PRE-LEASE DUE DILIGENCE FOR COMMERCIAL TENANTS: A PRACTICAL APPROACH

"*He who asks is a fool for five minutes, but he who does not ask remains a fool forever*." -Mark Twain

"*Diligence is the mother of good luck*." -Ben Franklin

"**Doveryai no proveryai *(Trust but verify*)"– President Ronald Reagan, quoting a Russian proverb

The Case for Due Diligence

I rather doubt that Messrs. Twain, Franklin, and Reagan had commercial real estate transactions in mind when they formulated the quotes above, but their advice is nonetheless sound and timely when applied to modern leasing transactions. In this article, I suggest an approach for analyzing how much, if any, due diligence is appropriate for a tenant in a given commercial lease transaction. (This article assumes that the lease in question is for space in an existing commercial building--which is the most common scenario--but many of the concepts discussed below apply equally to any type of real-property lease. The focus of this article is the actions that the smart tenant can take, outside of the lease itself, in order to minimize risk; further risk mitigation can be afforded by the negotiation of revisions to the lease by a competent lawyer, but that's beyond the scope of this article.)

What is Meant by "Due Diligence"?

By entering into a lease, the tenant assumes myriad risks and liabilities. Due diligence is simply the process of evaluating and mitigating those risks and liabilities before committing to the transaction. Common due diligence practices include:

- Reviewing title (and an ALTA survey if available) to the property. In particular, the smart tenant is concerned about the effect of any recorded use restrictions and CC&RS (because they typically contain use restrictions that could restrain the tenant's use of the property), and the existence of mortgages (because, if not paid by the landlord, they could result in a termination of the lease if there is a foreclosure; this is a key issue if the tenant is investing its own money to improve the property).
- Confirming that current zoning permits the tenant's intended use.
- Commissioning third-party inspections to determine the physical condition of the property (a so-called Property Condition Report or Assessment), energy costs, the environmental status of the property (a so-called Phase I Report), compliance with accessibility laws (such as the Americans with Disabilities Act) and building codes. These types of investigations are particularly important in a transaction which is not a true turnkey arrangement whereby the landlord is constructing the tenant improvements at the landlord's sole cost, and when the building in question is older.
- Assessing natural hazards (earthquake, flood, and wildfire).

- Understanding the local tenant-improvement permitting process (if the tenant will be the party contracting for those improvements).

Your broker or attorney should be able to provide referrals for these services. Note, too, that there are now a number of companies that coordinate these services so the tenant can have a single point of contact, rather than having to find and retain multiple service providers.

Relative Lack of Due Diligence by Tenants

It's common--and in fact almost universal--for buyers of commercial property to undertake rigorous due diligence before committing to a purchase, but commercial tenants are much less likely to take these steps. The relative lack of due diligence by tenants is in large part explicable by the diminished risks of leasing as opposed to owning real property, and by the smaller capital outlay that a lease typically entails; understandably, most tenants simply aren't eager to spend money on due diligence unless they perceive some tangible and commensurate risk reduction in return. It's also explained in part by the absence of lender involvement in lease transactions—while it's customary these days for the buyer's lender to require Phase I environmental reports, and to always require a lender policy if it's a secured loan, for example, there's no lender to generate those requirements on the tenant's side. Finally, the lack of due diligence by tenants is often the result of ignorance—tenants sometimes simply don't understand the risks they are assuming by signing the lease. For example: it comes as an unwelcome surprise to many tenants to find out that either the lease itself or applicable law may make them potentially liable for the cost of correcting pre-existing conditions on the property, such as cleaning up asbestos or other hazardous materials, physical barriers to accessibility (so-called ADA violations), or building-code violations, or at end of the lease term, that they must replace an HVAC system.

Effect of As-Is Clauses and other Disclaimers in the Lease

Landlord-oriented leases typically contain comprehensive "as-is" and exculpatory clauses. The legitimate purpose of such clauses is to encourage the tenant to independently inspect the property, and to assist the landlord in defending against any claims that the landlord made implicit or explicit representations about the condition of the property that the tenant relied on in entering into the lease. The more problematic aspect of these clauses is that they may attempt to shift very significant liabilities and costs to the tenant—for example, the lease may state that the tenant must correct physical defects in the property if not brought to the landlord's attention early in the term, or that the tenant is responsible for making and keeping the property compliant with all laws. As a general matter, the more the lease attempts to transfer these types of risks to the tenant, the more due diligence is warranted on the tenant's part.

Who (Landlord or Tenant) is Building and Paying the cost of the Tenant Improvements?

If the tenant is the party undertaking the pre-commencement alterations to the property, or if the landlord is capping its contribution to the cost of improvements being constructed by the landlord for the tenant's benefit (a so-called "allowance" deal), heightened due diligence is called for. In this circumstance, there's always the potential for conditions (such as the presence of asbestos, and ADA violations, for example) that could add considerable expense and delay to the construction process, particularly if the building is an older one.

What are the Tenant's Maintenance and Repair Obligations under the Lease, and What Do you Know about the Current Property's Condition?

The more extensive the tenant's maintenance and repair obligations under the lease, the greater the justification for inquiry by the tenant. To the extent that the tenant is required by the lease to maintain, repair, or replace any of the building systems and other components of the property, it's prudent for the tenant to understand the current condition of those components and their projected useful life. Some of the most expensive systems to repair and replace include the HVAC, roofing, and pavement, so it may be advisable to include inspections by HVAC, pavement, and roofing specialists in the scope of your Property Condition Assessment (PCA) if those systems are the tenant's responsibility under the lease. A pre-lease PCA can help the tenant evaluate the cost of any immediately needed repairs, and the estimated long-term costs of maintenance and repairs. In addition, the PCA can provide a baseline that documents the property's condition at lease commencement, which can be very useful in avoiding disputes at the end of the lease term, since the typical lease requires the tenant to surrender the property in the same condition as received, ordinary wear and tear excepted. Again, the age of the property and the lease's allocation of repair responsibilities are the key drivers here: the older the property and the more extensive the tenant responsibilities, the more due diligence is advisable.

Don't Assume the Law Alone Will Protect the Tenant from Risks of Pre-existing Conditions

Many tenant-clients over the years have asked me a variant of the following question: "Is the landlord legally obligated to deliver the premises to me free of code violations and in good condition?" My response is invariably "What does the lease say?" While they response may seem flippant, the law does in fact afford commercial parties considerable latitude as to how they allocate their respective maintenance, repair, and compliance-with-law obligations, and a typical landlord-prepared lease tends, unsurprisingly, to favor the landlord on those issues; as a general rule, there's nothing that prevents the lease from transferring to the tenant obligations (such as correcting existing code violations or repairing dilapidated building systems) that entail considerable and perhaps unanticipated costs. Rather than rely on general doctrines of law for protection, the better practice is to read the lease carefully, perform the appropriate due diligence to understand the practical implications of the lease provisions, and negotiate tenant-favorable revisions.

What Does Your Lawyer Recommend?

It may sound a tad self-serving for a lawyer to recommend that you seek legal counsel, but an experienced and thoughtful real estate lawyer can in fact add significant value to the transaction by taking steps such as the following:

- Helping to define the scope of any PCAs or other third-party reports and inspections, based on the terms of the lease itself and the lawyer's knowledge of local laws.
- Modifying the lease to more fairly allocate risks like maintenance, repairs, compliance-with-laws, and the tenant-improvement build-out process.
- Reviewing the condition of title to the property.

Conclusion

Hiring a lawyer to negotiate a commercial lease transaction for a tenant is generally a good idea, and a common practice. Undertaking the appropriate level of due diligence on the property is another good

practice, and may well save the tenant a lot of grief later. I'm pretty sure Mark Twain, Ben Franklin and Ronald Reagan would agree with me.

DISCLAIMER: This article does not constitute legal advice. Readers should consult with their own legal counsel for the most current information and obtain professional advice before acting on any of the information presented.

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