Legal Due Diligence Issues in Real Estate Purchase Transactions

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This article offers some observations and suggestions regarding the management of the legal due diligence process in connection with the purchase of real property.

The primary purpose of due diligence is to obtain information, and the extent and type of due diligence that purchaser’s counsel may undertake will depend on, among other factors:

(i) the risk profile and business objectives of the purchaser;
(ii) the type of real estate asset involved;
(iii) the time frame for completion of the transaction;
(iv) the cost of conducting due diligence; and
(v) whether the purchaser will obtain third party financing either pre-transaction or post-transaction closing.

As a prelude to commencing legal due diligence, purchaser’s counsel first must negotiate effective due diligence provisions in the purchase and sale agreement. Following execution of the purchase and sale agreement, purchaser’s counsel typically undertakes a review and analysis of the title commitment applicable to the property, the underlying title documents referenced in the title commitment, and the property survey. Depending on the property type, the due diligence process may include obtaining and reviewing property leases, ground leases and other property-related documents, some of which may be prepared by outside consultants.

Contract Negotiations

The purchase and sale agreement contains five important provisions relating to property due diligence:

(i) the representations and warranties;
(ii) the due diligence deliveries section;
(iii) the provisions describing the duration of the due diligence period and the purchaser’s inspection rights during the due diligence period,
(iv) those contract provisions relating to the seller’s obligation to provide consents and/or estoppel letters from certain third parties; and
(v) the confidentiality provision.

As with due diligence itself, the primary purpose of contract representations and warranties is to provide the purchaser with information regarding the seller and the property. Purchaser’s counsel should strive to include as many property-related representations and warranties in the contract as is practicable under the circumstances. Property-related representations and warranties are particularly useful in circumstances where a seller must expand or modify a ‘‘standard’’ representation and warranty (e.g., a representation and warranty that the seller has not received knowledge of any building code violations) in order to provide information that identifies issues of particular concern to the purchaser (i.e., in the example above, the actual existence of a building code violation). If a representation and warranty deviates from the standard ‘‘no problems’’ language, then purchaser’s counsel should request additional information from the seller during the due diligence review period regarding both the ‘‘problem’’ and the legal consequences of the existence of that problem.
The contract should contain a detailed list of all due diligence delivery items, as well as a schedule for the delivery of copies of the due diligence materials to the purchaser and its counsel (or, in the alternative, the date on which the items will be made available for review at the property or another location). Many sellers currently use online due diligence “rooms” where the necessary due diligence documents are made available to the purchaser and its counsel immediately following contract execution.

The contract must provide the purchaser with a specific period within which to complete its due diligence and raise any objections with the seller. The commencement and length of this “due diligence period” or “review period” is often the subject of much negotiation, as the seller typically desires to have the due diligence period commence upon contract signing (or earlier, if the seller has provided the purchaser with due diligence information during any letter of intent negotiations) and be as short as possible. Depending on the complexity of the transaction and the volume of due diligence information, the parties may negotiate “phased” due diligence periods whereby the purchaser will have to comment on title and survey by one date, and other due diligence matters by one or more other dates.

Depending on the asset type and transaction structure, counsel for the purchaser may need to add a provision to the contract describing the seller’s obligations to obtain third party consents and/or estoppels. Third party consents may be necessary in situations where the purchaser is assuming existing mortgage or bond financing in connection with the acquisition, while estoppel requirements are customary in purchase transactions involving office buildings, industrial facilities and shopping centers (i.e., transactions where there are significant tenant leases, ground leases, reciprocal easement agreements (“REAs”), declarations of covenants, conditions and restrictions (“CCRs”), commercial condominium, or other documents that affect the use or operation of the subject property). Counsel should carefully review all due diligence documents to determine if those documents expressly obligate the parties thereto to furnish estoppel letters upon request.

Finally, the contract usually contains provisions requiring that the purchaser keep all of the due diligence information regarding the property confidential, irrespective of whether the information is furnished to the purchaser by the seller or independently obtained by the purchaser from its consultants. The purchaser’s counsel must make sure that the confidentiality provisions permit the purchaser (i) to meet with and interview any necessary third parties (e.g., tenants, representatives of governmental authorities, ground lessors) and conduct any appropriate on site physical inspections and testing during the due diligence period, and (ii) to share due diligence information with the purchaser’s lenders, accountants, insurers, attorneys, consultants and other relevant advisors.

Due Diligence

Immediately following contract execution and prior to commencing due diligence, the purchaser and its counsel should allocate between themselves responsibility for performing the various due diligence tasks. Depending on the purchaser’s organizational resources, the purchaser usually will take responsibility for reviewing all financial information (including capital expenditure requirements), physical condition information (i.e., property condition and environmental reports), appraisals, and similar items, while purchaser’s counsel will undertake the review of the title commitment, underlying title documents, survey, leases and other legal documents. The purchaser’s counsel also should discuss with the purchaser the need for any third party reports or searches of a legal nature, such as a title commitment and current survey (if the purchaser is responsible for those items), zoning reports, UCC searches, and building code violation searches in order to make sure that those items are ordered and received in sufficient time for review prior to the expiration of the due diligence period.

Unless otherwise instructed by the purchaser, purchaser’s counsel should prepare written summaries or abstracts of all due diligence documents reviewed by counsel. These summaries should be as detailed or brief as the client and/or the nature of the transaction require, but the summaries will be a very useful resource both during the due diligence review period and after transaction closing.

Title Review

Counsel for the purchaser should analyze the title commitment and underlying title documents (including any REAs and CCRs) in the context of the client’s current and anticipated use of the property. For example, if the client is purchasing an apartment project with a view to converting the project to condominiums, then counsel must confirm whether the title documents allow, prohibit or otherwise condition the use of the project as condominiums. Also, counsel must review all easements and other agreements that affect the property in order to (i) understand the rights, if any, of the purchaser under the documents and, to the extent possible, make sure that those rights are insured by the title insurance company under the owner’s title insurance policy issued at closing, (ii) identify any obligations under those documents that will bind the purchaser after closing (e.g., common area maintenance and expense obligations in connection with the ownership of a shopping center), and (iii) determine whether any additional easements or other agreements of record, or the modification of any existing agreements of record, will be necessary in connection with the purchaser’s ownership and intended operation of the property post closing.

On rare occasions, provisions in the underlying title documents may impact the purchaser’s proposed ownership structure. For instance, the terms of the
CCRс may prohibit fractional ownership of real estate. Such a restriction, unless modified, may prevent a tenant-in-common sponsor/syndicator from purchasing an asset.

During the title review, counsel also should determine as soon as possible whether any third party consents are required under the various title documents, as well as decide which parties to the documents should provide estoppel letters in favor of purchaser (and purchaser’s lender, if any) in connection with the acquisition transaction. Based on these determinations, counsel should prepare and forward to the seller’s counsel any required third party consents and estoppels.

If the purchaser is going to finance its acquisition of the property, then purchaser’s counsel also must review title in the context of identifying and resolving issues that the lender may have regarding the underlying title documents. Such issues may be as simple as making sure that all estoppel letters are addressed to both the purchaser and the lender, or as complex as requiring that the seller amend existing REAs, CCRs or ground leases to provide more lender protections in those documents. If the purchaser is assuming an existing loan as part of the acquisition transaction, then counsel to the purchaser must review both the loan documents of record and all other loan documents to make sure that both the seller and the purchaser are complying with the loan assumption requirements. In addition, counsel should identify any provisions of the loan documents that require modification to conform to the purchaser’s requirements, e.g., transfer and insurance provisions.

In situations where a municipality has ongoing involvement in the development and/or operation of a property (e.g., where the purchaser is purchasing a (i) leasehold interest in a property owned by a governmental body, or (ii) property where the current owner has outstanding performance obligations to a governmental body, such as unreMedied building code violations), purchaser’s counsel must review all relevant documents (recorded and unrecorded) in order to identify those obligations that will survive the purchaser’s acquisition of the property and become the purchaser’s responsibility. These obligations may include obtaining a replacement or new letter of credit or surety bond or providing a guaranty as security for unfinished obligations to be performed by the property owner, or negotiating with the appropriate governmental authorities the terms of any additional development to occur on the property or the timetable for curing outstanding building code violations post-acquisition closing.

Finally, prior to the expiration of the due diligence review period purchaser’s counsel should (i) inform the seller’s counsel and the title insurance company in writing of any required revisions to the title insurance commitment, (ii) ascertain the availability and cost of any endorsements to the final title insurance policy that the purchaser will require as a condition to closing, and (iii) notify the title insurance company of any co-insurance and/or reinsurance requirements.

**Survey Review**

The survey may represent the only “view” (albeit a two dimensional view) that purchaser’s counsel will have of the property prior to closing. Counsel must carefully review the survey in order to confirm (i) that the legal description contained in the title report is the same as that contained in the survey; (ii) the location of the various easements and other exceptions to title (to the extent those exceptions can be depicted on a survey) on the property, and (iii) the availability of a survey or similar endorsement for inclusion on the owner’s title insurance policy.

Wherever possible, in connection with the acquisition of improved property the purchaser should obtain an ALTA/ACSM “as-built” survey prepared in accordance with the most recent “Minimum Standard Detail Requirements” and dated not earlier than 30 days prior to the last day of the due diligence period. ALTA/ACSM surveys are typical in most sophisticated transactions, and the ALTA/ACSM survey format costs more than state-standard surveys and requires that the surveyor provide more detailed information about the property than most state-specific survey standards. Purchaser’s counsel should discuss with his client what additional matters (in the form of the so-called “Table A” items) should be included on the survey. Table A items include matters such as zoning information, flood zone information, calculation of building area and any wetlands designation. Purchaser’s counsel also should, in consultation with his client, identify the parties that will be the addressees of the survey (i.e., the parties that are entitled to rely on the survey) and determine the need for any specialized survey certification language that the purchaser or its lender will require from the surveyor. In making these decisions the purchaser and its counsel must balance the need for obtaining the additional information that Table A or a non-standard survey certification form may provide, against the additional cost of obtaining those items.

The second appendix to this article contains a sample checklist that purchaser’s counsel may use as a guideline to reviewing a survey.

**Zoning Reports**

In some circumstances, certificates of occupancy for the property may not be readily available and/or for due diligence purposes the purchaser may desire a letter from the applicable municipality confirming the zoning classification of the property and that the current property use complies with applicable zoning laws. In those cases, purchaser’s counsel should engage a zoning services company to work with the municipality to obtain copies of the certificates of occupancy (or confirmation that no such certificates exist) and a signed zoning letter. In particular, the zoning letter will provide additional support to the title insurance company if the purchaser wants a zoning endorse-
ment to its owner’s title insurance policy, and in jurisdictions where zoning endorsements are not available (e.g., Texas) the zoning letter will serve as a very useful substitute.

**UCC and Other Searches**

Purchaser’s counsel should consider ordering UCC, tax lien and other searches of the seller in order to make sure that any liens and encumbrances against the real property or personal property being acquired by the purchaser in the transaction are identified and released at closing (to the extent the purchaser has not agreed to assume certain liens and/or encumbrances as part of the deal). UCC searches are particularly useful in identifying encumbrances affecting personal property that are not identified by the title insurance company as part of the title search process. These searches also can help confirm the accuracy of the title insurance company searches of the real property. Finally, judgment and tax lien searches can confirm (or take the place of) corresponding contract representations and warranties by the seller on those matters.

Building code violation searches are useful to supplement the purchaser’s physical due diligence on the property, especially in situations where the purchaser plans to undertake renovations of the property after acquisition.

**Other Due Diligence Documents**

Depending on the purchaser’s needs and the type of property being acquired, as part of the due diligence process purchaser’s counsel may be asked to review and summarize critical terms of leases, ground leases and property financing documents. As with other due diligence document reviews, the goals should be to:

(i) ascertain that the documents allow the purchaser to operate and/or modify the property consistent with the purchaser’s business objectives;

(ii) identify the purchaser’s post-closing rights and obligations under those documents;

(iii) confirm the financial provisions (e.g., rent, expense reimbursements, landlord payment obligations) of the documents; and

(iv) determine whether a lender will require any modifications to the documents as a condition of providing mortgage financing for the property.

**Property Transfer Requirements**

Some jurisdictions have specific requirements that must be satisfied as a condition to transferring title to real property. For example, the City of Chicago requires that the water meter at the property be read and the water bill be paid prior to recording the deed. Other municipalities require an inspection of the property as a condition of title transfer. Purchaser’s counsel should identify any such legal requirements and make sure that the seller or the purchaser, as applicable, is complying with those requirements.
Appendix 1
SAMPLE PROVISION REGARDING DUE DILIGENCE DELIVERIES

Seller has previously furnished to Purchaser or will promptly furnish or make available to Purchaser at the offices of Seller in [City, State] within two (2) business days after the Effective Date (and at all times thereafter):

(a) The most recent survey for the Premises in the possession or control of Seller;
(b) Copies of the most recent title policy or commitment for the Premises in the possession or control of Seller;
(c) A true, correct and complete copy of each written Lease and a true, correct and complete written summary of each oral Lease;
(d) A true, correct and complete copy of each written Service Contract and a true, correct and complete written summary of each oral Service Contract;
(e) Copies of:
   (i) Prior real estate tax bills, including special assessments or incentives, copies of all tax protests, and related correspondence and protest results for the Property for the past three (3) years; and
   (ii) Prior twelve (12) months’ utility bills for the Property.
(f) A true, correct and complete copy of the current management agreement;
(g) Certificates of occupancy for the Premises and other documentation with respect to compliance of the Property with government requirements;
(h) A current, certified Rent Roll, including unit number, unit size, market rent amount, contractual rent amount, vacant units, down units, model/employee units, security deposit amounts and pet deposit amounts;
(i) Financial books and records for the Property, including, without limitation,
   (i) Detailed operating statements for the past two (2) year ends, current year-to-date and a twelve (12) month rolling history; and
   (ii) Schedule of replacement costs and capital expenditures (if not already included in detailed operating statements) for the past two (2) year ends, current year-to-date and a twelve (12) month rolling history;
(j) General ledgers for the past two (2) year ends and current year-to-date;
(k) Rent Rolls for the past two (2) year ends and the past twelve (12) months;
(l) Twelve (12) month rolling occupancy report;
(m) Lease expiration report for the next twelve (12) months;
(n) Current payroll listing of all employees of the Seller involved with the Premises, their names, contact information, job descriptions, union/non-union status and current salaries or pay rates, as well as a payroll register for the last twelve (12) months including employer taxes, contributions and benefits;
(o) Detailed tenant delinquency reports and/or aged receivable reports for past two (2) years and the current month;
(p) Current and future month’s concession report;
(q) Current month’s pre-paid rent report, security deposit audit report, property status report that shows total number of units occupied, vacant, employee, models and down units and a detailed unit status report that shows status for all vacant, vacant pre-leased, on-notice, on-notice pre-leased and down units; and
(r) Current year-to-date leasing summary report that shows activity by marketing source and reasons for tenant move-outs;
(s) Accounting records for the Property, including without limitation,
   (i) Last twelve (12) months’ cash receipts journal, including bank statements and reconciliations;
   (ii) Last twelve (12) months’ cash receipts posting summaries (a.k.a. rent reconciliation reports);
   (iii) Last year end and current month’s accounts payable;
   (iv) Last year end and current month’s balance sheets;
   (v) Insurance premiums for current year insurance policy and
   (vi) Access to selected vendor invoices and tenant lease files;
(t) All third party engineering, environmental and geotechnical reports and assessments (both draft and final), action and/or work plans, contracts for remediation, soil and groundwater sampling reports and results;
(u) All termite, radon and mold tests or studies;
(v) A copy of Seller’s [partnership agreement][organizational documents];
(w) A true, correct and complete list of all tenants who permit the Property to qualify as a qualified residential rental project under Paragraph 142(d) of the Code, together with copies of all income certifications furnished by tenants since the commencement of the qualified project period, as such term is defined in Paragraph 142 of the Code;
(x) A copy of all plans and specifications in the possession or control of Seller relating to the Improvements on the Property;
(y) A current, certified Rent Roll, including unit
number, unit size, market rent amount, contractual
rent amount, vacant units, down units, model/
employee units, security deposit amounts and pet
deposit amounts;
(z) A list of all personal property;
(aa) A list of all permits, warranties and unexpired
guaranties;
(bb) Copies of existing insurance policies, a sum-
mary of all claims submitted in the past three (3)
years and any pending claims relating to the Prop-
erty;
(cc) A schedule of pending litigation affecting the
Seller or the Property;
(dd) Evidence of the zoning classification of the
Property;
(ee) Any and all other contracts, agreements, docu-
mentation or evidence relating to the ownership,
zoning, financing, value, income, expense, opera-
tion, leasing, construction, maintenance and repair
of the Property;
(ff) Copies of all requests for disbursement of
proceeds of the Bonds and evidence of such dis-
bursement and records relating to the investments
of proceeds of the Bonds;
(gg) Copies of all filings, certificates and reports
required to be made under the First Mortgage Loan
Documents, including but not limited to any filings
related to arbitrage rebate; and
(hh) Any and all appraisals in Seller’s possession or
control.
Appendix 2

SAMPLE CHECKLIST FOR EXAMINATION OF PLATS OF SURVEY

Requirements with respect to a plat of survey and matters to be checked will vary depending upon the purpose of the survey and the physical condition and proposed use of the property. This checklist is general in its nature and is not intended all-inclusive. On the other hand, certain items on this checklist may be inapplicable in a given situation.

1. Check legal description for possible defects.
2. Check boundaries and courses on the plat against the legal description.
3. Check legal description against title insurance commitment or other title documents.
4. Consider necessity of review of plats of underlying subdivisions or obtaining contiguity or other endorsement in title insurance policy or both.
5. Is survey of a fairly current date?
6. Check certification, and as a minimum required reference to appropriate survey standards.
7. Does plat show sufficient details relative to location of improvements on and easements over adjoining land?
8. Access to public streets and highways.
9. Area, dimensions, courses and angles.
10. Area, dimensions, height of improvements.
11. Location of improvements relative to property lines, including setbacks, etc.
12. Show appurtenant and dominant easements identified by document numbers.
13. Location of utilities onsite and connections to source.
14. Are improvements shown as completed, or only as to locations of foundations?
15. Method of describing curves and angles.
16. Showing of pavements, parking areas, driveways, curbs, fences, trees and shrubs, etc.
17. Topography.
18. Lot numbers and location of lots in underlying subdivision.
19. Compliance with set-back and parking requirements of zoning.
20. Compliance with record restrictive covenants.

1 This is a very difficult task in the current purchase and sale environment, where in even the largest transactions sellers often make few or no representations or warranties regarding the physical condition of the property or concerning any other matters where the purchaser can obtain information by making inquiry of unrelated third parties (i.e., obtaining and reviewing title commitments, physical condition reports, and environmental reports).

2 In the case of a building code violation the purchaser should want the seller either to remedy the condition prior to closing or, alternatively, provide purchaser with a credit against the purchase price in an amount necessary to cure the violation.

3 See Appendix 1 to this article for a sample provision.

4 Phased due diligence may occur in a situation where the seller is responsible under the contract for providing a current title commitment and survey to the purchaser but has incurred delays in obtaining those documents.

5 Sometimes it is necessary for the lawyers to review the business due diligence documents as well. One example of this is where the purchaser is a tenant-in-common (TIC) sponsor and the purchaser’s counsel will be responsible for preparing the private placement memorandum in connection with the offering of the tenant-in-common interests.

6 ALTA/ACSM is an acronym for American Land Title Association/American College on Surveying and Mapping. The “Minimum Standard Detail Requirements” establish the minimum level of work that the surveyor must perform to prepare an ALTA/ACSM survey. The most recent revisions to the “Minimum Standard Detail Requirements” occurred in 2006.

7 If the purchaser wants the title insurance company to delete the general exception for survey matters from the owner’s title insurance policy and provide a survey endorsement, then the title company must be one of the addressees of the survey.