Look Before You Leap: Why Due Diligence Matters in Commercial Real Estate

Sarah C. Federation, Esq.

Buying commercial real estate is a major investment. A property may look perfect on paper—and even in person—but there can be important details beneath the surface that affect its value, usability, and future costs. That is where **due diligence** comes in. In commercial real estate, due diligence is not simply a checklist to complete before closing. **It is one of the most important decision-making tools a buyer has.**

Due diligence is the process of investigating a property before closing on the purchase. The process typically begins after the parties sign a purchase and sale agreement and continues through a defined period of time. During that time, the buyer and its professionals review documents, inspect the property, investigate zoning and land use, examine title and survey matters, review leases and financials, and investigate other issues that could affect the transaction. The exact scope of due diligence depends on the property and the deal. A small owner-occupied office building will have different considerations than a shopping center, industrial facility, multifamily property, or development site.

Why Does Due Diligence Matter?

The property's current use may not comply with zoning requirements, an easement may limit future development, or a survey may reveal an encroachment. The roof or other building systems may be nearing the end of their useful lives, an environmental assessment may identify a potential concern, or existing leases may contain obligations or restrictions the buyer did not anticipate. There may be tenant rights that affect the buyer's plans, outstanding municipal violations, missing permits or approvals, or operating expenses that are substantially higher than expected. None of these issues necessarily mean that the buyer should walk away. But the buyer should know about them **before closing**, rather than discovering them after becoming responsible for the property.

The Purchase and Sale Agreement Sets the Stage

One of the first things a buyer should understand is that the due diligence process is closely tied to the purchase and sale agreement. The agreement establishes the buyer's due diligence period, access rights, inspection rights, termination rights, and deadlines for raising certain objections. This is important because the due diligence period is not an open-ended opportunity to investigate the property whenever the buyer wants. **There are deadlines**. A buyer who waits until the end of the due diligence period to order an environmental assessment, obtain a survey, or investigate zoning may find that there is not enough time to address an issue.

Title: What Exactly Are You Buying?

Title review is one of the **fundamental components** of commercial real estate due diligence. The buyer's attorney will typically review the title commitment or title examination to determine who owns the property and what other interests or restrictions affect it. Some title matters may be routine. Others can have a significant impact on how a property can be used.

The Survey: Where are the Property Lines?

A survey provides another important piece of the puzzle. A survey can help confirm property boundaries and identify easements, encroachments, setbacks, access, and other physical features affecting the

property. A fence may cross a property line. A driveway may sit partially on another parcel. A building or other improvement may be closer to a boundary than expected. These details can become particularly important if the buyer plans to renovate, expand, add parking, construct an addition, or otherwise change the property. In other words, the question is not simply **"Where is the property?"** It is also **"What can I do with it?"**

Zoning and Land Use: Can You Actually Use the Property as Planned?

One of the most important parts of due diligence is confirming that the buyer can legally continue the property's current use and pursue any planned expansion. A buyer should not assume that because a business has operated at the property for years, the same use is automatically permitted. Zoning and land use due diligence should address the property's zoning classification, whether the intended use is permitted, whether the existing use is legally nonconforming, whether special permits or variances are required, development or expansion limitations, and whether the buyer's future plans are feasible. This is especially important when purchasing property for specific business use because a property may be physically ideal for the business but legally unsuitable.

Physical Condition: What Are You Really Buying?

Physical inspection is often the part of due diligence that buyers think about first. Commercial buildings contain many expensive components, including roofs, HVAC systems, electrical, plumbing, elevators, fire protection systems, parking areas, and structural components. The more important question is whether the buyer understands the property's condition and the likely costs of maintaining it. For example, a roof that is functioning today may still require replacement in the next few years. An aging HVAC system may continue to operate but represent a significant future capital expense.

Environmental Due Diligence

Environmental due diligence is another important consideration in commercial real estate. Prior uses of the property or neighboring properties may create potential environmental concerns. A buyer may obtain a Phase I Environmental Site Assessment and, if appropriate, additional environmental investigation. The purpose is not to assume that every commercial property has an environmental problem. Environmental concerns can affect not only the property's value, but also financing, redevelopment plans, and future ownership costs.

Leases: The Property May Come with Tenants

The building may only be part of what the buyer is purchasing—the tenants and their leases are equally important. A buyer should review the existing leases to understand the rent, lease expiration/renewal dates, security deposits, tenant improvement obligations, operating expenses, maintenance responsibilities, assignment and subletting rights, tenant options, and obligations that will continue after closing. Because the leases are a major part of the property's value as an income-producing investment, a buyer should make sure the anticipated rental income is realistic before closing.

Tenant Estoppels: Hearing Directly from the Tenants

A tenant estoppel allows the buyer to obtain confirmation from a tenant about important aspects of its lease and relationship with the landlord. For example, the tenant may confirm the rent, lease term, security deposit, and whether there are known defaults or outstanding claims. This gives the buyer an

opportunity to compare the landlord's information with information coming directly from the tenant and confirm important items.

Financial Due Diligence: Does the Property Make Sense as an Investment?

Buyers should review rent rolls, operating statements, property taxes, insurance, utilities, repairs and maintenance, management expenses, and capital expenditures to understand the property's financial performance and determine whether it supports the buyer's expectations. Buyers should also consider future expenses that may not appear in a year's financial statements, such as a roof that is nearing the end of its useful life and may require replacement. The goal is to understand both the property's current financial performance and its anticipated future costs before closing.

Municipal Records and Permits

Due diligence may include reviewing building permits, certificates of occupancy, zoning approvals, inspection reports, and outstanding violations. The buyer wants to know whether the property has the approvals necessary for its current use—and whether the buyer's intended use will require additional approvals. This is particularly important if the buyer intends to make changes to the property after closing. A planned renovation, addition, change in use, or expansion may trigger requirements that are not obvious during an initial property tour.

What Happens When Due Diligence Finds a Problem?

Finding a problem does not mean the deal is over. Discovering an issue during due diligence gives the buyer an opportunity to address it before closing. Depending on the purchase agreement and the nature of the problem, the seller may agree to fix it, the parties may negotiate a purchase price reduction or closing credit, or the buyer may investigate the issue further. If the problem is significant and the purchase agreement allows the buyer to terminate during the due diligence period, the buyer may decide to walk away. The important point is that the **buyer has options because the issue was discovered before closing**.

Due Diligence Is About More Than Finding Problems

It is easy to think of due diligence as an exercise designed to uncover everything that is wrong with a property. That is not really the goal. A successful due diligence process may confirm that the property is exactly what the buyer thought it was - The title is clean. The zoning works. The building is in good condition. The leases make sense. The environmental investigation is satisfactory.

Don't Let the Due Diligence Period Become a Race Against the Clock

One of the biggest practical lessons in commercial real estate is that due diligence takes time. Title work, surveys, environmental reports, inspections, zoning research, lease reviews, and financial analysis take time—and some issues cannot be fully evaluated until another piece of information is received. A well-planned due diligence period leaves enough time to follow those issues wherever they lead.

A successful commercial real estate purchase is not simply about buying the right property. It is about knowing exactly what you are buying—and making sure it works for your plans.

***The foregoing was presented for conversational purposes only, it is not legal advice, and does not create an attorney-client relationship.**

The information in this article was provided by Attorney Sarah C. Federation from our Springfield Office. Attorney Federation is an Associate in our firm's Corporate and Commercial Law Department, from our Springfield Office. She is a member of the Hampden County Bar Association as well as the Governance Advisor on the Executive Committee for the Young Professional Society of Greater Springfield.