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DUE DILIGENCE FOR THE PURCHASER OF A DEVELOPMENT

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1. What is due diligence

1.1 Contractual Right to Due Diligence

Due diligence can refer to a number of different contractual rights including:

- (a) Where the seller has provided due diligence material for access by electronic documents, provision of documents on disc or provision of the physical documents for inspection.
- (b) A period within which the buyer can undertake investigations on the subject property and decide whether or not to proceed.
- (c) After the contract is signed, the buyer can undertake searches which may or may not give rise to a right to terminate.

I will consider each of these separately.

1.2 Due Diligence by Document Exchange

Often in larger transactions, the seller will have put together the due diligence documents which will be made available to the buyer. In property transactions, it is more likely that there will be fewer documents than in a merger or business acquisition so that the seller may provide the physical copies of the documents. Where the transaction includes more documents, particularly for example, a shopping centre with a large number of leases or where the due diligence material is being made available to a large number of potential buyers perhaps through a tender process, then the documents may be available electronically.

In either case, it is important that the contract clearly identifies the documents which have been provided to the buyer in a schedule, preferably by reference to a specific number, such as the registration number of the lease, the document number for a drawing, the date of an approval from Council, etc. Particularly with drawings, there can be a number of different versions and these need to be identifiable. The building approval from Council should refer to specific drawing numbers which would be

annexed to the approval. It is important that these drawings are kept separate from as build drawings and that each can be separately identified.

Where the documents are provided either on disk or in hard copy, there should be a similar index or list to verify the exact documents which have been provided.

In the contract, there should be a warranty from the seller that the documents provided on due diligence are true and correct and an acknowledgement that the buyer has relied on the provision of the documents in reaching its decision to enter into the contract. Where the seller has provided the due diligence, I also recommend that the contract provide a mechanism to capture any request for further information or clarification in the form of a question and answer schedule.

It is important that the contract clearly identifies the representations and documents upon which the buyer has relied when making its decision to enter into the contract and to accept the due diligence material. While the contract itself may state there are no other documents or warranties, as you are aware, a disgruntled buyer may seek to bring an action under the *Trade Practices Act* claiming that false and misleading statements induced it to enter the contract. If the buyer can establish that a false statement did induce it to enter into the contract, then a provision in the contract which states the seller has not relied on anything else will not have effect because the contract itself has been tainted by the misrepresentation.

Where the contract contains such a clause stating that there had been no other warranties or representations made, or other documents relied upon and then the contract sets out the documents upon which the buyer has relied, it would be more difficult for the buyer to allege that a statement or document which has not referred to in the contract was in fact relied upon. This can be particularly important where, for example, an information memorandum or other marketing material has been provided which may deal with issues such as the area of land, terms of leases, etc. There may also have been statements made during negotiations about any of these important matters.

If the buyer has been provided with due diligence material, and the information memorandum or statements have not been listed in that which is correct material, and the buyer has not added those items into a list of information upon which it has relied when entering into the contract or proceeding with the contract, then it becomes difficult for the buyer to subsequently claim that a false statement in the information memorandum induced it to enter into the contract to its detriment.

From the seller's point of view, it is important that the material provided for due diligence investigations by the buyer is correct but also that no relevant information is omitted. For example, if there has been a variation to a building approval or a lease, then each document should be provided.

Sometimes, the contract will provide for disclosure of documents and reports by the seller but will then specifically provide that the buyer has undertaken its own investigations and due diligence enquiries and an acknowledgement that it has bought the property relying solely on its own enquiries. If this is the intention of the parties, it is important that the contract specify that any records or documentation provided by the seller to the buyer are provided for the buyer to undertake its own due diligence investigations and that the seller does not warrant that any of the information is true and correct and that the seller makes no statement that the information or records provided is the most recent or all of the available information and records.

1.3 Due diligence by the buyer

A more common provision is that the contract is subject to due diligence by the buyer. Either the parties can enter into a contract which is conditional upon the buyer

undertaking due diligence and being satisfied with its due diligence enquiries, or alternatively the arrangement may be for the buyer to undertake its due diligence and to be satisfied prior to entering into the contract.

1.3.1 Conditional contract

If the contract is subject to the buyer undertaking its own due diligence, it is important that the contract deal with issues such as access to records and the property to undertake the due diligence investigations and also the contract needs to state whether the buyer makes the determination whether it is satisfied with due diligence in its absolute discretion, or whether there is an objective test regarding due diligence.

The more common provision is for the buyer to make a decision regarding due diligence in its absolute discretion. This has the disadvantage for the seller that in effect there is an option during the due diligence period as the buyer may terminate the contract without providing any reasons for doing so.

The termination may be without penalty or the seller may claim a "break fee" being the initial deposit. Usually the fee would reflect the cost to the seller for having engaged lawyers to draft the contract and entering into preliminary negotiations.

The alternative is to provide for some objective grounds for termination. This is not often used because it is difficult to identify what should be grounds for termination. It may include specific matters of concern, such as environmental issues or review of the lease.

1.3.2 Prior Due Diligence

The other alternative for dealing with the due diligence is for the buyer to undertake the due diligence prior to entering into the contract. The benefit of this is that it clearly identifies the basis for the buyer entering into the contract. It reduces the ability of a buyer to subsequently claim that it was induced to enter into a contract by false and misleading statements of the seller. Even where a buyer has absolute discretion whether or not to proceed with the contract following due diligence, there may be arguments that if the information provided prior to the buyer entering into the contract was false and misleading, that information induced it to enter into the contract in breach of the *Trade Practices Act*.

By undertaking due diligence prior to entering into the contract, the basis of entering into the contract is in fact the buyer's own due diligence enquiries.

Where the buyer is to undertake due diligence prior to entering into the contract, the parties will often enter into an agreement to ensure that the seller is not negotiating with anyone else at the same time so that the buyer can be comfortable that it is expending the money on the due diligence and the seller will not sell the property from under it.

The buyer will also need to be given authority from the seller to undertake searches, to inspect the property and potentially to interview third parties such as builders, tenants etc. If the seller is providing confidential information about the property, the seller is also likely to require a Deed of Confidentiality from the buyer.

While there is the benefit in respect of potential TPA claim, the disadvantage with undertaking due diligence before the contract is that after the due diligence has been satisfied, the parties may not be able to reach a

commercial decision regarding the contract terms. If this occurs, the buyer has wasted the cost of undertaking the due diligence.

1.3.3 Option

An alternative would be for the parties to negotiate the contract and enter into an option arrangement so that the contract only comes into effect once the buyer exercises the option. The buyer would do so after completion of its due diligence and the option deed would set out the rights to undertake the due diligence searches and the obligations of confidentiality in relation to that due diligence.

In some circumstances, the sale of the property itself may be a matter which the seller wishes to keep confidential. This may be because of competition from other property owners or it may be that the seller does not want its tenants to know that it is considering selling the property. In those circumstances the contract allowing the buyer to undertake due diligence may need to limit those with whom the buyer may discuss the purchase. Often the contract will provide that the buyer may not interview tenants without prior notification to the seller and preferably only in the presence of the seller or the Centre Manager.

1.4 Due Diligence under the Contract

The mechanism for due diligence under the contract is to undertake searches after the contract and rely on a standard form contract such as the REIQ Commercial Land Contract. In effect, such a contract only provides due diligence in respect of the lease terms, allowing the buyer to terminate after it has reviewed the terms of the lease. Other issues which may be relevant, including approvals, environmental issues etc may only give the buyer a right to terminate or compensation if notices have issued. There may be no right for the buyer if approvals have not been obtained, but no notice has issued or if there is an environmental problem but the matter is not on the Register.

In most commercial development contracts, the buyer would need a due diligence period within which to carry out investigations and a right to terminate if those investigations are not satisfactory.

2. Title Search

A search of the title of the property is fundamental for any due diligence. The title search will identify issues such as encumbrances and also administrative notes. In addition to the title, a search should be undertaken of the plan to identify the land being sold.

The area in the plan needs to be reviewed and a survey undertaken to ensure that the area sold is the same as the area which is available for sale. Particularly in areas such as CBD, even minor variations in the area can have significant effects on the development opportunities available.

3. Access

Access issues do not arise very often but they are particularly important in rural areas and where there are older subdivisions which may not have correctly identified the access arrangements.

It is important to undertake a search of the plan to ensure that the subject property has access to a public road.

3.1 Right of User

It may also be important to ensure that no neighbouring property requires access through the subject property.

Property Law Act s. 180 provides that:

"Where it is reasonably necessary in the interests of effective use in any reasonable manner of any land that such land or the owner for the time being of such land should in respect of the other land have a statutory right of user in respect of that other land, the court may, on the application of the owner of the dominant land, but subject to this section, impose upon the servient land or upon the owner for the time being of such land, an obligation of user or an obligation to permit such user in accordance with that order".

The statutory right of user may be by way of easement, licence or otherwise and may be for such period as the court directs. The owner of the servient land can be adequately compensated in money for any loss or disadvantage which it may suffer.

This can be particularly important where there has been an old subdivision with a rear block with no access which continues to be owned by the seller or a previous seller.

While the standard REIQ contract allows a buyer to terminate if land is legally landlocked, this provision does not guarantee access. It only gives the buyer a right to terminate prior to settlement if there is no lawful access. In the decision of Justice Wilson in *Jarema Pty Ltd –v- Kato [2005] 1QdR592* the court found that where the contract properly described the land even though that land did not provide for any legal vehicular access to the car park of the building, the buyer's only right was to terminate prior to settlement and the buyer had no right to compensation as there was no mistake or error in the description or particulars of the property. In that case, the building had street frontage but access to the car park was through a lane way at the rear of the building which did not have protection of an easement, licence etc. The lane way appeared to be a road in that it had bitumen finish with kerbing etc, but was in fact part of a neighbouring lot and not a gazetted road.

The plan may also reveal that while the building has frontage to a particular road, there is an access limitation strip a device by which Council may alienate a small strip of land to prevent access to, usually, a busy road. Such an access limitation strip may restrict future development or subdivision of the land.

3.2 Rural Land

With rural land, there may be other access issues.

Some property may have access to a road reserve, but that road reserve may not be formed so if the buyer wants to rely on that road, it would need to pay for the formation of the road. Some road reserves I have seen in rural property, have in fact been impassable because they are too steep or because of the cost of building bridges, culverts etc. Access therefore has to be negotiated through neighbouring land.

Plan 1 shows a cancelled road reserve. The plan shows a road reserve and the area shown on the plan is the area of the land less the road reserve, but there is a notation that the road has been closed and that an extra area of 2616m² is to be added to the area of the lot being the area of the closed road.

In some rural properties, the road reserve has been used for farming purposes either by use through a licence or without any consent. The neighbouring land owners have no right to use or obstruct a reserved area and there are penalties up to \$30,000.00 for using a road reserve without a permit to occupy or a road licence. Where the land owner has used the road reserve for growing crops without a licence, there may be a

significant diminution in value both for the value of the crops which have been grown unlawfully but also because of the extra cost in cultivating the land if the planting has to go around the road reserve.

Where there is a road reserve it is therefore necessary to check whether there is a licence to occupy or any other permit to use the reserve area and, if not, to make enquiries about whether the reserve is fact being used and, if so, what is the effect if the reserve is not used both on the area which would be lost from cultivation, any extra costs in ploughing and sowing excluding the road reserve and if any irrigation is over the road reserve.

Particularly in older subdivisions, there may also be an unallocated road reserve. Plan 2 shows a floating road reserve. This is not readily identifiable from the plan or the title, but there is a notation that "the area of 5 acres 24 perches is reserved for road purposes in the subdivision". Before the area can be dealt with by subdivision, amalgamation etc, the floating road reserve has to be dealt with. In this case, my client is looking to buy the floating road reserve prior to a subdivision. This will be a process of at least 18 months to finalise and my client will pay market value for the reserve area.

If this had not been identified during due diligence, the buyer may have paid more for the area than expected when taking into account the cost of buying the road reserve.

There may also be third party access rights over the land which are not readily identifiable as easements. For example the *Sugar Industry Act* provides for railway easements which are recorded as an administrative advice on title. The dealing number of that administrative advice will provide any documents which relate to the railway easement or the permit to pass over the land granted as a sugar access right.

Plan 3 shows the sugar access right across Lot 2.

Where a road licence has been granted to the neighbouring owner which has use of the road reserve, that licence must be transferred with the title. Sometimes there may be restrictions on the title, for example I have seen a condition where two lots had to be transferred together with an accompanying road licence as the road reserve abutted both lots. The condition was linked through the licence itself which is a separate title. The application for the transfer of the road licence needs to be lodged with the Department with the transfer application form, the fee and evidence that all rent has been paid together with a statutory declaration by the transferee stating it is aware of the condition of the land, any conditions that must be complied with and the annual rent. Once the Department has approved the transfer of the road licence, it will sign a Form 18 General Consent which can be lodged with the transfer of road licence form and Form 24 at the Titles Office. This would be lodged with the transfer of the neighbouring land.

3.3 Development Approvals and Access

Access issues may also be dealt with in development approvals.

As part of the due diligence, any approvals need to be reviewed to identify any restrictions which may affect the use of the land.

For example in the purchase of a shopping centre the approval included the conditions set out in Attachment 1.

The restrictions in the approval limit access to the site to particular directions along particular streets and prevent access through a residential area. There are also time restrictions on the use of the loading dock and requirement for use of an acoustic consultant. These restrictions on access to streets and to the loading dock need to be reflected in the leases to the premises, particularly in the lease to the anchor tenant. As part of the due diligence, I reviewed the lease documents to ensure that the DA

conditions were present. There may be other DA conditions which also need to be reflected in the lease and other ongoing contractual relationships to ensure there is not a breach of any town planning or development conditions.

3.4 Encroachment Affecting Access

Finally, with access, the due diligence should consider any encroachments over or by the subject property.

I was recently involved in an acquisition where the access to the property was very "tight" because the property abutted a narrow winding road which is very steep. Access to the property had been made easier by an encroachment of approximately 0.5m across the neighbouring land. Because of the fall of the land, it would be difficult to widen the entrance within the subject property and to do so would require the removal and replacement of a significant retaining wall. The subject property had access from a rear road, but that road was more of a service road and did not have the same commercial appeal.

When we sought to terminate the contract because of the encroachment, the seller objected and in the subsequent Supreme Court action, the court found in our favour because of the difficulty of the site and the nature of the encroachment. There were also other encroachments from the subject property with retaining walls having been built on neighbouring land and minor encroachments into the road reserve on both frontages by retaining walls.

3.5 Summary

Access is fundamental to the use and redevelopment of most sites. Sometimes this is taken for granted, but there are many issues which arise with access which need to be reviewed as part of the due diligence process to ensure that the existing access is lawful, that there are no encroachments, and issues about the lawful access to the property.

4. Inundation

The standard enquiry regarding flood will provide information about flooding levels from creeks or rivers in the vicinity. Usually this will provide an RL and the 1 in 100 years or 1 in 50 years flood levels to the area.

While flood as such is an important issue, there are other inundation issues which need to be considered.

- 4.1 Some sites will be subject to surface water flow. In areas such as West End in Brisbane, there are low lying streets which do not show up in a flood search as having being affected by flood, but have restrictions because of surface water flow. The properties have been built in old water courses. If the property is subject to surface water flow, Council may restrict development under the ground, such as basements and may prevent fill on the site.
- 4.2 For larger commercial properties particularly in coastal areas, consideration needs to be given for future inundation by rising tides and storm surge. I have a client who is particularly concerned with long term investments over potential rising of sea level in the future because of global warming. In the due diligence for a coastal shopping centre, I arranged for investigations by an hydrologist regarding various modelling of rises in the height of sea level. The modelling revealed that even small increase in the height of the sea level, could affect the site particularly with storm surges. As the lease to the major tenant had substantial rent reductions if the number of car parks were not available for a particular number of days per year, there was a risk that if there was a number

of storm surges within a year, the number of car parks available may reduce below the trigger level and the rent would therefore reduce. This was a risk that my client was not willing to take on that site.

5. Environment

Part of the due diligence would be to undertake the usual searches with the Environmental Protection Authority and to see whether the land is on the Contaminated Land Register.

The level of contamination can vary greatly. Often rural property will have contamination in the form of arsenic from a cattle dip through to substantial contamination requiring remediation.

The potential contamination may be obvious such as where the site is a former service station. There are numerous examples where the contamination or potential contamination is not readily ascertainable.

For a green field site, part of the due diligence may be to undertake soil sampling to determine what is under the ground. This may be undertaken as part of a geotechnical investigation to determine the nature of the underlying ground for construction purposes or may be done as a separate investigation.

On a recent project I acted for a builder, where the owner had acquired a vacant development site where the previous buildings had been demolished and removed by the seller. The site appeared to be clear and there was no contamination recorded on the site. During geotechnical investigations by my client, my client identified a dump containing asbestos material from the demolished buildings which the demolition company had left on site and covered over. Presumably the demolition company had done this in breach of its demolition contract with a previous owner. The current owner had no contractual relationship with the demolition company and had no rights against the previous owner. The rehabilitation of the land was a significant expense and delay to be undertaken before construction could commence.

While this is an extreme example, quite often development sites can incorporate old dumps or unclean fill which may require remediation. The existence of the contaminant may not be disclosed on any register and can only be identified by soil testing.

6. Leases

As part of any due diligence of a commercial development, it is necessary to review the leases of the property.

Where the development is relatively new, it is more likely that the leases will be on standard terms and the lease review process can identify the commercial terms, review the standard provisions and then comment on any special conditions in a particular tenancy. When acting for an owner who is likely to on-sell the development, it is useful to develop the standard lease where any changes to the standard provisions are incorporated in a schedule rather than making changes in the body of the document. This will make the due diligence process easier and make management of the development easier for the owner or centre manager.

Often leases will have been negotiated over time and there will be various versions of documents or even completely different documents. Each lease would then need to be reviewed independently identifying the commercial terms and any particular risks which may lie with the owner and special provisions dealing with matters such as redecoration or reinstatement at the end of a term, the ability to terminate a lease or move a tenant for redevelopment purposes and any particular obligations such as warranties about

competition within the centre. Major tenants such as Woolworths and Coles or department stores may have particular requirements about the number of tenancies which must be current otherwise the rent will reduce or there may be complex turnover rent provisions.

In undertaking the due diligence of retail premises, part of the due diligence process should be to ensure that the parties have complied with the *Retail Shop Leases Act* and that all disclosure statements have been given in the proper time to ensure that each lease is enforceable.

Under the *Retail Shop Leases Act* s.22(1) the Lessor is required to provide a draft of the lease and disclosure statement at least seven (7) days before a prospective Lessee of a retail shop enters into a retail shop lease. If the Lessor does not comply or the disclosure statement is defective, the Lessee may terminate the lease by giving written notice to the Lessor within six (6) months after the Lessee entered into the lease, and the Lessor would be liable for the Lessee's reasonable compensation.

Under s.22B the assignor of a retail shop lease must give a prospective assignee a disclosure statement at least seven (7) days before asking the Lessor to consent to the assignment and the prospective assignee must give a disclosure statement to the assignor before the Lessor is asked to consent to the assignment. As part of the due diligence, it may be necessary to confirm that the disclosure statements have been given and that the Lessor, at least seven (7) days before the assignment, has given the prospective assignee a disclosure statement and a copy of the lease under s.22C. Failure to comply with the disclosure on assignment is not as drastic, as under s.22E failure to comply with these sections only gives a right to ask the Tribunal for an order that the disclosing person give the required document.

As part of the due diligence process, it is necessary to consider whether the rent has been increased as stated in the lease (and that the increase is lawful under the *Retail Shop Leases Act*) and all outgoings have been claimed as appropriate. Where the seller has failed to make increases, the buyer may be in a position to immediately increase the rent depending on the terms of the lease and whether there is any restriction on the owner increasing the rent after the review date. Similarly, there should be calculation to ensure the rent has not been increased too much which may give the tenant a right to claim any overpayment and which would affect the yield of the property.

When undertaking the due diligence of leases, it is important to be able to identify any tenants which are not performing for example, because of over due rent or a history of late payment of rent. It is important to be able to identify the history and not just the current position regarding the tenancies.

Depending on the purpose of the acquisition, the leases should be reviewed for the right to be able to register a Community Management Statement or to relocate tenants to enable further development.

Part of the lease due diligence is also to review what is the responsibility of the tenant and what is the responsibility of the landlord for maintenance and repairs. In particular in the definition of "Outgoings" (if these can be passed on to the tenant) whether the outgoings definition is wide enough to include general maintenance and repair and what exclusions there are for capital works.

Often the outgoings will include passing on the costs of service contracts. The service contracts would need to be reviewed particularly in respect of matters such as air conditioning, elevators, escalators etc. With an older building, a building inspection to identify future capital works or replacement of services would need to be undertaken. In particular, air conditioning can be an on-going problem in a building and investigations need to be made that the coolant is environmentally suitable and a time table for any capital works required.

7. Building Inspection

As part of the due diligence, the buyer should engage quantity surveyors and specialist consultants to view the building itself.

The inspection should consider the physical state of the building, the potential capital repairs which may be needed, and ease of maintenance.

While the cost of maintenance may be paid by the tenants, the landlord will have obligations under Workplace Health and Safety to provide a safe environment. If the building has difficult to access lights, windows to be cleaned etc, there may be Workplace Health and Safety issues which arise in the future.

It can be useful to review a history of the maintenance of the building to see if there are any particular aspects which require more frequent maintenance than is usual. Sometimes a building may have capital works which continually require repair for example, cracking of concrete, where windows may fall from an office building or tiles lift from walls and floors. Repairs such as these may be maintenance but if they are regularly attended to, tenants may argue successfully that the work is in fact capital work to repair defective original work rather than maintenance.

8. Tax Issues

Finally, an important aspect of due diligence is to review the tax implications of the purchase.

There will be GST implications about whether it is the purchase of a going concern and, if not, the effect of paying GST on the price.

More importantly, the due diligence should review the depreciation claimed on the development. Buyer's accountants should review the existing depreciation schedules and perhaps the buyer should engage a quantity surveyor to determine whether those depreciation claims are reasonable and whether it may be able to claim other depreciation after the purchase.

9. Summary

The due diligence period is a time when the buyer can identify whether or not to proceed with the contract.

The nature of the due diligence to be undertaken will depend on the nature of the subject property and also the requirements of the buyer. To some buyers there are particular matters which are important perhaps because of previous problems encountered or because of particular interests such as my client's concerns about rising sea levels. Other clients may have particular concerns about contamination.

Often the time provided for due diligence is quite short and it can be difficult to have results of the searches available within the time frame. This will be a matter for discussions with the various authorities and perhaps paying extra fees for urgent turn around or to physically inspect the records for Council. Where the buyer has been given the opportunity to carry out due diligence, either through its own investigations or by reviewing material provided by the seller, the buyer will be in a difficult position to claim damages if, after proceeding with the contract, the buyer identifies a problem.