



## **Importance of Asset/Real Estate Due Diligence and ways to Mitigate the Risks**

### **1. Introduction**

Over the last few decades, due diligence has become integral element of any acquisition/transaction. It is a well established principle in English law, “let the buyer beware” or *caveat emptor*. S.16 of the Sale of Goods Act 1930 incorporates the principle of *caveat emptor* which reads as, “*Subject to the provisions of this act or any other law for the time being in force there is no implied condition or warranty as to quality or fitness for any particular purpose of goods supplied.*”<sup>1</sup> The Latin maxim not only applies to the quality of goods/materials being purchased, but also to the title of the land which is sold, it is the duty of the purchaser to view the land and inspect and inquire the title-deeds.

Due diligence involves gathering the information and analyzing the potential risks involved in the subject matter of a transaction, subsequent to which, the prospective purchaser, carries out due diligence to evaluate the pros and cons of the deal/transaction. Due diligence is not a substitute for contractual protection, rather it assists the parties to work out the measures to protect their respective interests. Conversely, contractual protection is not a substitute for due diligence.<sup>2</sup>

### **2. Asset / Real-Estate Due Diligence for a transaction**

Likewise, due diligence exercise is one of the most crucial aspects of a transaction involving real estate. The diligence process has the potential of not only impacting the commercials but also deducing the feasibility of the transaction itself. Issues such as a faulty title, inadequate construction permissions/approvals, encumbrances/liens on the property, can impact the entire transaction and have a bearing impact on the commercials of the transaction, where the prospective purchaser is aware if the property being acquired has a clear title or requisite approvals in place. The basic prerequisites which form the basis of a real estate due diligence constitute the following:

- i. Whether the Owner/Lessor has an authentic title/interest in the property and does he have a valid right to sell/lease the property.
- ii. Whether there are any pre-existing encumbrances or liens on the property, *inter-alia* - unpaid taxes, charges, mortgages, litigation etc.

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<sup>1</sup> Sale of Goods Act, 1930 S. 16

<sup>2</sup>Slaughter and May - Due Diligence and Disclosure in Private Acquisitions and Disposals , 2017



- iii. Whether the Owner/Lessor has all the approvals/permissions in respect of the subject property.
- iv. Are there any restrictions on the proposed use of the property? (eg.: if a property has been constructed for residential purposes, whereas the intended purpose of use is commercial purpose).

### **3. Hospitality industry**

There are numerous structures in the market for ownership and operation of a hotel. The more feasible and sustainable model being followed by most of the reputed brands in the hotel industry is operating model, this is where the term Hotel Management Agreement (“**HMA**”) comes into the fray. HMA is the preferred and popular modus operandi being followed, and HMAs have become increasingly prevalent amongst the major international hotel operators. HMA is a preferred option wherein, the owner wishes to obtain the benefit of the operator's expertise in advising and providing services to hotel owners in connection with the furnishing, equipping, marketing, maintenance, operation, management, supervision. AHMA records the relationship between the owner and the operator of a hotel. The operator is in charge of the regular functioning of the hotel which includes hiring and firing of employees. Under such agreements, the hotel operator has almost exclusive control over the subject hotel.

One of the most essential aspects of a HMA involves real estate diligence. Real estate diligence, involves an extensive and in-depth review of the ownership i.e. title of any property starting from its inception to the current date. It is primarily conducted to verify the ownership of title over the property and search any pre existing encumbrances over the property. It is paramount to realize the importance of verifying the title, checking approvals and permissions, legality of construction, pending charges and encumbrances while conducting real estate diligence for hotel operators. Real estate diligence, in case of HMA is not a very common practice, but the importance and necessity of a thorough diligence prior to execution of the HMA, limits multiple risk factors which may arise in the foreseeable future.

### **4. Importance of Asset / Real Estate Due Diligence in the Hospitality industry**

Although in case of operating model, the ownership vest with the hotel owners, the need for a thorough real estate diligence has increased manifold. It is of utmost importance that the hotel operators are careful when negotiating such lease agreements to address the key concerns, such as:



**a. Checking Owner's/ Lessor's Title**

First and foremost, it is essential to ascertain the authenticity of the title of the owner/lessor. A complete search must be conducted by the legal advisors of the Hotel Operator, wherein they should conduct an extensive search/inspection about the chain of title of the property ranging from instances *inter-alia* - to that of sale/ resale/ long term lease transactions/gift etc. It is ideal that the search/inspection should be conducted for a period of (thirty) 30 years from the date on which the seller/lessor in question came to acquire the property. In most cases, the search should include, detailed inspection of all aspects relating to the authenticity of the registered documents, history of the subject property, such as the status of encumbrances over the property, the status of disputes relating to the property etc.

**b. Checking the Nature of the Property and Legality of Construction**

It is essential to ascertain the nature and use of the property, whether the property is freehold or leasehold, whether the property/land is for residential purposes or commercial purposes. These are all important factors which need to be identified while conducting real estate diligence.

Another important aspect is to check the legality of construction. Every state/development authority has laid down their rules and regulations which lay down a mechanism in which the constructions need to be carried. Therefore, the legal advisor of the hotel operator should be familiar with the local construction laws, applicable in the region in which the building is situated and accordingly determine whether these have been complied with. For instance, a No Objection Certificate (“**NOC**”) is required to be obtained from the Airports Authority of India for any structure/building falling outside CCZM<sup>3</sup> (regulated) area and having a height greater than or equal to 150m Above Ground Level.<sup>4</sup> Another such example is that the GNIDA<sup>5</sup> requires that any structural design whose built-up area is more than 5000 Sq. Mt. needs to be vetted by the Indian Institute of Technology or its equivalent.<sup>6</sup> One of the most important approvals/clearances required to be obtained is the Fire NOC from the concerned authority. Hence, all approvals/permissions must be verified and validated.

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<sup>3</sup> “Color Coded Zoning Map”.

<sup>4</sup> GSR 751 (E), Ministry of Civil Aviation, 30th September, 2015.

<sup>5</sup> “Greater Noida Industrial Development Authority”.

<sup>6</sup> Building Regulations, Greater Noida Industrial Development Authority <http://www.greaternoida.com/>.



### c. **Checking for any charges, encumbrances, litigation etc.**

It is necessary for the legal advisors of the hotel operators to verify any existing encumbrances/liens, charges, mortgages on the property in question. The records of the concerned sub-registrar of properties should be inspected to ensure that the property is free such encumbrances. It is important to confirm if the property in question is involved in any litigation, as it may affect the title of the subject property in the near future.

In a relevant case, involving City and Industrial Development Corporation (“**CIDCO**”) (Government of Maharashtra Undertaking) on which Inorbit Mall and the Four Points hotel was constructed, the Mumbai High Court held that the allotment of the said the property was illegal due to gross violations of rules, CIDCO policy and constitutional norms and directed the Developer to hand back vacant possession of the land to CIDCO. As a matter of fact even though the land in the subject case was allotted by CIDCO (a Government of Maharashtra undertaking), instances and cases such as this highlight the necessity and importance of a thorough asset / real estate due diligence. A thorough due diligence of the land involves verifying the approvals and sanctions of a project, the same would have red-flagged issues and irregularities, which in-turn would have diminished such liabilities/risks.

## 5. **Conclusion**

Real estate due diligence is of utmost importance for every commercial real estate transaction and also for hospitality industry, as discussed above. A comprehensive due diligence/physical assessment of a property can be an effective and proactive tool for management of risks, associated in a prospective transaction.

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