SINCE 1854

Chicago Daily Law Bulletin®

Volume 156, No. 181 **Thursday, September 16, 2010**

Are you ready for the *real* 'as is'?

By Jessica G. Lingertat

Distressed real estate assets evolve through many different sources and, chances are, if you're buying in this market, either your seller or the property itself is experiencing some sort of distress. There is often precious little cash available to solve looming problems. Accordingly, many deals, whether or not specifically marketed as such, are "as is," a term that has taken on a whole new meaning. Rather than simply a warning that particular defects (often physical repair items) will not be remedied or credited at closing, it can now translate into a very one-sided scavenger hunt: Take it or leave it and you're on your own.

Problems may arise from a seller's financial condition or the physical or market conditions of the property itself. As we are all painfully aware, real estate companies are not staffed like they once were and it is likely that the person who put a project together is not handling the sale. Nontraditional sellers may never have had comprehensive information on the property to begin with. This loss of institutional knowledge on behalf of your seller can slow the process and impede access to reliable information.

The key to surviving the process and making good decisions is to make sure you understand what you're getting yourself into. The specific due diligence investigations to be performed now are no different than ever. The trick is that now, when it is so much more likely that you will discover costly and time consuming issues, it also is increasingly difficult to track down information that will enable you to uncover such issues. By conducting comprehensive due diligence investigations, you will be better able to identify and evaluate the impact of any existing or potential problems.

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Below are 10 items of particular concern that you should include in your due diligence investigations:

1. Know who you're dealing with. Active parties in this market include a host of nontraditional sellers, including former lenders, receivers, owners arranging short sales and bankruptcy trustees, each of which may have different motivations than a traditional seller. You need to understand their goals (and where your bargaining power is); how much cooperation you can expect in the delivery of existing materials and assistance with third parties; who has authority to make the deal; and what the approval process will be.

2. Value of any representations and indemnities. Does the party making such representations have a reliable basis for knowledge? Will they be around in the future, and do they have any assets to back their statements?

3. Physical condition. It is more likely now that you will encounter deferred maintenance items or capital improvements, if not seriously deteriorated improvements, so it is important to do a careful inspection of all improvements. Abandoned or partially completed improvements require particularly careful evaluation. In either case, you should evaluate remaining warranties, as well as the issuing parties, and have them assigned with consent by the issuing party.

4. Be prepared. You will likely have a limited timetable to perform due diligence and need to prioritize your main concerns, streamline the process and line up your staff and outside consultants to move quickly.

5. Lease review. Given the overall economic environment today, there is an increased likelihood of default. Security deposits may also have been applied; rents reduced through oral agreements or acceptance of reduced payments; or tenant improvements, credits or other benefits not provided by landlord. Accordingly, it is crucial to verify current lease terms and the status of other issues up front though a written estoppel certificate (preferably at the beginning of due diligence). You should also try to speak with tenants directly and make sure you have copies of the full leasing files for each tenant.

6. Financial condition of property associations. If the property is encumbered by cost sharing or community association obligations, you need a careful analysis of the association's financial condition and, ideally, audited financials. If you will assume the role of declarant under such association, you need to understand any ongoing obligations, whether you will be responsible for funding past or future operating shortfalls, and whether budgets and reserves are appropriate.

7. Title. Title insurance is a different game today, and you can't assume that something you've had no trouble with in years past will go smoothly now. Some title endorsements, like Creditors' Rights, are no longer available at all. Even extended coverage can be difficult to secure. Title companies are much more conservative about from whom they will accept indemnities and affidavits, the percentage required for holdbacks and, in particular, requirements for mechanics' lien coverage. It is imperative to start early and get specific commitments from both seller and title company on deliveries and requirements for issuance of an

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acceptable owner's policy.

8. Liens. Many different liens can derail a transaction, so you need to beware of them all: mechanics' liens (record an original release, not just a waiver); delinquent or sold real estate taxes; brokers' commissions; code violations; property associations; federal/state tax liens; UCC filings; judgment liens; and bulk sales liens are a few common suspects. Some will not appear on title, so it is wise to perform broader searches on your seller through a search company.

9. Development matters. If considering a partially completed project, you need to carefully review public or private development agreements and meet with applicable municipalities or third parties to confirm the status development obligations and financial commitments. If possible, obtain estoppel letters and a rrange for assignment of the obligations you intend to assume (carving out those that you won't).

10. Land use/entitlement concerns. The terms of entitlements should be reviewed carefully to determine whether assignable and suitable for your purpose. Many permits are not transferrable. If the property carries a conditional or special use, you need to make sure that the continued use will be available going forward, especially if the project was abandoned or incomplete.

Although not an exhaustive due diligence checklist, considering these items will make you a more effective and knowledgeable buyer and help you avoid getting tripped up by hidden costs and delays after closing.