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APARTMENT ACQUISITIONS REQUIRE DUE DILIGENCE

A construction attorney's perspective on why this task should never be overlooked when you're buying your next apartment building.

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With historically high rents fueling the resurgence in the apartment market, sellers are once again demanding top dollar for rental properties, while buyers have become increasingly aggressive in their pursuit of available inventory. During this process, the prevalence of defective construction in the apartment industry should not be overlooked. Conducting thorough due diligence investigations is essential in avoiding the substantial

repair and maintenance costs that can directly affect the economics of an acquisition.

Understanding Apartment Construction

Even reputable commercial inspection companies often focus their due diligence investigations on interior systems and generic sources of water intrusion — rather than focusing on the specific assemblies unique to apartment construction that are highly susceptible to water damage when improperly built. In this market, it is important that an investigator be sophisticated in where defective construction is most likely to cause damage and how that damage tends to manifest on the finished surfaces of the building.

Forensic investigators who provide support to attorneys can be an excellent resource for buyers during due diligence. For example, they can review architectural plans for common architectural details prone to water intrusion. They can then walk a project and very commonly identify locations that have a high probability of leaking without incurring the cost of destructive testing. This information can then be used to evaluate the economics of the sale.

Understanding Who Built Your Project

Original construction files are also commonly overlooked during the due diligence period. Reviewing design drawings, subcontracts and prime contract documents can assist a buyer

in assessing the quality of those who originally built the project. How does one make this determination?

First, ask about the developer. Some reputable developers function as their own general contractors. This is a red flag that should trigger caution. When developers act as their own general contractors, there is an increased probability that quality control will suffer for the sake of maintaining the development pro forma and schedule. This is particularly true if the developer did not hold the asset for a significant amount of time after it was built.

Second, ask about the design professionals. Some architectural firms are better at generating contractor-friendly plans than other firms. If the plans are too complicated, it is surprisingly common for subcontractors to simply ignore them, and instead implement their standard means and methods of construction.

Third, ask about the subcontractors who actually performed the work. How many of those subcontractors are still in business? What was their reputation when they worked on the project? A builder's habits have a tendency to carry over from project to project, good and bad.

Attorneys and inspectors who work with apartment owners in your region should know who each of these players are and can help answer these questions.

Understanding The Maintenance History

Because purchase and sale agreements commonly have limited representations and warranties, buyers should seek to gain as much "actual knowledge" about the function of the project as possible. Maintenance records are often the most important records for ascertaining this information and they are commonly ignored. Patterns in maintenance trends can provide valuable insight into what systems are not performing. The problem may not be the tenants, but instead may be the system itself.

Talk to maintenance personnel. On one occasion, a client was horrified to learn that a team of painters did nothing but caulk and paint siding, because of installation errors in the building envelope. The buyer never bothered interviewing any members of the maintenance team who freely volunteered to lawyers in subsequent litigation that the project was referred to as the Golden Gate Bridge, because the asset was perpetually being painted.

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Understanding Claims Preservation

There are three important legal theories that purchasers of apartment properties should be aware of prior to closing escrow on a property.

First, there is an absolute bar to suing a builder for defective construction more than ten years after the project was completed.

Second, for projects less than ten years old, claims for construction defects can nonetheless become time barred if not pursued within three years of when an owner knew or should have known that the defect existed.

Third, the right to sue for defective construction is a personal property right that does not automatically transfer with the sale of the property. As a consequence, if a seller is aware

of defective construction prior to the close of escrow and does not specifically transfer the legal right to sue for that defective construction, the right can remain the personal property of the seller, and the buyer will have no recourse against the builder.

Due diligence requires patience, hard work and professionals who possess the expertise to properly advise their clients. A proper investigation includes a thorough understanding of the project's construction and maintenance history, as well as a thorough understanding of the available rights to be conveyed.

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