

**WHEN YOUR
PROPERTY
IS UNDER THE
MAGNIFYING GLASS**



**LERMAN LAW
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THE REAL ESTATE INVESTOR'S LAWYERSSM

WHEN YOUR PROPERTY IS UNDER THE MAGNIFYING GLASS

*What every commercial property owner must know
to prepare for the financing, refinancing or sale
of your real estate*

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INTRODUCTION

At some point, every property is "sold", and whether this sale takes the form of a sale to a buyer or a financing, the result is the same-your property will be under the magnifying glass.

How attractive your property appears under scrutiny, before, during and after the transaction, will depend in large part on the preparations undertaken in advance of any contemplated sale. Lack of preparation, lack of familiarity with contract terms and their implications, and surprise due diligence discoveries can delay or kill the sale or result in a substantially reduced purchase price or loan amount.

Conversely, proper preparation and familiarity with contract terms and their implications should result in an expedited transaction and a higher realized value for your property.

THE DUE DILIGENCE INVESTIGATION

Preparing for the financing, refinancing or sale of your improved real estate ("Property") begins with an understanding of the due diligence investigation. The due diligence investigation is the detailed and directed examination of your real estate and improvements by purchasers, lenders and their counsel designed to verify assumptions of the purchaser and the representations made by the seller.

The extent of the due diligence inquiries may vary based on the type and size of the land, improvements, particular sale or financing transaction and the nature of the businesses operating in and even around the subject property. The due diligence investigation may be initiated as soon as negotiations begin and usually consists of physical inspections, interviews, questionnaires (including estoppel certificates) and a thorough review of the

documents relating to the property. The following is a list of documents typically requested of an owner seeking to finance or sell his property during the due diligence process:

A. *Tenant Information*

- Rent roll showing, for each tenant, the tenant's name, suite number, size of premises, base rent, rent increases, percentage rent (if any), pro rata share of common area or operating expenses, caps, security deposit, term, commencement and expiration dates, options, exclusive use rights, use restrictions, approval rights, and other material provisions
- All leases [including all exhibits, attachments, guaranties, amendments, supplements, addenda, modifications (formal and informal)] and subleases
- Concessions made to tenants, including free or reduced rent, above-standard tenant improvements, cash payments, moving allowances or takeover of previous lease obligations
- Most recent financial statements and credit information and reports, if any, on any tenant and of any guarantors
- Any executed letters of intent with prospective tenants
- Most recent leasing status report from outside or in-house broker
- Standard form lease

B. *Operating Information*

- Historical financial statements of the Property for prior three calendar years (audited, if available) and for the current calendar year as soon as available
- Year-to-date unaudited financial statements for the Property
- Current operating and capital budgets of the Property, including comparison of actual to budgeted results and an explanation of significant variances
- Listing of capital expenditures for the Property for the prior three years
- Copies of all service, maintenance, leasing, management, or other contracts, and all other agreements, warranties, and guaranties relating to the operation, use, management, or maintenance of the Property
- Copies of real estate tax bills (including special assessments) for the prior three (3) years, including evidence of payment of each
- Aged receivables report through the date of this Letter of Intent and monthly receivables reports for the prior twenty-four (24) months
- Copies of all insurance policies now in effect with respect to the Property, copies of any claims under such policies, and any evidence in Seller's possession that tenants are maintaining the insurance coverages required under their leases

C. Building Information

- Any engineering reports, including reports on foundation, walls, roofs, floors, and supports
- Any mechanical reports, including HVAC
- Any roof reports
- Any environmental reports, including soils tests and asbestos reports
- Any seismographic reports
- Any plans and specifications showing "as built" condition of the Property
- Any reports showing compliance with Americans with Disabilities Act (ADA) requirements
- Any architect's certificate certifying the square footage of the building

D. Real Property

- Title policy with legible copies of all documents relating to exceptions identified therein
- Surveys
- Ground Leases
- Reciprocal easement agreements
- Certificates of occupancy (for the building and for each tenant)
- Copies of any notices of violations of any federal, state, municipal, or other health, fire, building, zoning, safety, environmental protection, or other applicable codes, laws, rules, regulations, or ordinances relating or applying to the Property
- Any correspondence with any government agency regarding the Property

E. Personal Property

- Equipment leases
- Warranties
- Bills of sale

F. Debt Documents (not applicable to sale without assumption of debt)

- Loan agreements
- Promissory notes
- Security agreements
- Uniform Commercial Code filings

G. Material Contracts, Licenses and Permits

- Material contracts (usually with vendors)
- Business licenses
- Permits (building, signage, etc.)

H. Intellectual Property (larger properties only)

- Trademarks (e.g., to Property name)
- Brochures
- Websites

I. Litigation (against the Property, Seller, or any general partner of the Seller that relates to the Property)

- Pending
- Threatened

PREPARING FOR THE DUE DILIGENCE INVESTIGATION

The due diligence investigation will provide the purchaser or lender with a comprehensive picture of the Property's strengths and weaknesses, including matters not including matters not appearing on any listing brochure or financial statements. The risk is that the investigation will highlight your Property's problems and raise questions designed to put you on the defensive, resulting in a lack of bargaining power (yes, even borrowers still have some bargaining power with today's lenders, especially if you are lucky enough to get two lenders competing for your business and/or you are willing to sweeten the pot by maintaining "compensating balances" with the lender).

However, with proper preparation, a due diligence investigation will only confirm your convictions regarding the value of your Property. Following is a list of suggested proactive steps to prepare your Property for its financing or sale:

1. Assemble all information and documents that will most likely be reviewed in the due diligence investigation.

Most property owners have no idea how much information and how many documents are required and how long it will take to assemble (or, in some instances, originate) that information and documents and organize it in a way that presents you and your Property in the most professional and positive light possible. Using the above list as your guide, put together all information and documents either in a single file or binder or in several files or binders so that everything is easily retrievable.

2. Perform an internal due diligence investigation and evaluate the results from a lender's or purchaser's perspective.

Now that you have all the information and documents which a lender or buyer will most likely want to review, perform your own due diligence investigation, putting yourself in

their shoes and employing the most objective and critical eye possible. Anticipate questions, comments and concerns that a lender or buyer may have.

3. Identify the following:

- a. Which agreements, licenses, permits, debt documents are assignable and under what conditions;
- b. Which agreements will require prior notice or consent to any change of control, and;
- c. Which contracts are not assignable.

Negotiate the removal of provisions in material contracts that prohibit (or threaten to frustrate or delay) assignments in the event of a sale of the Property in the manner anticipated.

4. Resolve disputes.

Identify and resolve any threatened or pending claims [especially those from tenants (which could potentially impact lease revenue) and from contractors (which include or could potentially result in mechanics liens)]. If a dispute has escalated to the point of actual litigation, bring the matter to a prompt resolution if at all possible [e.g., by compromise and settlement (using informal negotiation or formal alternative dispute resolution methods such as mediation or arbitration) or by motion for summary judgment or motion for judgment on the pleadings). Any open litigation will at best complicate and at worst de-rail any financing or sale.

5. Title.

Obtain an updated title report (sometimes referred to as a "date down"), familiarize yourself with the condition of title, make sure it is "marketable" and free and clear of all objectionable encumbrances or "clouds". Make sure you have legible copies of all underlying documents; if you do not, it may take considerable time to try to track down copies that can be read and understood, which any purchaser or lender will require as a condition to closing any loan or purchase.

6. Check rent roll to optimize Property's value.

Review your rent roll to determine if you have any "upside potential" you can take advantage of in the near future. Do you have below-market leases? If so, are they coming due soon? If they are, you may choose to wait until you can bring those rents up to market (either by renewal or releasing to another tenant at market rents). For every dollar of additional net operating income you can generate, you may receive a multiple of that in the form of an increased loan or selling price. Similarly, do you have any leases you want to make sure you keep (because they are with a credit tenant) but they are running out within the next 1 to 2 years? If so, consider approaching those tenants now and negotiate an early extension of their lease, if possible; their presence adds value and,

conversely, the risk of their future vacating of the premises could detract from the Property's value.

7. *Perform deferred maintenance and repairs.*

Walk your Property with a critical eye. Pretend you are seeing it for the first time. See it through the eyes of your potential buyer or lender's appraiser. Do you have any deferred repairs or maintenance? Items like painting, landscaping, signage, directories, and parking lots frequently provide a first impression of the quality of a property; if that impression is negative, it will be reflected in the price. Similarly, if you can dress up the curb appeal of a Property by investing resources to clean up these areas, you will almost certainly reap the rewards in a higher property value. Larger repair items may be handled differently for a loan as opposed to a sale. A lender may require these items to be repaired as a condition to funding a loan or, alternatively, may require a mandatory impound of a replacement reserve. If you are selling, however, it may be best to disclose the repair item and simply allow the buyer a reasonable credit to perform the work himself. That way, if there is a problem with the repair (say, for example, a roof), the buyer/new owner can look only to the contractor he selected-and not to you-for his remedies.

8. *Consider ordering third party reports.*

Typically, third party inspections and preparation of the resulting reports (physical inspection, hazardous waste inspection, surveys, and appraisals) are the most time-consuming part of the due diligence process. To make matters worse, they provide some of the greatest potential for revealing unhappy surprises that could end up costing you money (for unanticipated repairs) and delays (if those repairs are significant). You may minimize these risks by obtaining your own report in advance to minimize these surprises down the road. However, be forewarned: this strategy is not without risk. First, the cost of these reports may not be recoverable; there is no guarantee the lender or buyer will accept your reports in lieu of obtaining their own. Second, if your reports reveal any material fact that a reasonable lender or buyer would want to know, you must disclose this fact.

IMPORTANT:

Please note that with any material produced as part of the property owner's internal review, there is a risk that such information or documents will be used against the owner in subsequent litigation. It is therefore imperative that a review, particularly in areas where compliance with applicable laws are being investigated, should be conducted by experienced counsel who will see that such a review is tailored properly to your Property's size, type and other relevant circumstances and, to the extent allowed by law, benefits from protections available under the attorney-client and privilege and attorney work product rule.

**PREPARING TO NEGOTIATE
THE FINANCING OR SALE
AGREEMENT**

Thorough preparations for the due diligence investigation will expedite the financing or sale of your Property. You will be able to reply to due diligence requests quickly and completely, identify and solicit necessary consents to the transaction, and discover and remedy problems which may have a negative impact on the value of the Property. However, these efforts alone cannot protect you from costly concessions at the negotiating table.

Loan agreements and purchase contracts often begin with a "standard" form. Simply because language is characterized as "standard" does not mean your standard of review should be lowered. Everything in the agreement should be viewed as price-related and fully negotiable (having said that, I am quick to acknowledge that today's lenders are much more sophisticated and less likely to make concessions than those of a decade or two ago; especially if the lender is a conduit packing and selling a basket of "standardized" loans to the secondary market). Representations and warranties, covenants and indemnities can turn out to be costly undertakings years down the road. Consider these continuing liabilities as concessions that can be limited, eliminated or shared.

Following are suggestions for (1) preparations to be taken before entering into negotiations, and; (2) how to approach the loan agreement or purchase contract.

Before Negotiating:

1. Make the recommended due diligence preparations (see above);
2. Evaluate the implications, particularly the tax effects, of different transaction structures (e.g., straight sale vs. 1031 tax deferred exchange);
3. View your Property and market (by geographic region, type of property, etc.) from the lender's or purchaser's view and be prepared to extol your competitive position therein;
4. Establish control over the financing or sale. If you have partners, solicit and obtain their approval;
5. Know your bottom line;
6. Determine if you need a broker (you may know the "best" lender or potential buyer already and can approach them directly; by doing so, you may save money by cutting out the broker "middleman"). Even if you decide to use a broker, determine if you have any lenders or prospective buyers you want to "exclude" from the broker's commission agreement for a limited time (usually no more than 30-60 days at most) to enable you to make a deal with your existing relationships.

Approaching the Contract:

1. If possible, "control" the documents by having your legal counsel be responsible for drafting the necessary contracts. This puts you in the position of accepting or rejecting comments as to proposing them.
2. Limit your representations and warranties, covenants and indemnities. Remember to view the contract terms as being price-related; representations and warranties, covenants and indemnities represent continuing liabilities to you and should be given only with proper regard to the purchase price being offered as compared with the approximate economic risk the representations and warranties, covenants and indemnities potentially represent. Consider survival of representations and warranties beyond the execution of the contract and the closing in the same light.
3. Since representations and warranties are your guaranty to the purchaser of lender that the affirmations of facts contained in the contract are correct, offer only representations of facts that have been verified and attempt to limit them to those within your actual knowledge without any duty of inquiry or investigation (as opposed to the "best" of your knowledge).
4. Limit indemnities with the use of a time limit (i.e., a date on which the indemnity will expire), a cap (i.e., a limit on your maximum aggregate liability) and require mutual indemnification with a comparable limit and cap (typically, the seller indemnifies for liabilities accruing prior to and through the closing and the buyer indemnifies for liabilities arising after the closing).
5. Consider the potential tax effects to you of any allocation of the purchase price.

CONCLUSION

The dynamics of each financing or sale are unique and depend in large part on the size and nature of the transaction, the type of property, and the relationship between the parties. These tips introduce you to measures you can take today to maximize your Property's value and attractiveness to potential lenders and purchasers. Careful preparation for an anticipated financing or sale should expedite the transaction, maximize your net economic result, reduce your post-sale liability and allow you to enjoy the cost-savings typically associated with doing things right the first time.