppel certificate.

With respect to all issues that fit this description and which have unknowns, this sort of analysis should be done and a tailored package of seller representations with an indemnity and other items as noted above should be recommended to the client as part of a proposed amendment to the purchase contract. This exercise is not meant to address and resolve the actual discovered issue but instead to contain it. It is meant to put you in the best position to

resolve the issue. When you have your opponent contained and against the ropes, that is the time to strike.

When your containment plan falls through, whether because the seller is unwilling to make additional representations or the representations are inadequate or insufficiently backstopped, the risk borne by the unknown can still be allocated elsewhere through insurance. Title insurance is an obvious example of this and its need widely understood in the industry. But conventional insurance companies also offer other products of insurance that may be useful for containment. Examples include environmental insurance and representation and warranty insurance. The buyer should check with its risk management team and insurance broker to see if a suitable insurance product or endorsement exists. The cost, however, could be significant. The buyer may insist that the seller bear some or all of the cost depending on the circumstances and the buyer's negotiating power.

When addressing issues that could be characterized as long term risks, consider whether the buyer would be willing to deliver the same seller representations and backstop to a future purchaser or lender of the property. And in the case of insurance, consider whether the insurance product or endorsement is uniquely available to the buyer or during the current state of the market. If so, advise the client because the value of the asset could still be adversely impacted as a result of being viewed as potentially less marketable or financeable.

Resolution by Payment

After containment, it's time to address the issue head-on, face-to-face. If the issue is monetary and capable of being adequately addressed by the payment of money, like a mechanics lien or a judgement of some sort, then resolution could take the form of a purchase price adjustment or a seller obligation to make the payment at or before closing.

If the issue is nonmonetary, a buyer may still look to the seller for payment. When the seller is unwilling or unable to cure the issue at or before the closing, the buyer will need to expend time and money after taking ownership and possession to cure it. If the buyer is able to quantify to a reasonable degree of certainty the total expense of curing, then a purchase price adjustment or an escrow of the seller's funds could be an appropriate resolution. And a seller may prefer this method because it shifts the burden of "clean up" to the buyer. A seller also cuts its losses and shifts the risk of cost overruns to the buyer if

curing proves to be more expensive than anticipated.

A purchase price modification could be memorialized in a purchase contract amendment by reducing the purchase price or adding a purchase price credit or adjustment mechanism. If the agreement is for seller to make direct payment to the payee, then not only should an affirmative covenant requiring the seller to make the payment at or before closing be added, but also a closing condition that evidence of payment has been delivered to the buyer. However, think through whether a purchase price reduction versus credit versus adjustment versus a seller direct payment obligation will have tax consequences or effect figures that may be dependent on the purchase price, like state and local transfer taxes, title insurance premiums and mortgage financing. One might be more advantageous for the buyer than the other.

Resolution by Action

If the issue is nonmonetary and the expense of curing is either difficult to quantify or the buyer is unwilling to accept the “clean-up” burden or cost overrun risk, then resolution may need to be action by the seller to cure the issue. Here are examples of actions a seller may be required to take to resolve a nonmonetary diligence issue:

- If you discover in any contracts that the other party’s consent is necessary or the other party to the contract must be notified about the transaction, then the seller will need to obtain the consent or deliver the notice before closing.

- If you discover in any underlying title document a third party purchase option or a right of first offer or right of first refusal, then the seller will need to obtain a waiver of that right.

- You may insist that the seller amend or modify or terminate existing agreements or contracts, including any agreements or contracts that require consents or notices or that contain purchase options or rights so as to eliminate those requirements or rights and not hamper the buyer when selling the property in the future. As another example, if acquiring a lessee’s interest under a ground lease and you discover that the

leasehold mortgagee protections are less than those customarily required in the current leasehold lending market, then you may insist that the seller negotiate a ground lease amendment with the ground lessor.

You should analyze each nonmonetary issue and formulate a custom resolution. Whatever the seller action, it should be memorialized as part of a proposed amendment to the purchase agreement by adding (1) an affirmative covenant obligating the seller to take the action at or before closing, and (2) a closing condition that the buyer received evidence to its reasonable satisfaction that the action was taken.

If a diligence issue cannot be cured until after closing or cannot be cured before the desired closing date, a buyer may agree to allow the seller to complete the action and cure the issue within a period that extends beyond the closing. This, however, should be an option of last resort for a buyer. Sellers are less incentivized to act after closing. If your buyer client is willing to do this, you should consider the addition of any mechanisms or credit support that would motivate the seller to timely comply such as a holdback of funds or a guaranty from a creditworthy seller entity.

Parting Words

As real estate lawyers become more experienced, for some reason, due diligence oftentimes loses its luster and left to the less experienced on the team to manage. Negotiation of the definitive transaction documents becomes more prominent and its significance over due diligence exaggerated. But make no mistake, obligations and restrictions the buyer takes subject under diligence materials are as important as those contained in any definitive transaction document and negotiation still necessary as it relates to containment and resolution measures. The last round of the due diligence analysis should not be ignored or dropped on our clients to just figure out. Buyers need expert guidance from experienced counsel to navigate through the complexities of the diligence issue. In this engagement, winning based on points is better than a TKO.

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