

Commercial Real Estate Due Diligence - Checklist

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COMMERCIAL REAL ESTATE DUE DILIGENCE

Checklist

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The following checklist is intended to assist real estate professionals in their due diligence in respect of commercial real estate acquisitions in Ontario. The checklist does not purport to be an exhaustive list of the matters that may be considered in connection with a potential acquisition of property. Nor is it intended to summarize the myriad off-title searches that counsel for the prospective purchaser may undertake. If requested, the writer would be pleased to direct anyone interested to a number of very good checklists of such searches.

As will be noted throughout the checklist, in addition to a real estate lawyer, depending on the complexity of the property, the prospective purchaser's team may also include: an experienced real estate salesperson, land use planner, environmental consultant and surveyor.

1. PRE-OFFER / PRELIMINARY DUE DILIGENCE

At the preliminary stage, the prospective purchaser will have to determine the extent of due diligence it wishes to undertake prior to entering into an Agreement of Purchase and Sale. Some purchasers do not wish to invest time and money in a potential transaction at this stage. If the property is listed for sale, certain preliminary information may be available from the listing real estate agent. In addition, property information such as zoning, real estate taxes and availability of municipal services can be obtained from local municipal offices. Most Ontario real estate solicitors have access to Teraview software which allows them to perform online title searches throughout Ontario. For a nominal fee a solicitor can subsearch title to the property to verify that the purported owner of the property is indeed the owner. Other relevant information such as the previous purchase price, encumbrances and easements is also disclosed by such a search.

- Property Details
 - address
 - location
 - legal description
 - lot size
 - building (number of buildings, number of stories)

- rentable area of each floor
- other structures
- services (municipal water, sewer and sanitary systems)
- Title Subsearch to verify name of registered owner, period of ownership, previous purchase price, encumbrances
- Corporate Search of Vendor- corporate profile report
- Current zoning and present uses

2. VENDOR'S DELIVERIES

From the Purchaser's perspective, it may be more cost effective to obtain and review the vendor's property information prior to engaging a lawyer to draft and negotiate an Agreement of Purchase and Sale. However, many vendors will be reluctant to provide extensive deliveries pending execution of a definitive agreement or, at the very least, a letter of intent. Also, the extent of the vendor's deliveries will depend on the nature of the property and the level of sophistication with which it has been managed.

I. General

- Appraisals - copies of existing or previous appraisals
- Chattels List - a list describing all equipment, machinery, attachments, appliances, chattels and tangible personal property necessary for or used in connection with the operation, management or maintenance of the property
- Tax Bills - copies of current tax bills, including realty taxes, business taxes, occupancy taxes and special assessments for the previous two years
- Utility Bills - copies of all monthly utility bills for last two years including water, sewer, hydro, gas, water heater, drainage maintenance etc.
- Notice of Assessment - current realty tax assessment notices with reasonable detail of any outstanding complaints, applications, reconsiderations of assessments or appeals made by the Vendor, a tenant or by a municipal tax officer or assessor relating to the assessment of property taxes, including any application to the relevant municipality for a cancellation, reduction or refund of all or a portion of property taxes with respect to the current or prior year

- Encumbrances - copies of all encumbrances which are not registered against title to the property
- Agreements - all agreements, including sign leases, telecommunication agreements, management agreements, parking licences or permits
- Contracts - all contracts in any way related to the supervision, operation, management, servicing, maintenance, repair or cleaning of the chattels or the property or the furnishing of supplies and services thereto, and billing for the last 12 months, with a list of all suppliers and addresses
- Warranties and Guarantees - copies of all warranties and guarantees relating to the chattels, lands and buildings
- Survey - an up-to-date survey of the property, certified by a duly qualified Land Surveyor, showing the current location of all structures, buildings, fences, improvements, easements, rights-of-way and encroachments affecting the property (alternatively, existing survey in the Vendor's possession or control and surveyor's real property report)

As noted below, depending on the purchase price of the property, title insurance coverage may be available for defects that would be revealed by an up-to-date survey. Since the introduction of title insurance in Canada, it has been the writer's experience that an up-to-date survey is rarely provided. At best, the survey may be an "existing survey" which is often not up-to-date or even legible. While title insurance is helpful in this regard, it is not a substitute for an up-to-date survey.

- Vendor's Authorizations - executed authorizations to all relevant governmental authorities having jurisdiction permitting inquiries by the Purchaser or the Purchaser's solicitors as to outstanding work orders, compliance with health, fire by-laws, etc. and authorizing the release of any and all information on file in respect of the property

It is not uncommon for vendors to insist that the form of authorization must specifically state that "this is not a request for and does not authorize an inspection of the property". Vendors do not want to expose their properties to inspections by governmental and quasi-governmental authorities, such as, for example, fire or health departments, especially where the transaction is still conditional on the purchaser's due diligence.

- Plans and Specifications - all architectural, mechanical and engineering plans and specifications and as built drawings (including approved drawings and specifications relating to tenant improvements)

- Permits - copies of all building permits and development permits, and any permits, orders, licences, consents or approvals with respect to the property (including permits relating to tenant improvements)
- Property Reports - copies of all previously completed reports addressing the physical or environmental condition of the property including building condition reports, maintenance or inspection reports, soil tests, topographical, structural or engineering reports and environmental studies and reports and remediation plans (including draft reports or raw lab test reporting where no final report was prepared), including all such items previously requested by or provided to mortgagees
- Reliance Letters - executed reliance letters and authorizations to the authors of all of the reports and studies submitted to the Purchaser, permitting the Purchaser to rely on such reports and studies

The scope of any experts' investigations should be carefully considered as should any limitation of the liability of the authors of the reports. In this regard, it may be prudent to review the original proposal or engagement letter from the authors of the reports.

- Work Orders - copies of work orders, notices, directives or letters of non-compliance issued by any governmental authority, if any, including any such items relating specifically to building, zoning, fire, health and elevator inspections, together with copies of all building, occupancy and operating permits, licences, consents or authorizations, together with copies of any notices or other correspondence with any applicable municipal or other authority in respect of such work orders, notices, directives, licences, permits, consents or authorizations
- Insurance - copies of all current policies of insurance including all riders and risk assessments, and any inspection reports received from insurance company

II. Deliveries related to Tenanted Property

- All leases, including all amendments, extension agreements, all material correspondence and other offers or agreements
- Access to building files and tenant files including correspondence to and from tenants relating to any outstanding issues associated with the leases
- Rent Roll / Lease Summary
 - name of tenants and subtenants

- leased premises (suite/unit number, floor)
 - term (commencement date and expiration date)
 - rentable area (square footage)
 - option to extend
 - right of first offer or right of first refusal
 - option to purchase
 - base rent
 - additional rent / percentage rent
 - security deposit / pre-paid rent
 - termination right
 - exclusive right
 - maintenance and repair obligations
- Rentable area measurements and certificates prepared in accordance with leases and/or BOMA Standard Method of Measuring Floor Measurement
 - Tenant Acknowledgements (confirming lease details, purported landlord defaults, outstanding tenant allowances, inducements, improvements)

In the ordinary course, Vendors prefer to obtain and deliver Tenant Acknowledgements prior to closing rather than during the purchaser's conditional period. This is because most landlords are reluctant to inform tenants of the pending sale of the property while the transaction remains conditional. From a Purchaser's perspective, it may be desirable to review Tenant Acknowledgements prior to having invested in extensive due diligence. Alternatively, the Purchaser should insist that its obligation to close the transaction is conditional on being satisfied with the Tenant Acknowledgments.

- Operating expense statements and budgets with respect to the property, for the two most recently completed fiscal years of the Vendor, prepared on the basis of generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS), by the Vendor's accountant, including projections of current year's operating costs
- A detailed listing of all expenses paid directly by tenants together with all copies of proof of payment, invoices, and contracts and a sample of a tenant billing for reimbursable expenses

- Financial statements for the last two (2) years (audited, if available), and monthly financial statements for the year-to-date beyond the most recent financial statement

- All listing agreements for rentals at the property

Commissions may be payable at the time of renewal of any lease. Therefore, the matter of responsibility for payment of commission needs to be addressed. Consideration must also be given to whether the Vendor or Purchaser is responsible for tenant allowances, inducements and concessions payable after Closing.

- Details regarding application for LEED certification, if applicable

The Leadership in Energy and Environmental Design (LEED) Green Building Rating System™ is a third-party certification program and a benchmark for the design, construction and operation of high performance green buildings

- Information regarding Feed-in Tariff (FIT) Program, if applicable

The Ontario Power Authority (OPA) is responsible for implementing this program which allows building owners to contract for renewable energy generation such as, for example, rooftop solar panels. The OPA pays the contract holder for the electricity produced by the project.

III. Deliveries related to Assumption of Existing Financing

- copies of the existing mortgage and all documents related thereto
- all loan documents
- conditions of assumption
- any fees or penalties
- a letter from the Vendor to existing lender authorizing it to discuss with the Purchaser all issues and release all information relating to assumption of the mortgage
- written consent/approval from existing lender in respect of the assumption of the mortgage by the Purchaser or its assignee
- an up-to-date statement for assumption purposes addressed to the Purchaser

3. DUE DILIGENCE AFTER EXECUTION OF AN AGREEMENT OF PURCHASE & SALE

I. Various Experts

- New appraisal (may be required as a condition of financing) – to be performed by a qualified property appraiser
- Up-to-date survey – to be performed by a qualified Ontario land surveyor
- Environmental reports - Phase I and, if indicated by the Phase I, Phase II Environmental Site Assessment (hazardous materials, pollution, solid waste, wastewater, air issues, asbestos, PCB's, radon, lead, etc.)

As with any expert, the scope of the proposed investigations must be carefully considered as should any proposed limitation of liability of the authors of the reports. Further, if it is intended that the reports be relied upon by a lender or other third parties, the matter of reliance letters should be addressed prior to engagement of the experts.

II. Lawyer's Searches

- Full title search
 - encumbrances e.g. mortgages, charges, debentures, encroachments, easements, restrictive covenants, liens, leases etc.
 - adjoining lands search re Planning Act
 - crown patent
 - previous corporate owners
- Confirm access for vehicular and pedestrian ingress and egress to public road or highway
- Municipal Services
- Execution search against Vendor
- **Corporate Searches**
 - Corporate existence - Vendor and previous corporate owners by obtaining Certificate of Status, Corporate Profile, Document List
 - Bankruptcy and Insolvency Search
 - PPSA Search - Personal Property Security Act in Ontario

- Bank Act
- **Off-Title Searches**
 - Property Tax Certificate
 - Arrears Certificate including water, hydro, gas and any other utilities charges
 - Building compliance report
 - Zoning, permitted use, Official Plan designation

In the ordinary course, solicitors submit inquiries to the local municipality requesting confirmation of compliance with zoning. For the most part, municipalities, including the City of Toronto, will not review a survey submitted in connection with such an inquiry. The response is likely to merely indicate the zoning designation of the property. Therefore, it will be up to the purchaser's solicitor to review the zoning. In the absence of an up-to-date survey, compliance of any building on the property with coverage and setback requirements cannot be verified. Further, given the increasing complexity of zoning in Toronto some solicitors may be reluctant to provide zoning advice. In addition, while Teraview has allowed solicitors to search titles and close transactions throughout Ontario, they may not be familiar with the zoning issues they encounter in all such jurisdictions. Therefore, depending on the nature of the property, it may be prudent to engage a land use planner to conduct a zoning review and report on matters such as density, parking and use conformity. An alternative may be title insurance for non-compliance with zoning by-laws affecting existing uses. However, title insurance does not cover future proposed uses.

- confirm compliance with registered municipal agreements - subdivision agreements, development agreements, restrictive covenants
- confirm compliance with registered third party agreements - reciprocal agreements, cost-sharing agreements
- Hydro unregistered easement (municipal)
- Hydro unregistered easement (provincial)
- Conservation Authority
- Environmental - Index Review Report

- Environmental - records under the Freedom of Information & Protection of Privacy Act

In order to avoid redundancy, check with firm doing Phase I Environmental Site Assessment whether these searches will form part of its investigations.

- Fire Department
- Health Department
- Electrical safety
- Elevator
- Fuel tank - underground/aboveground
- Boiler and pressure vessels
- Airport Zoning Regulations

For example, because of its proximity to the Toronto Pearson Airport, much of Brampton is subject to regulation by the Greater Toronto Airports Authority (“GTAA”). Therefore, should development of a site within the regulated area be considered, detailed plans must be forwarded to GTAA for review. Similarly, it may be necessary to engage a land use planner to determine whether an existing building complies with the regulations.

- Properties listed/designated for Heritage Preservation
- Cemetery
- Corporate owner search

4. TITLE INSURANCE

Depending on the value of the property and the complexity of the transaction, title insurance may be a valuable tool in reducing the scope/cost of due diligence. Coverage for unmarketability of title and other matters such as existing zoning and defects that would be revealed by an up-to-date survey is available from various title insurers, including First Canadian Title, Stewart Title and Title PLUS (developed by Lawyers' Professional Indemnity Company (LAWPRO[®])). LAWPRO underwrites the professional liability insurance program for all members of the Ontario bar amongst others.