

Legal Highlights: Distressed Property: Grab It While the Crisis Lasts?

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August 04, 2015

The  **Moscow Times**

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When a recession hits, distressed assets become a popular topic, their purchase often being seen as a good investment in times of crisis. Yet the matter is not so simple, especially when it comes to so-called distressed assets on the commercial real estate market.

To start with, high quality commercial properties have always been in short supply in Russia. Moreover, they are specific in terms of location and might come with various unique technical problems or historical issues relating to the land or asset owner, so such assets are, in fact, difficult to group into any single "distressed" category. I would even go as far as to say that there is no such thing as an absolutely "clean" real estate asset. From our experience, even the highest quality property always turns out to have certain problems.

As the market is not flooded with high-quality properties, to identify a profitable deal virtually means recognising the right time to sell or buy; in a crisis, this would be judging when the market is at or near the bottom.

It is a no-brainer that, besides striking just the right time to buy or sell, it is essential for the investor to assess the asset, including by identifying any critical risks (deal breakers) and factors affecting the price. So a comprehensive technical, financial and legal due diligence is the key.

Distressed Assets – the Nature of the "Distress"

There is no point in citing the entire due diligence checklist, as the list of issues and documents reviewed often consists of dozens of pages. Although the due diligence process is fairly self-evident for professionals, it might be interesting to discuss a few examples of critical and non-obvious due diligence issues.

First of all, it must be understood that some problems simply cannot be resolved, such as when a property has been built where construction of the given type is prohibited or there are other essential violations of the construction regulations. In this respect, technical and legal due diligences often complement each other in examining the property's technical condition and construction background. Technical specialists do not verify whether the requisite documents are in place, just as lawyers are unable to check whether, for instance, the building's utilities are serviceable. There might be other risks of a corporate nature. Violations are sometimes committed in securities issues or payment of authorised capital, when such payment cannot be confirmed or assessed; consequently, there is a risk of a subsequent sale being challenged (in the case of a corporate real estate sale). While assessment of commercial risks is a matter of individual opinion, many will see them as a "red flag" and, in fact, an obstruction to a transaction.

Resolvable problems include ones relating to operation of the building, restoring the requisite legal papers or other commercial issues, such as lack of a parking lot (or extra parking lot) required for operating the building or boosting the trade centre's business. Such problems are not insuperable if the investor has the time, relevant qualifications, expertise and resources for assessing them correctly and resolving them. These problems may be lived with and many see purchase of such assets at a risk-adjusted price as an opportunity for improving some asset performance indicators and achieving higher yields in the future.

Investors might pursue even more ambitious goals by, for instance, purchasing a trade centre, re-branding it in an attempt to alter its format, bringing in new tenants and brands, changing the customer traffic, raising revenues and, accordingly, the trade centre's profitability. Needless to say, this is no easy task and it requires certain skills and competences.

Obvious and Otherwise

Let us briefly consider the risks — both obvious and otherwise, either of which may or may not be deal breakers.

It might sound strange, but risks relating to land plot boundaries are not always obvious. In fact, technical due diligence of the target (such as an office building or a shopping centre) does not generally stipulate marking out the land plot boundaries. What does this mean? We have seen situations when, on paper, a building is located within the land plot boundaries and a visual inspection does not identify any discrepancies either. Yet an attempt to mark out the boundaries reveals that either the building extends beyond the land plot or the boundary of the land plot itself is violated. From the legal viewpoint, there are various consequences of a building extending beyond the land plot boundaries, including, in the worst case scenario, even demolition. It also often entails a variety of commercial issues. For example, if a land plot designated for parking does not in fact exist or is smaller than anticipated, the implications for your business might be significant and actually affect the property's future liquidity and profitability.

For these simple reasons, it is always recommended to have the land plot boundaries marked out during the due diligence stage. This is a simple and low-cost procedure and it is especially relevant in Moscow, where the development density is high and all properties are in close proximity to one another. Although the relevant registers (now accessible online) contain

quite accurate information about land plots, land plot boundary violations in Moscow are still fairly common and, while these are not always critical, it is better to be aware of them prior to buying the asset.

Today, another important issue for an investor to look at is tenant solvency analysis. When operating on a growing market, no-one was really concerned about this. Tenants' obligations were secured by deposits and, if a tenant left for any reason, it was easy enough to find a replacement, even on better terms. With the current limited demand for vacant space, however, this is becoming critical. Tenants' inability to perform their contractual obligations, including to pay any termination penalties, is an especially pressing issue. Solvency analysis is, therefore, essential, even though it is not the most obvious or easiest aspect of a due diligence. Information of this kind is hard to come by.

In-House or Outsourcing

Most experienced players we know outsource the entire process: legal, technical and financial due diligence and the transaction procedure itself. Even though many of them have strong in-house resources, outsourcing is advisable for a few reasons I will discuss below.

Speed is a key consideration, whereas, even though experienced, qualified and highly skilled, professional investors often have lots of parallel tasks on their hands and are unable to focus entirely on a single property or transaction.

Meanwhile, ability to close quickly is equally important in times of crisis or uptrend. We here are experiencing high volatility, whereas the London commercial real estate market is booming. With 10 to 15 potential buyers per property, the ability to run a due diligence and exchange documents quickly gives a significant competitive edge. The due diligence and the entire transaction in the UK might take only a month or two.

A market in crisis (such as Moscow's at the moment) is, however, fraught with "new day" challenges: you might wake up one day to a "war" or significant currency devaluation, so all deal-closing would naturally be forgotten. Last winter, we saw some actual cases of transactions being cancelled because the parties took too long to agree the price. Or rather, they would actually agree but would have to renegotiate a fair price a couple of days later at a new rouble exchange rate. Even more worrying were the volatility and uncertainty about the future. Of course, in this case, lawyers cannot facilitate the transaction, no matter how quick they are. Nevertheless, if you intend to close an asset purchase, you obviously need to act as fast as you can once the decision is made.

The second key factor is proper allocation of liability within the business. It is no secret that international law firms are covered by professional liability insurances worth hundreds of millions of dollars. By engaging such firms, investors also insure their own exposure if material risks are not identified. For foreign banks and institutional investors, involvement in a transaction of an ILF covered by relevant insurance is a "tick the box exercise" simply from the risk and compliance point of view.

What Foreign Investors Should Keep Their Eye On

There is certainly no massive influx of new investors from overseas on the Russian market

at present. For foreign investors, it is psychologically easier to buy less risky assets, even though at a higher price. In times of crisis, international investors set tougher requirements on asset quality than they do on a growing market. A good mitigation solution is to partner with a player that has had some Russian exposure and such cases are now very common.

One more thing for foreign investors to remember: certain straightforward M&A tools, such as W&I Insurance (insurance against losses as a result of breach of warranties or indemnities), are rarely used on the Russian M&A market, so one should focus more on high-quality due diligence and be prepared to use alternative security arrangements (bank, corporate or personal guarantees, retention deposits, etc.).

* Goltsblat BLP is the Russian practice of Berwin Leighton Paisner (BLP), an award-winning international law firm headquartered in London and with offices operating in major commercial and financial centres throughout the world — Moscow, Abu Dhabi, Beijing, Berlin, Brussels, Dubai, Frankfurt, Hong Kong, Paris and Singapore. The firm has a team of 100 Russian, English and US law qualified lawyers based in Moscow and over 800 lawyers in the other international offices. Goltsblat BLP currently has over 700 clients among the major international investors operating in Russia, including 23 Fortune 500 companies.

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