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## Due Diligence

Doing Your Homework

By Meryl Feiner

House hunters often spend weeks, months, sometimes even years searching for that perfect place to call home. Finally they find it - great space, perfect location, price within the budget. But, before signing on the dotted line, purchasers of co-ops and condos should do their homework - or, as it's referred to in the legal world, their due diligence. Due diligence is the level of care, prudence and activity that a person would reasonably be expected to meet under particular circumstances.

When purchasing a co-op or condo, a purchaser and his legal counsel should undertake the due diligence process together, review their findings and determine if the purchase makes sense. Legal advisors have varying opinions on how much activity should be included in the due diligence process and often the process is shaped by the details of a particular sale. The purchase of a one-bedroom apartment in a well established, multi-unit co-op building will likely differ from the purchase of a unit in a small brownstone with only one or two other shareholders.

### The Basics

No matter what the size of the apartment, there are a few steps that every purchaser should take in the due diligence process. "Before you make an offer, get familiar with the surroundings; look for potential trouble spots," says Adam Finkelstein, a partner specializing in real estate with the Manhattan law firm of Wagner Davis and Gold, PC. "For example, a penthouse apartment may have water or leakage problems, or a first floor unit may have noise or traffic issues. Look at the condition of the appliances - are they in working order? Pay attention to the details," he adds.

Michael Present, a real estate attorney with Sexter and Warmflash, PC, a Manhattan-based law firm, says it's a good idea to visit the apartment several times at different times of day. "At the open house on a Sunday morning it may be quiet, but it might be very different at five o'clock in the afternoon on a weekday," he says.

The next step in the due diligence process is to review the building documents and financial statements. This includes reading the offering plan and amendments. "This may be irrelevant in an older building, but not always," says Finkelstein. "If a building converted in 1986, the engineering report may be helpful for major capital improvements. If you see the roof was replaced at the time of conversion and you know roofs are generally good for 20 years, you can deduce that the building will be due for a new roof soon."

Also included in the building documents are the building bylaws, house rules and proprietary lease. These documents will outline the building policies on various issues such as pets, sublets and any other restrictions or requirements that might affect the closing.

On the financial statements, experts recommend reviewing the statements for the past three to five years. "Look for trends of expenses and revenues," says Finkelstein. "Shareholder or unit owner expenses should go up in small increments. If I see there has been no maintenance increase in five years, I may comment negatively on that," he says adding that the building may be deferring maintenance.

The other thing to look for in the financial statements is information about the building's underlying mortgage. "Look to see the maturity date on the loan, the interest rate, and if it is a self-amortizing mortgage," says Present. This information is in the notes to the building's financial statements.

Purchasers are cautioned that building financials typically only come out once a year and someone looking to purchase an apartment in March or April of 2004 will likely only be able to review statements from 2002, since 2003 typically will not be ready until May or June.

To get around this - and to supplement the information in the financial statements - most attorneys recommend reviewing the minutes from board meetings. Copies of board minutes are usually kept with the managing agent and are typically available for review in that agent's office. According to Finkelstein, this is one of the most important items in the due diligence process. "It is the most current information about what is going on in the building right now," says Finkelstein, adding that the minutes may include information about noise complaints involving a prospective new neighbor or whether there are problems with certain shareholders being in constant arrears.

While reviewing the minutes may highlight potential problems, Eric Gonchar, a partner with the Manhattan law firm of Kane Kessler, PC says the board minutes may not include everything. For example, the minutes are often "cleansed" of certain information, including names of shareholders and sale prices for apartments. "Another problem with the minutes is that few buildings are completely up-to-date. Some buildings don't even meet every month," says Gonchar.

To gain additional information, Gonchar says his firm sends out an extensive questionnaire to the managing agent. Among other things, the questionnaire confirms the maintenance amount and number of shares for the unit, the percentage of tax deductibility, current reserve fund, and cash on-hand. Gonchar also asks about the maintenance history and plans for any future maintenance increases. "We ask how improvements are paid for, major capital improvements or repairs expected in the future, and we ask about major systems condition and repair," says Gonchar.

With condominium sales, Gonchar recommends reviewing the allocation of common elements to each unit and asking how many units are owner occupied. "This is very important because you may have trouble getting financing in a building with a high investor concentration."

When purchasing an apartment in a newly constructed condominium or co-op, Douglas Kleine, executive director of the National Association of Housing Cooperatives (NAHC) says buyers should "make sure the developer has the financing to finish the project and do warranty work. Also look at the pace of sales - a slow pace could be a red flag."

To avoid surprises at closing, Gonchar recommends confirming closing costs and fees that are to be paid by the purchaser. For example, while flip taxes are usually paid by the seller, Gonchar says he had an instance where the purchaser was responsible for paying the flip tax.

"All the findings of the questionnaire are put into a memo to the client," says Gonchar. "This puts the client on notice about anything that may be of issue in the building or the unit."

#### **Potential Problems**

So what are the signs that there may be trouble ahead? According to Present, a big discrepancy in the budget versus actual expenses is a potential red flag. Large maintenance arrears may be caused by a sponsor default, special assessments, and large variances in expenses from year to year. "Look for consistency," advises Present. "Expenses should only go up two to three percent per year in most cases."

"If there are large legal expenses, that could be a tip-off there may be a problem with a lawsuit with the sponsor or a shareholder," says Present. "Problems usually jump out," he adds.

Finkelstein also advises to look for reserves in a comfortable range. "In buildings of 60 to 100 units, I usually like to see a minimum of \$2,500 per unit in reserve fund," he says, "usually \$2,500 to \$5,000 per unit in better-run buildings. If there is no reserve, ask how they will finance capital projects."

#### **Environmental Issues**

Over the past few years there has been a mounting concern about mold and other environmental hazards in homes. Linda Alderman, a partner in the law firm of Alderman and Alderman headquartered in Connecticut and specializing in environmental issues says if mold or asbestos is found in a building, shareholders may be liable for the clean-up. "Ask if there has been a mold inspection or an asbestos abatement, and review the documents to see if there is any liability to the unit owner," says Alderman.

Present advises potential buyers of loft units that were formerly used for manufacturing to make some inquiries about the type of work that was done in the building. "It's not well-publicized, but there could be toxic substances in the walls depending on what was manufactured there. If you have young children, you might want to have the loft tested."

#### **Tell-All?**

The standard sale contract requires the seller to make few representations other than the apartment will be left vacant and broom-clean, free and clear of any liens, and that all appliances are in working order. There are no representations about the financial condition of the building or about any quality of life issues.

While New York State's Mandatory Seller's Property Condition Disclosure law - which went into effect in March of 2002 - requires every seller of one- to four-family residential housing to provide a completed Property Condition Disclosure Statement to potential buyers, the law doesn't apply to new construction, co-ops, or condos. And while the seller cannot take action to hide information that could influence the sale of an apartment - such as putting a piece of furniture in front of a water-damaged wall - the seller is not obligated to speak when the parties are dealing at arms' length, according to sources interviewed.

As for the broker, while many brokers are often knowledgeable about the apartment and building they are selling, buyers would do well to remember that the broker is working for the seller and is under no obligation to make any representations.

#### **Recourse For the Buyer**

In a hot market, buyers may be tempted to skimp on their due diligence, but as the old adage says, buyer beware. Once that contract is signed, it is not easily broken by the purchaser. Buyers are well advised to hire an attorney that specializes in real estate law. Some attorneys will put clauses into the sale contract to protect the buyer. Gonchar for example says he often asks the seller to make representations in the contract that there is no water infiltration in the unit, that they are not aware of any complaints about noise, odors, or lack of heat, there are wood floors under any carpet, and there is nothing hidden by furniture that would negatively affect the buyers decision to purchase the unit.

In the end, the decision is up to the buyer - but if he or she has done proper due diligence, that decision will be a well-informed one.

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