Hairy Deals

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An article emphasizing the importance of seller due diligence.

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In any commercial property sale, especially in high-value congested urban areas, there's usually some "hair" of some kind attached to the property somewhere – something about the property that makes it less than perfect. Maybe there's a title issue, a lease with weird renewal rights, a tenant in trouble, a minor problem with an exterior wall, or an issue about the legality of one of the rental spaces.

In a frenzied seller's market, buyers often overlook that hair. In a more buyer-friendly market, such as today's, it's different. Any variance from perfection creates a hook for negotiations, price adjustments, and contingencies. Something a buyer might have overlooked in 2013 leads in 2018 to agonized conference calls, long meetings, and complex contractual clauses and procedures.

That dynamic plays out, at its worst, if the buyer doesn't identify the hair in its early investigations, the parties sign a contract with a due diligence period and a free out, and the buyer discovers the problem through its due diligence. By then, the other potential buyers have gone on to other things. The seller has only one buyer left, the one that had a due diligence out and found a problem that it claims will be very expensive to solve and wasn't taken into account in its financial model.

Unless the seller wants to start over, the seller just has to deal with the hair, often with a price adjustment, a delayed closing, a contingency, an obligation to obtain something from a third party, complex post-closing obligations, a larger holdback, or some other unappealing measure.

To avoid these problems, a seller that plans to take its property to market should know more about its property than any buyer will ever figure out. The seller needs to get ahead of the process. If it knows about a possible issue it should try to do something about it before it becomes a problem. Ideally, before the seller lists the property the seller will identify all issues with the property and solve them, so buyers can't find them – which the seller should assume they will – and then express concern about them.

That isn't always possible, of course. Sometimes the seller doesn't necessarily want to "solve" a "problem" with the property unless there's a closing. For example, if the "problem" consists of a long lease that will impede development, that lease might not be a problem at all if the seller doesn't sell. It might be a good thing. So the seller might negotiate an option to terminate the lease if the seller actually does sell the property.

If the seller knows of problems, might it make sense to do nothing and hope the buyer doesn't notice? That might have worked in 1956. It doesn't work in 2018. Today's buyers, with lenders and equity investors looking over their shoulders, all supported by smart lawyers vying with one another to find problems, are typically smart, careful, and more than duly diligent. They dig. They find things. When they do, it's usually worse than if the seller had been forthcoming from the beginning. Among other things, it often leads to a loss of trust, which ripples into the entire transaction and contract negotiations.

So it's up to the seller to investigate its own property at least as carefully as any buyer ever will. That means understanding any issues in the leases and any physical problems. It means ordering a title report and looking for surprises and problems. A pragmatic seller that wants to avoid surprises may also order an environmental assessment, reports from government agencies, and an updated physical report. In short, the seller should seriously consider doing all the due diligence a buyer will do, and more.

Aside from preventing problems later, that approach can also speed the process along and reduce uncertainty and burdensome terms in the contract.

First, if the seller gives the buyer all the information the buyer will discover through its own due diligence, that can shorten or perhaps even short circuit the buyer's due diligence. Instead of demanding 60 days for due diligence, the buyer may be able to justify only 30. Of course, the most important investigation any buyer performs in its due diligence period consists of determining whether it can raise the money it needs to close. The seller can't help much with that.

Second, the seller's investigations can define a baseline for the property. If lucky, the seller might persuade the buyer to agree that it can terminate for due diligence only if it discovers anything the seller didn't disclose as part of the baseline. Buyers may find that arrangement a bit claustrophobic, though, given the importance of the due diligence period to enable the buyer to find financing for the purchase.

Third, the seller may be able to handle the problem or even solve it before the parties go to contract. The problem won't be a surprise and, ideally, won't be an issue.

Fourth, if the seller makes things easier and cheaper for the buyer – because all property information is neatly and completely assembled and the buyer doesn't have to order its own third-party reports in the first instance – this might attract and keep the interest of more potential buyers and eventually produce higher bids.

Caveat emptor may sound great, but in practice it's the seller that should start out by being aware and preventing problems, or at least being ready to deal with them, before they arise. In Latin, the phrase is *caveat venditor.*

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