

Legal Risks and Documentation in Real Estate Transactions

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Introduction

You will be faced with several legal documents and legal issues in connection with the purchase of a property. Firstly, you have to identify and recognise the purpose or function of the documents. Secondly, you have to evaluate its relevance for the transaction. Thirdly, you have to take actions in the light of the risks you have identified. In order to recognise if there are any relevant legal risks in relation to certain issues or agreements you have to have a good feeling for the essentials of the transaction. Furthermore, you need some experience in real estate law. It is recommended to incorporate a real estate law specialists in the due diligence work as it is easy to oversee or falsely assess the legal risk of a document and its impact on the transaction.

Legal Due Diligence

Evaluation of Legal Risks

The legal due diligence is an overview of and an analysis of the legal risks in the transaction. Some legal risks may be evaluated completely separately but most of the risks are connected to and shall be assessed in the light of the financial or technical due diligence.

You will see below that the legal evaluation of certain documents may have a significant impact on the transaction in one case, but may be irrelevant in another. For example, you may want to back out from the deal if a certain legal issue is not able to be solved before signing or you may want to adjust the purchase price.

Due to the large amount of documentation in a real estate transaction, a structured documentation is crucial for the risk analysis.

Real Estate Register and Cadastre

The real estate register contain information regarding i.a. the property as such, ownership, mortgages, encumbrances and easements. The property's name, number and address are registered in the real estate register. The name and number in the real estate register will be used to define the property in the purchase agreement. However, the real estate register does not contain any maps and therefore is it important to compare the real estate register with the cadastre, which contains maps and the official boundaries of the property. If you do not take enough time to analyse and compare these documents you may end up purchasing the wrong property or just a part of the property you intended to purchase.

If there is a mortgage registered on the property it is necessary to regulate what will happen with the mortgage in connection with closing. The most common way of handling a mortgage is to terminate it or to hand it over at closing. If a bank is the holder of the mortgage the mortgage will be terminated or handed over simultaneously with the payment of the purchase price. This need to be prepared in due course before closing

since the bank needs to calculate the amount it requires for releasing the mortgage. If you forget to regulate this issue in the purchase agreement or take necessary actions in connection with closing you may purchase a pledged property. It is needless to say that this may lead to significant losses.

There are several forms of encumbrances or easements such as right-of-way, pipeline right-of-way and build over the boundary. Registered encumbrances and easements are in principle valid and binding for and against everyone. As all beneficiaries of an encumbrance, e.g. a neighbour or an electricity service provider, have to approve a deletion, it is in general no use in trying to negotiate a deletion with the seller. You will simply have to assess its impact on the value of the property.

A right-of-way easements may be essential for a property and have a significant impact on the value. However, a pipeline right-of-way easement does normally not have any impact on the value at all.

It may also be necessary to check encumbrances on the surrounding properties so that they correspond to the easement on the relevant property. Should an essential easement not be registered is it recommendable to demand the seller to organise the registration before signing. Then, the registration may be dependent on the approval of one or several third parties.

Building Permit

The documentation of the building permit may be very extensive and it is recommendable to check this issue in connection with the technical due diligence. It is obvious to check for the building permit when you purchase a site or a new building. When purchasing older buildings you may assume that the building permit is in place. However, you have to be careful even in this case, in particular when the building has been extended. Even if a building permit may be obtained retroactively, you will have costs for the application. Furthermore, you may lose rental income as the tenants may have a right to reduce the rent.

Some sellers are not prepared to guarantee a valid building permit and it may be difficult to identify one during the due diligence process. In such cases you have to assess and calculate the risks - is there a risk that you have to evict the tenants in the attic or even in the whole building? Anyhow, it is recommendable that an architect gives an opinion on the issue.

The Financial Due Diligence

Co-operation between Financial and Legal Teams

The information regarding the income and costs of the property also needs to be analysed from a legal point of view. Can the figures and assumptions in the calculation be confirmed as legally valid and binding?

A close co-operation between the financial and the legal team is essential. The lawyer may have to little information of the transaction and thus focus on legal issues which are not important in the specific deal.

Rental Income

The easiest and most effective way of verifying the information on rental income is to compare the tenant list with the bank accounts. This shall also be confirmed by control samples of the lease agreements. However, a seller may not be prepared to provide the

purchaser with a copy of the bank accounts. The rental income shall in such cases be verified by the tenant documentation folder. In such case a significant amount of control samples are recommendable.

The tenant list is an essential part of the purchase agreement and it shall always be guaranteed by the seller. Should it not be correct you may have a claim for reduction of the purchase price.

Residential Lease Agreements

As the residential lease law contains several mandatory regulations and the courts, in particular in Germany, are very tenant friendly; it is normally no use in assessing all residential lease agreements. Hence, an investor usually assumes that certain clauses may be invalid, such as the obligation to renovate, and consider this in its calculation.

However, a sufficient amount of control samples shall be made in order to verify the tenant list and to check if the agreements maintain a reasonable standard.

Commercial Lease Agreements

It is not unusual that commercial lease agreements are closed for a 10 year period or longer. On the face of such an agreement you may assume that you have a valid and binding contract for a 10 year period. However, should the agreement or the duration clause not be valid and binding, the tenant may cancel the agreement before the agreed expiry date. This will most likely have a significant impact on the calculation and the value of the property, in particular if the rent corresponds to or is above the market rent. If the rent is below the market rent and you do not see any problem to lease to market rent it may be positive if the 10-year lease agreement is not valid and binding. Hence, all commercial agreements shall be assessed from a legal point of view if you deem that they are crucial for the calculation.

One special issue in German commercial leasing law is that commercial contracts over more than 1 year have to be in “written form”. This means that the contract must be in writing and validly signed by both parties within three weeks time. This is also valid for all amendments to the agreement. Should the agreement not fulfil the written form criteria is the agreement as such valid, but the tenant is allowed to terminate the lease in accordance with the commercial lease act, i.e. with 6 months period of notice.

Commercial Contracts

In an asset deal you normally only buy the property as such. Any commercial contracts which have been closed by the seller will not be transferred to the buyer without the approval of the purchaser and the contractor. However, the seller may wish that the purchaser shall step in and take over the contractual position of the seller. Otherwise the seller will most likely be charged for terminating the contract before expiry. In this situation is it important to analyse the conditions of the contracts. For example if the purchase price is in line with the market or under which conditions the agreement may be terminated?

Certain kind of service agreements, for example heating service contracts may be secured by an encumbrance. In this case the service provider may have the right to deliver services even if the seller or the purchaser have terminated the contract. Thus, you have to deal with this risk before signing and if necessary adjust the purchase price.

Legal Risks in Connection with Closing

Transfer of Purchase Price

Before the purchase price is transferred all condition precedents shall be fulfilled. The main condition precedents are the registration of the priority notice of conveyance, the confirmation regarding pre-emption right by the municipality and the release of security by the financing bank. In Germany the fulfilment of the condition precedents is confirmed by a *notar* who has been appointed to take care of the closing process. The purchaser will get a written confirmation that all condition precedents are fulfilled and that the purchase price is due. Even if the *notar* is liable for the closing process it is recommendable to check all condition precedent internally. In Sweden the closing process is carried out by the parties and their legal advisors. It is needless to say that the closing meeting shall be very well prepared as several parties are involved and that the seller and the banks have taken actions in relation to the transfer of the purchase price.

New Bank Accounts

The mitigation of the risks connected to the switch of bank accounts is one of the main issues in connection with closing. The tenants will normally be informed by the purchaser that they shall pay the rent to a new account. However, some tenants may oversee the information and pay the rent to the old bank account and you will in general not be able to claim the rent from the tenant if they have paid to the old account. Therefore, it is essential that the purchase agreement contains an obligation for the seller to transfer such payments to the purchaser. It is recommendable to negotiate a deposit covering this risk in particular when the seller is a legal entity with only one asset, the property.

Transfer of Security Deposit

The tenant's deposit for his obligations under the lease agreement shall be transferred in connection with closing. Some sellers may be reluctant to simply transfer the deposit to the purchaser since the seller under certain circumstances will be liable for the repayment to the tenant.

In connection with closing the tenant will be asked to approve the transfer of the deposit. If the tenant does not approve the deposit will be repaid to the tenant. Even if the purchaser has a claim against the tenant to pay a new deposit the repayment to the tenant shall be avoided as such procedure is time consuming and there is a risk that the tenant will not pay a new deposit. Hence, it is necessary to either convince the seller to transfer the deposit to the purchaser or draft a letter to the tenant in a way that they do not call for repayment but rather accept the transfer.

Documentation

Risk Analysis

There are normally a lot more documents than described in this report that you will have to obtain and analyse in connection with a real estate transaction. To keep an overview of all the information you have to structure the information in a suitable way.

It is useful to work with a due diligence list in which you enter all documents relevant for the transaction. This may be a standardised list, which can be adjusted from deal to deal. It will facilitate the documentation management and you will have control over the

obtained and still outstanding documents. You may provide the seller with the list so that he can prepare and provide you with the relevant documentation. Should some information not be possible to obtain, this shall also be recorded. In this case you have to assess the risk of not having the relevant information.

Documentation Management

A structured documentation is not just important for analyzing the legal risks before signing. It will facilitate the exchange of documents at closing and it will also make the internal handover of the documentation to the asset manager smoother.

Furthermore, should any disputes regarding guarantees occur, it is essential to have good documentation of the transaction, otherwise will you not be able to prove your claim.

In connection with external financing it is crucial to be able to deliver certain documents in a certain form. In case of exit it will also be necessary to provide the potential buyer with the information on and around the property.

External Legal Due Diligence

Should you instruct external legal advisors to carry out the legal due diligence it is crucial that the legal advisors get detailed information about the deal respectively instructions which issues they shall focus on.

In larger transactions it is recommendable to instruct external legal advisors in writing. In such cases the law firm may want to define the scope of assignment and to limit its liability. However, it is important that the liability mirrors the size and the complexity of the transaction.