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Buy? A Primer on Buying Real Commercial Real Estate in New York

Liraz Yuval, Anat Lahovitsky and Sasha Bau of our real estate department put together a primer highlighting the issues to be considered when purchasing commercial real estate in New York.

The process of purchasing a commercial real estate asset is a complex and expensive endeavor, that should not be undertaken without proper preparation. Unlike the purchase of a residential property, the buyer of commercial assets is, in many instances, a larger group of individuals. The price is typically significantly higher. The intended and permitted use of the property is more complex and requires more creativity. Finally, financing of a commercial transaction is less 'boiler plate' and requires extensive negotiation and a deeper understanding of the lending market. When entering into such a transaction, one must conduct more extensive due diligence on the legal and physical conditions of the property and make sure to address all potential issues in negotiating the deal and in the final contract.

Performing Due Diligence

The first step in purchasing commercial real estate is performing due diligence. Essentially, due diligence is an investigation into the physical, financial, legal and geographic factors that affect a piece of property. First, you need to carefully research properly identify a property worth purchasing, while considering factors such as location, size, functionality, and demographic trends (population growth, employment, and income). Only when you have a clear picture of the community and environment in which your property is located, can you then make a prudent decision to go forward with a purchase.

Due diligence is an investigation into the physical, financial, legal and geographic factors that affect a piece of property.

Once you have zeroed in a property to purchase and have negotiated and signed the contract (see below), the next stage of due diligence is to carefully scrutinize the property itself. Some prudent purchasers would insist on performing this stage even prior to executing the contract while others have the contract contingent on the results of such due diligence. The due diligence includes looking at both the property's tangible and intangible components. While not exclusive, here is a list of some of the important things you should be reviewing:

1. The physical condition of the property. The proper way to accomplish this task is to get an engineering inspection and survey. An engineer review many aspect of the property, such as the foundation, roof, piping, boiler, and heating and A/C systems while the survey examines the boundaries of the property.

2. Environmental issues. You need at least a 'phase one' environmental report from a third party inspector to evaluate whether the property has been contaminated by hazardous substances. You also want the seller to give you a disclosure statement listing any known, or potential, hazards. A phase one report may reveal issues that require a more thorough 'phase two' report.

3. Insurance coverage. Generally, the seller requests a copy of the policy from his insurance company. A buyer should insist on obtaining a copy – as well as a copy of the building's most recent risk assessment report.

4. **Title.** One of the key components to any real estate deal is obtaining a title insurance

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Major Changes to Rule 144

Sam Silvers, our securities expert, reviews major changes recently made by the Securities and Exchange Commission (SEC) to Rule 144, affecting reselling of stock and other securities beginning in February 2008.

U.S. securities laws require the ***registration*** of stock or other securities before the securities can be offered or sold, unless an ***exemption*** is present. Companies often sell unregistered securities under an exemption called Regulation D. The purchasers of securities sold under Regulation D and other exemptions hold what is called "***restricted securities***." Restricted securities cannot generally be sold into the public securities markets. That means you cannot simply have your broker sell the securities for you, unless the securities satisfy the requirements of Rule 144.

Rule 144 allows holders of "restricted securities" to sell their securities into the public markets in certain circumstances. A key concept of Rule 144 is that the restricted securities must be retained for a ***holding period*** before they can be sold. The SEC has recently revised Rule 144 so that the length of the *holding period* depends on two factors:

1. Whether or not the ***issuer*** of the securities is a public reporting company; and
2. Whether or not the ***holder*** of the securities is an ***affiliate*** of the company. The term ***affiliate*** includes officers and directors of the company and holders of 10% or more of the securities of the company.

If the ***issuer*** of the securities is a public reporting company (filing reports like Form 10-K or 20-F and Form 10-Q with the SEC), then the *holding period*, under revised Rule 144, is **six months** from the date that the holder acquired

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policy. This policy guarantees that you are receiving full legal ownership of the property upon transfer of title. If someone later challenges your ownership, you can sue the title insurance company to recover losses. The title insurance company issues what is called a "title report" which sets out the current state of title to the property. It identifies the current property owner, provides a property description, and lists all encumbrances of record. Unless the encumbrances or defects are cleared up prior to closing, the insurance company will "except" them from coverage. While you are always free to purchase the property despite defects in title (i.e., those that have been excepted from policy coverage), it is essential that you consult with an attorney to either ensure that the risks are minimal, or construct ways to reduce the risk (for example, getting signed affidavits or having the seller place money in escrow pending clearance of such defects). And while it may seem obscure, make sure you review the water charges. Like taxes, water charges follow the land and therefore you, as the buyer, will be responsible for any charges once you take title whether or not such charges arose from activity before you took title. Therefore, get an actual reading as of the date of closing and if you cannot, make sure you have seller put in escrow an amount two times the last bill.

5. **Survey.** Generally, you want to commission a fresh survey. However, if a survey has been done within the last three years, and, after inspecting the property you are convinced nothing has changed, you may be able to get away without having a new survey done. Also, keep in mind that if you are financing the deal with a commercial lender (such as a bank), they will likely order a mortgage report which is in effect a "mini-survey." While this report is not as comprehensive as a full survey, again, you may conclude that it is adequate for your needs (this is particularly true if the title insurance company is willing to guarantee there are no boundary line issues).

6. **Zoning and land use regulations.** You need to determine if the intended use is permitted under local zoning ordinances. If not, you may be able to get a variance. A prudent move may be to include in the contract a provision making closing contingent on obtaining such a variance. Another route may be to purchase an option to buy and, during the option period, attempt to get the zoning law changed. If you succeed, you will exercise the option to buy.

7. **Tenant leases.** Have the seller obtain "estoppel certificates" from each of the property's tenants. Your ownership of the property will be subject to any valid written leases and therefore you need to determine the legal status of each tenant. This is a critical stage because in commercial buildings it is rare – if ever the case – that there are uniform leases. Therefore, you need to carefully examine every existing lease. Buried in a single individual lease, couched in obscure language, can be an item that could significantly affect your rights as owner. Some clauses you should look out for include options on purchase at a capped price, the right to occupy adjacent space, agreements to renovate or paint periodically, etc.

8. **Quality of the tenant base.** Examine the rent rolls, payment history, and credit files of every existing tenant to assess the risk to the building's continued income stream.

9. **Valuation.** While it is important to get a sense of the property's value before signing the contract, it is in the post-contract signing stage (when you are privy to documents and information), that you need to obtain an accurate valuation of the property. This comes down to pretty much one number: determining what your profit will be on the property. Profit is simply the net income determined by subtracting the debt service from the net operating income. However, beware – this does not mean the *potential* income and estimated expenses; you must, as part of your due diligence, get the real, *actual* numbers and confirm every element of income and expense by sifting through the balance sheet and other accounting documents.

Valuation also comes into play in the financing stage as lenders will use these numbers to determine whether to provide financing (see "Financing the Deal," below). Valuation can be a complex process and obtaining the services of a certified appraiser is a prudent move (in fact, most banks will not finance your deal without a professional appraisal). Commercial appraisals cost anywhere from $3,000-$30,000; the lower end of the spectrum applicable to most commercial deals with the higher end for such properties as large office towers.

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To accurately review the above list, you should obtain the following documents:

- Annual P&Ls for the last 5 years
- Balance sheets from the last 3 years
- Rent roll (which includes terms and payment history)
- Tax returns from the last 3 years
- Insurance policies (including any riders and risk assessments)
- Loan documents (notes, title policy, deeds of trust, etc.)
- Deeds
- Leases
- Service contracts (e.g., trash, extermination, maintenance, union agreements, management agreements, billboard, vending, etc.)
- Recent appraisals
- Recent engineering reports
- Recent environmental reports
- Surveys
- Architectural and engineering plans
- Payroll register
- Business licenses
- Inventory of furniture, fixtures, equipment, supplies, etc.
- Utility bills (electric, water, sewer, gas) – obtain the last 3 years of monthly statements
- Bank statements for the previous year
- Property tax tickets, both real estate and personal) for last 3 years
- Litigation history; either details of any pending litigation and judgments and if none, an affidavit from the owner

Negotiating the Contract

Before the contract is drafted and signed, signing what is called a letter of intent (or memorandum of understanding) is in many cases a good idea. By signing such a letter, you know up front that you and the seller agree on the major terms of the deal before you put in the time and expense of drafting the contract itself. However, it is extremely important to word the letter carefully, especially in respect to whether such letter is binding. Again, consult an experienced attorney to assist you in this endeavor.

While each deal is different and what needs to be contained in a real estate contract varies, all contracts should address at least the following:

- A detailed description of the property, including the land itself and all improvements (i.e., the buildings on the land)
- The purchase price and how – and when – it will be paid (by what method, in installments, or all at once)
- A list of equipment and personal property included in the sale
- A laundry list of contingencies for closing. These contingencies are essential because they provide you with an "out" if, between the time of contract and closing, issues come up that make the

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investment unattractive. Common contingencies include securing a mortgage loan of at least X% of the purchase price; your being satisfied with the inspection reports (engineering and environmental); and your determination that the property can be renovated and improved to your satisfaction.
- The mechanics for allocating the property taxes and utility bills between you and the seller.
- The type of title evidence (or, title insurance) the seller must provide
- The closing date
- Legal recourse in the event that either party defaults on its obligations
- Warranties. The law does not require a seller to warranty the property. In fact, many commercial real estate contracts specifically say that the property is being sold "as is" with no representations or warranties. However, you should try and negotiate a warranty provision in the contract. Specifically, you want a General Warranty Deed from the seller (a savvy seller will offer a Special Warranty Deed that only guarantees title for the time period that the seller owned the property). For income-producing properties, you also want to get the seller to guarantee the accuracy of the rental income figures as well as the expenses. Also have a provision in the contract that the seller is aware of no hidden defects in the property (i.e., something the inspector is unlikely to discover).

Some other things to consider while gearing up for the closing:

- **Consider putting legal title to the property in a business entity's name**. By putting legal title into a business entity – such as an LLC or corporation – in addition to potential tax advantages, you will limit personal liability.
- **Look into purchasing certain types of insurance**. Damage insurance will protect against damage by fire or other causes or events. Public liability coverage will provide coverage if someone is injured on the premises and sues you.
- **Determine who is going to pay the title insurance premiums**. Usually the seller does, but sometimes both parties do.

When negotiating the contract make sure to leave ample time to perform the due diligence, if not completed prior thereto. You want to give yourself at least thirty days after you have received all the documents. It is also a good idea to refrain from proceeding with due diligence until the contract is signed and make sure to condition any deadlines (such as the date of completion of the diligence) on the delivery of the last document with a provision for extension of time based on the discovery of any non-disclosed material defects.

A smart investor will calculate the maximum debt load the property can carry in order to obtain as much as possible financing from the bank.

Financing the Deal

Most lenders will not finance more than 75% of the property's value and will require a minimum 1.25:1 debt coverage ratio.
The debt coverage ration, also know as the debt repayment ratio, is the ratio used to determine the property's capacity to generate enough income to pay its debt obligations. In general, it is calculated by dividing the net operating income by the total debt service.
A smart investor will calculate the maximum debt load the property can carry in order to obtain as much as possible financing from the bank. To make this calculation, you need to determine the following:

- The property's net operating income
- The interest rate the bank will charge
- The lowest debt coverage ration the bank will accept (again, this is usually 1.25:1)
- What kind of amortization schedule is used for this type of loan

The above article covered the basic issues of purchasing commercial real estate. The body of knowledge required to handle a commercial real estate purchase is extensive (knowledge of real property, contract and tax law, financing, accounting, and insurance are essential). As always, we recommend hiring the right team to help you with the process and ensure your interests are fully protected.

(Continued from page 1) The 10 Commandments

degrees Fahrenheit.

7. Get Everything in Writing.
To avoid disputes or misunderstandings with your landlord, get everything in writing. Keep copies of any correspondence and follow up an oral agreement with a letter, setting out your understandings. For example, if you ask your landlord to make repairs, put your request in writing and keep a copy for yourself. If the landlord agrees orally, send a letter confirming this.

8. Duration of notice
Most landlords prefer at least 30 days of notice from the Tenant if they plan on leaving the dwelling prior to the end of the lease term. However, this is not set in stone and is based on the terms of the lease. If the Tenant plans on leaving the dwelling, she should be sure to provide the Landlord with significant notice pursuant to the lease terms.

9. Purchase Renters' Insurance.
Most insurance policies of landlords do not cover losses of a Tenant due to theft or damage. Therefore, it is important for Tenants to obtain separate insurance. Renters' insurance will also cover a Tenant if sued by someone who claims to have been injured in the dwelling.

10. Security Deposit.
Tenants should make sure their lease or rental agreement is clear on the use and refund of security deposits, including allowable deductions. Additionally, many states have deadlines which limit the time a Landlord has to

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the securities. If, on the other hand, the ***issuer*** of the securities is a private company or does not file reports with the SEC, then the *holding period* is **one year**. These holding periods are much shorter than they used to be under older versions of Rule 144.

Under the revised rule, if the ***holder*** is ***not*** an ***affiliate*** of the issuer, then once the *holding period* is finished, the securities can generally be sold without any further requirements being met. However, if the ***holder*** is an ***affiliate*** of the issuer, then, in addition to the *holding period* requirement, a number of other requirements must be met. These requirements, very briefly, are as follows:

- The issuer must publish updated information continuously;
- The holder may not sell more than a small amount of securities at a time;
- The sale must be made using certain specified methods;
- In some cases a lawyer's "Rule 144 opinion letter" will be needed; and
- In many cases, a Form 144 must be filed with the SEC.

Calculating the *holding period* can be complicated in cases of shares acquired for anything other than cash, such as gifted shares, shares from an estate, shares in a trust, shares acquired on the exercise of stock options or conversion transactions, or shares acquired in a corporate transaction. An attorney can assist you to determine the length of the holding period for your securities. A security attorney is also required to ensure compliance with Rule 144 and other securities law requirements.