

## The Basics of Commercial Real Estate Transactions: Due Diligence

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The most enduring maxim of any transaction is “caveat emptor,” therefore a key element of any commercial real estate transaction is due diligence on the part of the purchaser. A thorough investigation into the fundamentals of the property, the seller, the financing and the deal itself is the most crucial form of protection a purchaser has. Such an investigation exists to prevent surprises that might arise post-transaction. This post will briefly cover some essential elements of due diligence in the commercial real estate transaction.

First of all, the necessary scope of the due diligence will arise from the goals of the acquiring party. The goals of a developer seeking to improve property will vary from those of a mere investor looking to maximize a revenue stream. The purchaser should begin due diligence by determining the property’s expected uses after the transaction and using that as a framework for the investigation.

Due diligence then seeks to answer several questions, starting with the property itself. What is the full extent of the property the purchaser is acquiring? What rights are inherent in the sale? What assumptions are made as to the future use of the property? The investigation should cover every aspect of the property, from the very rights conveyed by the fee title to development rights. The investigation should look for restrictions that might inhibit the purchasers planned use of the property, such as zoning restrictions, licensing requirements and legal compliance issues with laws such as the Americans with Disabilities Act. Investigate all current uses of the property for the terms of any leases involving the land or any obligations to lessees that transfer with the property. It may seem just like common sense, but a thorough review of the property survey may yield new questions. The purchaser should ask for, receive, and scrutinize every single document related to the property. An insurance policy, for instance, can be a wealth of information on the property, and any claims history can provide clues as to the property’s past. A title insurance policy should provide information on easements and encumbrances that might affect the property’s future use.

The next step is to look to the seller itself. The purchaser should determine the full extent of the seller’s interest in the property. If the seller is an entity, the purchaser should verify the standing of that entity with the appropriate agencies. Due diligence should determine definitively that the seller possesses both the interest being sold as well as the authority to sell. The financial standing of the seller is also important, as a bankruptcy can affect multiple aspects of the transaction. Ask the seller for tax returns, service contracts, loan documents,

balance sheets, profit and loss statements, bank statements, utility bills and any other documents that may relate to the seller's financial status and use of the property. The seller may balk at such extensive requests, but a seller should understand that a sale requires as much scrutiny of the seller as of the property being sold.

The remainder of the investigation should thoroughly analyze all details of the financing and the deal itself, assessing any potential hidden or future costs, revenue streams, potential liabilities, etc. Fully understand the entirety of the transaction and confirm any assumptions. Evaluate all conditions precedent to the sale for completion.

The contract for sale should include ample time for due diligence. This time should be a date reasonably past the delivery of the last documents required by the purchaser to complete due diligence; this will both ensure sufficient time for review as well as give an incentive for the seller to deliver the documents quickly and effectuate the sale. The sale should be contingent upon written acceptance of the due diligence provisions, and that this acceptance is solely at the discretion of the purchaser.

This post is not meant to be an exhaustive list of due diligence items, but merely an initial starting point. Due diligence requires a thorough understanding and evaluation of the details of the transaction to a point where the purchaser believes that she or he is fully aware of all the costs, uses, interests and potential liabilities inherent in the purchase. The purchaser should have peace of mind that the property will provide all expected uses post-transaction with no restraints. If you need assistance with due diligence on a commercial real estate transaction, the attorneys of McBrayer can guide you through the process.

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