



GUEST ARTICLE

Don't Forget the Dirt

By Iryna Lomaga Carey, New Jersey IWIRC member and Partner in the Real Estate Department of Cole, Schotz, Meisel, Forman & Leonard, P.A.



Iryna Lomaga Carey

Do you think you are getting a bargain buying a loan or other asset in the distressed real estate market? Purchasing a loan or other real estate asset at a discount from an owner/operator or an existing lender can often produce a high return on your investment. However, in addition to market risk, you should also consider all of the other factors associated with acquiring real estate before you commit to the purchase. It is important to remember that your collateral for the investment is either in whole, or in part, the real property securing the loan or other asset, and that you may ultimately need to sell or own the “dirt” one day. Thus, you need to conduct the same due diligence you would expect to complete if you were actually acquiring the real property in a direct purchase or underwriting a real estate based loan. This includes, at a minimum, obtaining an updated title commitment, reviewing the existing survey, examining existing environmental reports and investigating the seller's records and initial underwriting analysis.

Failure to complete a thorough examination of the loan and underlying collateral may have negative consequences. Just because a parcel of real property was valuable as collateral five or ten years ago does not mean it has the same intrinsic value today. Many factors, aside from market conditions, may impact value. For instance, zoning and redevelopment plans, environmental conditions and title issues can have both a negative or positive impact on value and should be examined thoroughly depending upon a purchaser's intentions with respect to the collateral.

A typical due diligence period in a real estate transaction can be as long as one hundred eighty days. Often, a seller of a distressed asset is seeking to close quickly and will agree to only a thirty day or less due diligence period. In the rush to close, a purchaser frequently must rely on the due diligence materials provided by the seller. While the purchase agreement is being negotiated, it may be prudent to begin the due diligence process and seek to obtain from the seller or lender its due diligence files. It is important to remember that the lender or other seller of the asset may have completed its title, survey and environmental due diligence years ago, and reliance upon outdated information is extremely risky. However, updating title and environmental is always easier with baseline documents, even if they are dated. It is important to include in the purchase agreement a covenant for the seller or lender to provide all of its files, or at least access to same, once the purchase agreement is executed. It is critical to review all assumptions underlying the appraised value upon which the existing loan was based, and all factors and/or risks which may have affected the lender's imputed value of the property. Knowing what the seller or lender relied upon in connection with the previous transaction, and the level of risk assumed by the seller or lender is helpful.

An updated title commitment and survey should be fairly inexpensive to obtain quickly, particularly if you have the title policy and survey relied upon by the seller or lender in connection with its transaction. A complete examination of all title exceptions, including easements, declarations, and all encumbrances is critical to assessing value, particularly if the acquisition requires you to assume existing conditions. Easements and use restrictions may have a significant impact on value. If foreclosure is likely, as the note being acquired is in default, consideration must be given as to how those conditions and/or restrictions will impact future development. It is important to determinate whether encumbrances, like use restrictions, are expired or no longer enforceable.

For instance, in the retail setting, an exclusive may be valid only so long as the tenant is open and operating. In addition to the condition of title, a review of zoning and land use restrictions is also useful, as they may impact use, expansion and development of the underlying real property. If the property's original loan to value ratio was based upon existing or pending site plan approval, review of the status of the approval will be required. In addition to land use considerations, a complete review of building or other municipal violations is important and should be completed as part of the title assessment. This will enable the purchaser to determine whether any serious and/or costly violations exist which need to be addressed before closing. Finally, if acquiring the real property, it is prudent to obtain a new title policy to ensure that title is insured in the name of the purchaser.

Obtaining a new Phase I may be necessary depending on historical or current operations at the property. Obtaining a reliance letter from the environmental consultant, for a nominal fee, may be all that is necessary. However, although historical uses may have been investigated by the seller or lender, current use also must be evaluated. Depending upon the results of the Phase I, more in depth investigation by way of a Phase II may be necessary to assess the underlying risk associated with ownership of the real property. Depending upon Phase II results, you may wish to explore the possibility of obtaining environmental insurance. However, completing a thorough environmental analysis is frequently challenging if the due diligence period is less than sixty days.

If the property is leased, whether you are acquiring the loan or the underlying collateral, a thorough review of all leases is critical in evaluating value and potential cash flow. More importantly, if the real property is ground leased, a thorough examination of the ground lease terms and conditions is critical. Often lenders do not have accurate data regarding the status of existing leases, expiration dates and defaults. Estoppel certificates are useful in assessing whether there are any potential tenant issues and/or disputes with the seller. Also, it is critical to determine whether there are any uncured seller defaults and any contingent obligations of the seller which typically would be assumed by any purchaser. These unknown potential liabilities could have a negative impact on property value.

Finally, there are some less obvious considerations which often are overlooked in a typical due diligence analysis. For instance, what is the nature of existing loan defaults? Are there both covenant and payment defaults? Pending litigation is another issue which sometimes surfaces in title review and examination of public records, but not always. It is important to obtain representations from the seller regarding loan defaults and pending or potential litigation, as this is often the only way they are discovered. Typically, a seller will not reveal this information unless required to under the purchase agreement. It is important to obtain broad representations from the seller or lender, to the extent practical, to protect a purchaser on those areas where it is nearly impossible to obtain complete assurance through the due diligence process. An indemnification for breach of such representations and warranties is also beneficial, although once the transaction is closed, a seller who is not a lender may not have the resources to backup the indemnification.

The bottom line: to protect your investment and maximize your potential rate of return, make sure to complete a thorough due diligence and do not rely exclusively on historical, outdated information produced by the seller.