

# **DUE DILIGENCE REVIEW UNDER A PURCHASE AND SALE AGREEMENT**

*Prepared by  
Brian DeVoss  
and  
Josh Botts*

*June 27, 2007*

## ***DUE DILIGENCE REVIEW UNDER A PURCHASE AND SALE AGREEMENT***

This article will discuss (i) the typical issues which arise in the course of a due diligence investigation performed prior to the acquisition or disposition of real property, (ii) the types of investigations, document reviews, and inspections that should be considered by seller and purchaser, (iii) the motivations for each party in pursuing the information, and (iv) the potential consequences of not reviewing such information prior to the expiration of a due diligence period or closing date under a purchase and sale agreement.

Prior to the current real estate boom, purchase and sale due diligence was routinely performed in a mad-scramble fashion shortly before the expiration of a due diligence, or "free look," period or the actual closing date. Aside from the opportunity cost, a buyer typically had little to lose if he or she decided to terminate a contract. Seller did not have specific performance and earnest money was generally small relative to the purchase price.

However, as more capital entered the commercial real estate market, the competitive environment has allowed sellers to demand more earnest money. Today good real estate, whether unimproved, income producing or potential redevelopment, will attract multiple potential buyers, enhancing the ability of a seller to get more earnest money relative to the purchase price and shorten the due diligence free look period in order to weed out less serious suitors. Consequently, by the time a buyer executes a purchase and sale contract today, the buyer typically already has a large monetary investment that will not be reimbursable within 15 to 90 days after the date of the contract.

Thus, it is important that a buyer in today's seller-friendly market fully understand (and be ready to mobilize) the due diligence process prior to execution of the contract. Considerations will vary depending on the asset type, but this paper will examine general due diligence considerations that apply to all types of commercial real property. A sample due diligence checklist is attached to this article.

### **A. DUE DILIGENCE RESPONSIBILITIES GENERALLY**

1. *Distribution of the responsibilities* between client, attorney and other professionals retained by client:

In addition to the buyer and seller's attorneys, a typical commercial real estate transaction will involve several specialized professionals, including accountants, real estate market analysts, surveyors, engineers, architects, contractors, and property management experts. Typically, the lion's share of due diligence professionals are independent contractors. However, larger and more sophisticated buyers or sellers sometimes prefer to handle the bulk of due diligence with their in-house engineers, architects, and construction and finance departments.

Attorneys play an extremely important role in the due diligence process. Outside or in-house attorneys often serve as the captains/coordinators of the due diligence teams and are responsible for coordinating all of the various due diligence pieces in a timely manner. Attorneys must also counsel their clients as

to the legal and contractual impact of the data and information produced by the due diligence.

Some of the most obvious aspects of due diligence that are handled by non-legal consultants include the following:

- (i) Phase I and subsequent environmental inspections, sample gathering and reports performed or prepared by environmental engineering or geotechnical companies and evaluated by engineers (and perhaps attorneys) specializing in the environmental matters;
- (ii) Soils and/or structural testing;
- (iii) Topographical and boundary surveying;
- (iv) Traffic studies;
- (iv) Analysis of operating statements and rent rolls;
- (v) Market and demographic studies;
- (vi) Title reports, copies of title encumbrances and lease abstracts; and
- (vii) Site evaluation by engineers and architect from the standpoint of the amount of development the site will support. This is generally done by preparing alternative site plans prepared after evaluating results from the above described due diligence.

Evaluation of land entitlements, such as zoning, platting, water rights, and permitting, is an area of shared responsibility for legal and non-legal consultants. Commonly, an attorney's office verifies zoning by submitting a request for official certification to the applicable zoning authority. The attorney must also investigate what is permitted and prohibited under the applicable zoning category, especially when acquiring vacant land or seeking a redevelopment of a developed property. If an application for zoning or rezoning is necessary, typically the attorney will investigate the process and report to his or her client as to the broad parameters. An attorney may also be retained to help the client through the platting or zoning process, although many engineering firms (and many former city employees who have maintained relationships with the city staff) provide similar services and can often provide a more cost-effective alternative. Other considerations in the zoning/platting process include gaining the support of neighboring landowners and businesses wishing to relocate to the new or redeveloped facility (and their potential employees). Sometimes a client will retain a public relations firm to assist in the presentation to the zoning authority and to communicate to the community in a positive manner the effects of the development on property values and quality of life.

2. Debt/equity structure (financing)

The detail and specificity that a buying entity and, to a certain extent, a selling entity will pursue due diligence is sometimes largely dependent on where and how the buying entity will raise its capital for a transaction. Typically, a buying entity will consist of unrelated principals with one principal being primarily responsible for the equity portion of the purchase price. The buying entity will leverage its equity and collateralize the property being purchased in order to gain the remaining portion of the financing through third-party debt. As a result, the managing principal of the entity that is typically responsible for the due diligence is seeking to satisfy the demands of its equity partner and its lender that have certain internal requirements that must be met before they will invest in or finance the purchase of real property. If the buying entity is simply seeking owner-occupied property in which to operate its business and will finance the purchase through a traditional community banking institution, then the due diligence checklist will take a less detailed look than an office building or development project being potentially financed by multiple tranches of debt, including some securitized debt with an institutional based equity partner in the buying entity.

**B. TITLE AND SURVEY REVIEW DURING DUE DILIGENCE**

Although Mr. Brown and Mr. Godsin will discuss review of title work and survey in much more detail later today, this is still a very important component of the due diligence process and one that falls almost exclusively in the hands of the attorneys representing the buyer and seller. Thus, we will do a quick run through a typical title and survey review performed by the buyer during due diligence along with a discussion of some hot button title/survey issues that are typically negotiated by the buyer and seller. We will not discuss the anatomy of a title commitment or a survey and will leave that discussion to the other panel members.

1. *Title Review* – Any properly drafted contract will contain a section that discusses the process of the title review and the time period that a buyer has to object to certain encumbrances that are revealed in a title commitment and how long a seller has to respond to buyer's objections. Thus, title review typically takes place in two waves: first, prior to the expiration of the due diligence period of the contract, and second, just before closing as part of the lender's objection.
  - a. *Buyer/Seller Objection Period* - These time periods are generally triggered by the effective date of the Agreement and either the buyer or seller will be required to procure a title commitment within the timeframe set forth. Even if the title objection period exceeds the expiration date of the due diligence period under a contract, each party will still be allowed to walk away from the contract without being subject to the default remedies of the other party.
  - b. *Lender/Equity Partner Objections* - Even though the buyer and seller may agree to certain encumbrances affecting the property, the buyer may have additional title objections it is required to make depending the desires of its capital source. Mortgage lenders and sometimes mezzanine lenders will offer their own title

objection letters and require that the buyer/borrower and seller take certain curative steps as a condition to the financing.

- c. *Anticipating Fire Drills* - Once the lender makes its title objection, the buyer/borrower can be in a very tight situation if it does not have a financing contingency provision built into the contract and has just a short time to cure the objections before the closing. Most issues can be cleaned up to the satisfaction of the lender through various affidavits executed by the seller and through title insurance endorsements that a borrower/buyer can purchase from the title company. The buyer/borrower needs to anticipate what its lender will object to on the title commitment and how the buyer/borrower can most efficiently cure those objections before closing. The title exceptions that a buyer/borrower should be most concerned with are those that will require third party consent to remove or subordinate. Some examples are as follows:
- (i) Leases - Any lease, whether recorded or unrecorded, that will remain on the property post-closing will need to be subordinated to the first-lien mortgage; and many times it is a challenge tracking down third-party tenants to obtain their signatures on the subordination form provided by the lender. A borrower should anticipate this problem and be very proactive in obtaining the subordination form from the lender and circulating the form to all tenants, including telecom tenants, at the earliest possible time.
  - (ii) Schedule C Liens - Any liens showing up on Schedule C, including tax liens, judgment liens and notices of lis pendens, will have to be cleared prior to closing; and the buyer and seller must work hard to make sure these issues are addressed earlier than later.
  - (iii) Easements / Restrictive Covenants - Any declaration of easements and restrictive covenants or any deed restriction should be reviewed in detail and will be subject to strict scrutiny by any lender. Buyer needs to make sure that the property is in compliance with the declaration or the deed restrictions and must pay particular attention to use restrictions, architectural/structural guidelines, parking and access rights to ensure that the property will fit the buyer's intended use. A buyer should always require the seller to certify the property's compliance with any declaration or deed restriction and provide evidence of third party consent to any deviation.
  - (iv) Mineral Rights - Mineral reservations will also be objected to by the lender and a buyer must work with the seller to obtain the proper surface waiver by the seller or a third party if necessary. If the property is urban or suburban, there may be a non-drilling ordinance in place at the municipal level, and evidence of this ordinance will allow a

title company to remove the reservation from Schedule B of the title commitment.

2. *Survey Review* – The buyer/borrower will want to review an ALTA survey in conjunction with its review of the title commitment and nearly all lenders on any commercial deal will require an updated survey as a condition to financing. All lenders will require that a surveyor certify that certain steps were taken in completing the survey and that any particular mark required by the lender which is applicable to the property is designated on the survey:

- (i) Survey Guidelines - ALTA/ACSM guidelines set forth an optional Table A which outlines various survey requirements which lenders often cite to in their survey certificate.

- (ii) Locate Easements - The location of utility, drainage and floodway easements which may impinge on the future construction and development plans of the borrower and will usually require third party consent to relocate or construct upon – these issues must be evaluated in the course of site planning, and a lender will examine the site plans in conjunction with the survey prior to closing the loan.

- (iii) Building Encroachments - Building protrusions on various easements and right of ways to which a lender will almost always object and request that the easement be abandoned prior to closing. This can only be done with the consent of all parties to the easement and will require a third party utility to acknowledge the abandonment in writing.

- (iv) Endorsements - As an alternative, a title company will usually offer a T-19 endorsement to a mortgagee or T-19.1 endorsement to the owner's policy which will insure the buyer/borrower and its lender against any costs associated with the removal of the protrusion. Most lenders will accept this alternative and allow the easement to remain on the survey and Schedule B of the title commitment.

- (v) Access - Parking, road access and zoning requirements are usually a part of any survey certificate provided by a lender and buyer/borrower will want to certify that the property is in compliance with such parking or zoning requirements. This will require a zoning verification letter from the zoning authority to determine the scope of the ordinance along with a zoning report from a zoning and land use specialist to certify the property's compliance.

- (vi) Parking Issues - Parking can become problematic when the seller is relying on off-site parking to which the property has no legal entitlement. A lender will certainly require a parking agreement to be in place with the appropriate third party and to the extent one exists, the third party must sign an estoppel letter prior to the closing. The survey should list the zoning and the number of parking spaces located under the surveyor's notes. The survey should also certify and designate public roadway access.

**C. RESTRICTIVE COVENANTS GENERALLY** (Many of these discussion points were pulled from a more detailed summary of restrictive covenants contained in the 8<sup>th</sup> Chapter of the 28<sup>th</sup> Annual Advanced Real Estate Law Course authored by Charles W. Spencer).

1. *Introduction* - Most title commitments affecting properties in incorporated areas will reference a declaration of restrictive covenants or applicable deed restriction which will contain a number of restrictive covenants. The restrictive covenants may establish architectural guidelines, use restrictions, provisions for maintenance of common areas, access and parking rights and other provisions that attempt to promote the quality and enhance the value of a development.
2. *Enforcement & Review* – Not all restrictive covenants and easement agreements will be considered value enhancers by a proposed buyer, and a party must diligently review the Declaration and its amendments to determine future development rights prior to losing its rights to a refund of earnest money. This section will discuss typical provisions that will arise and how they can impact a purchasing or selling decision. The covenants contained in a Declaration are real covenants and run with the land which will be discussed later today.
3. *REA's* - Sometimes, a non-profit entity is created to enforce the covenants and maintain the common areas and review future development plans for improvements and monitor and assess association expenses of the master development. Additionally, reciprocal easement agreements are typically contained within a Declaration of Covenants and Restrictions ("*Declaration*") and will provide for access to the owners of adjacent tracts and make utility construction and maintenance more viable.
4. *Architectural Committee and Guidelines* – The management association or the parties to the Declaration will usually provide for the nomination, function and procedure of an Architectural Control Committee ("**ACC**") in the Declaration. The ACC will typically have jurisdiction over the following:
  - (i) architectural style of buildings and building materials used;
  - (ii) setback lines, height restrictions and proposed building's compliance therewith; and
  - (iii) building area/location for a tract and a proposal to deviate from building area provisions.

A well-drafted Declaration will set forth the procedure for submittals to the ACC so a developer will have a better idea of its timeline for construction and development. If a buyer knows that it will seek deviations from the architectural guidelines contained in the Declaration, then it must determine what steps it must take to obtain approval of the deviations. Typically, the parties to the Declaration (or their successors-in-interest)

will have consent rights before a change or deviation from the architectural guidelines of a development.

5. *Use Restrictions* - A Declaration will typically set forth various specific and general uses which will not be allowed on the property covered by the Declaration. These use restrictions may be somewhat aligned with applicable zoning requirements, but will often go much further in detail and scope. A buyer must pay particular attention to any prohibitions against the operation of certain businesses, in place to preserve certain exclusives held by adjacent owners. Other use restrictions that typically appear in Declarations are those associated with:

- (i) storage or distribution of fuel or hazardous materials,
- (ii) outdoor sales activities,
- (iii) drive-through service features; and
- (iv) outdoor storage of vehicles or other equipment.

The buyer needs to know early in the due diligence process what use restrictions will not work for its proposed use of the property and determine who the buyer must obtain consent from for any modification, removal or amendment to the problematic use restriction. Most adjacent owners will want to negotiate some benefit and consideration in return for their consent to removing a use restriction even if the use restriction has limited value to the potential consenting owner. A potential buyer should determine prior to the expiration of the due diligence period what consideration various consenting owners will require in an effort to better quantify the economics of the purchase.

6. *Setbacks/Height Restrictions* – A typical Declaration will provide rear and side setback lines in addition to various structural building restrictions including height restrictions. Keep in mind that the Declaration must comply with governmental requirements and, to the extent they are stricter than those set forth in the Declaration, then the governmental requirements will control.
7. *Building Area/Coverage* – This issue can come up a lot on shopping center redevelopment where a developer wants to increase or decrease the anchor space or add some new pad sites that do not comply with the existing restrictions. The primary concern of adjoining owners will be that space for access, parking or utility easements is impacted. That said, if an adjoining owner's consent rights are tempered by certain criteria, then parking and access usually are a disguise for some type of anti-competitive agenda by the adjoining owner; and the developer will have to find a way to get all parties on board with the new plan.
8. *Reciprocal Easement Agreements ("REA")* - Although very similar to the Declaration, the REA is an agreement more focused on the granting of easements to contiguous owners over the property of the granting owner for such purposes as mutual access, maintenance/repair, utilities and

other considerations related to use, building structure, parking and amenities. A detailed discussion of the REA is beyond the scope of this presentation, but the REA is a useful tool to enhance the appearance, quality and value of the development where separate owners will exist. The REA is typically focused on addressing the access, utility and drainage needs of each property owner in the development.

- (i) Location - As part of the buyer's due diligence, buyer's counsel should locate these easements and determine what impact their location will have on future development or construction problems. It is not uncommon to find that roads and even buildings are built on top of utility easements. In this situation, a prospective buyer may have to require seller to release the easement and move the utility line contained within the easement.
  - (ii) Usable Land - There is definitely added cost involved with these issues and the time required to appropriately address these issues may make the purchase untenable. Another consideration for the buyer is whether the surface of the easement limits the property's use. Many times a drainage easement will limit the use of a significant portion of the property; and in such situations, an adjustment in the purchase price is appropriate to reflect the net area that can be used by the buyer.
9. Maintenance/Repair - Finally, a REA will also address installation, maintenance, repair and restoration of the various easements with each owner typically being responsible for its own property and the costs associated therewith. This is important with an existing development because if the tract being evaluated contains significant common areas, access and utility easements, the prospective buyer needs to determine what the annual maintenance costs will be and if they are able to share such cost with adjacent owners.
10. Voting Control/Amendments – Typically, a Declaration will provide for two levels of management with the Declarant and sometimes any major anchor lot owner maintaining approval voting rights. The Declarant's power is usually phased out after the development period ends and the super voting power will ultimately rest with the owner of the largest and most valuable tract (typically, the anchor tenant tract in a shopping center or business park development). Each tract owner will typically have some voting rights, but little can be done to amend the provisions of the Declaration or the REA without the consent of the Declarant or other parties retaining super voting rights. Sometimes the parties will be held to a standard which limits their discretion in consenting to amendments or modifications to the Declaration, but a prospective buyer must understand the number of votes needed to implement any change in the development and work during the due diligence period to determine what the prospective consenting owners will require in order to provide written authorization. As the old adage goes there is no such thing as a free lunch and that is usually the case with amendments to a Declaration or REA.

## D. ENVIRONMENTAL DUE DILIGENCE

Most real estate investors and developers are keenly aware of the potential costs involved if a property is discovered to be contaminated with hazardous substances, and a seller will usually shift as much potential post-closing liability as possible to the buyer in the contract so it becomes imperative to the buyer that it perform a detailed and proper environmental assessment of the property during the due diligence period and, to the extent necessary, a Phase II environmental assessment if the Phase I report indicates any environmental issues. The goal of any prospective buyer is to avail itself to the Innocent Landowner's Defense under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), informally known as Superfund Law, as modified by various federal statutes, including the Superfund Amendment and Reauthorization Act of 1986 (SARA) and the Small Business Liability Relief and Brownfield Revitalization Act of 2002 (Brownfield Act). Environmental law experts will tell you CERCLA and its progeny are not the only environmental statutes the property owner must evaluate prior to the purchase of property. However, unless a buyer is evaluating an environmentally sensitive property or is in the business of storing, transporting or removing hazardous substances, CERCLA is the primary law that governs and the Resource Conservation and Recovery Act (RCRA) and its progeny are not of primary importance for most real estate developers and buyers.

1. *Brief History of the Innocent Landowner Defense* – Although the statutory defense by way of an act or omission of a third party ("**Third Party Defense**") has been around since the inception of CERCLA, its effectiveness was in question because CERCLA required that an Innocent Landowner have no direct or indirect relationship, contractual or otherwise, with the third party that caused the contamination. See CERCLA § 107 (b)(3); 42 U.S.C. §9607 (b) 3. Thus, it was virtually impossible to buy a property with any previous environmental contamination because the bona fide buyer could have a contractual relationship by way of the deed if the Seller had in fact been the third party that caused the contamination. SARA attempted to rectify this problem by excluding "transferring instruments" from the definition of "contractual relationship" if, at the time of acquisition, the buyer "did not know or had no reason to know" that hazardous substances had been disposed of on the property. CERCLA § 101(35) (B); 42 U.S.C. §9601 (35)(B). To utilize the Innocent Landowner Defense, SARA requires a prospective buyer to undertake, at the time of acquisition, "all appropriate inquiries into the previous ownership and uses of the property consistent with good commercial or customary practice." *Id.* SARA, as written, left certain gaps, including the precise definition of the "appropriate inquiry" which is required to utilize the "Innocent Landowner's Defense." Enter the Brownfield Act which, among other things, directed the Environmental Protection Agency to come up with precise standards and practices for what constitutes "All Appropriate Inquiries."
2. *New All Appropriate Inquiries Rule* – From and after November 1, 2006, any bona fide buyer of real property seeking to utilize the Innocent Landowner's Defense will have to prove compliance with either 40 CFR 312 or the revised version of ASTM E1527-05. ASTM (formerly known as

the American Society for Testing and Materials) has for many years provided the industry standards for environmental site assessments and has now revised its regulations to be in compliance with the new EPA rule. The revised ASTM E1527-05 and 40 CFR 312 take a performance based approach to the Phase I assessment and instead of just requiring certain information-collecting practices, they also require that the environmental professional answer a series of seven questions when performing the assessment, which are as follows:

- (a) How was/is the property being used?
- (b) What substances were/are used on the property?
- (c) Were/are wastes managed or disposed there?
- (d) What cleanup has been/is being conducted?
- (e) Are there any engineering controls in place?
- (f) Are there any institutional controls – restrictions on access or use?
- (g) Will/has contamination from nearby properties migrated onto the Property?

See Lenny Siegel, *Brownsfield Briefs*, Center for Public Environmental Oversight, August 2005. For the bona fide prospective buyer, it is important to recognize that the completion of All Appropriate Inquiries is necessary, but not sufficient, to qualify for protection against CERCLA liability. Among other things, a prospective buyer must also comply with land use restrictions and now identify all such restrictions as part of the Phase I site assessment. *Id.* Overall, the final All Appropriate Inquiries rule does not differ significantly from the ASTM E1527-00 standard in place prior to 40 CFR 312. See: Patricia Overmeyer, U.S. EPA's Office of Brownsfield Cleanup and Redevelopment, *All Appropriate Inquires Final Rule*, October 2005. The rule includes all the main activities that previously were performed as part of environmental due diligence such as site reconnaissance, records review, interviews, and documentation of recognized environmental conditions. *Id.* The final rule, however, enhances the inquiries by extending the scope of a few of the environmental due diligence activities as follows:

- (a) The final rule requires that significant data gaps or uncertainties be documented.
- (b) The final rule also requires the environmental professional to interview the subject property's current owner or occupants and is also mandatory, while the prior ASTM E1527-00 standard only required that the environmental professional make a reasonable attempt to conduct such interviews.

- (c) In addition, the final rule includes provisions for interviewing past owners and occupants of the subject property, if necessary to meet the objectives and performance factors, while under the prior ASTM E1527-00 standard, the environmental professional had to inquire about past uses of the subject property when interviewing the current property owner.
- (d) The final rule also requires an interview with an owner of a neighboring property if the subject property is abandoned, while the prior ASTM E1527-00 standard included such interviews at the environmental professional's discretion.
- (e) The final rule does not specify who is responsible for performing record searches, including searches for use limitations and environmental cleanup liens, while the prior ASTM E1527-00 standard specified that these record searches are the responsibility of the user and required that the results be reported to the environmental professional.
- (f) The final rule also requires the examination of tribal and local governmental records and more extensive documentation of data gaps while the previous ASTM E1527-00 did not. *Id.*

40 CFR 312 also includes specific educational and experience requirements for an environmental professional and defines an environmental professional as someone who possesses sufficient specific education, training, and experience necessary to exercise professional judgment to develop opinions and conclusions regarding conditions indicative of releases or threatened releases on, at, in, or to a property, sufficient to meet the objectives and performance factors of the rule, and has: (1) a state or tribal issued certification or license and three years of relevant full-time work experience; or (2) a Baccalaureate degree or higher in science or engineering and five years of relevant full-time work experience; or (3) ten years of relevant full-time work experience. *Id.*

Keep in mind that ASTM International updated its E1527-00 standard, "Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process," and the EPA certified that the revised ASTM E1527-05 standard is consistent with the requirements of the final rule for all appropriate inquiries and may be used to comply with the provisions of the rule. Thus, certifying that the updated E1527-00 standard is being adhered to by your environmental professional conducting the Phase I assessment will put you in compliance with the new rule and allow a buyer to utilize the Innocent Landowner's Defense assuming the Phase I assessment comes back clean.

## E. PARTY AUTHORITY

With the prevalence of title insurance in almost every real property transaction, a title company now reviews the seller's organizational documents to determine the proper authority of the seller to convey the property to the prospective buyer; and a title company will not close a transaction and issue a valid owner's policy of title insurance unless the proper party authority is verified. As a buyer or seller, one should stay apprised of any party authority issues that surface and assist the title company in its effort to resolve such issues. In the event of any meaningful dispute over party authority, the opposing party will be able to exercise its default remedies under the contract as party authority is a standard representation/warranty made in nearly every purchase and sale agreement for the buyer and seller. Below is a run down of the typical entities that are a party to a real property transaction and the due diligence needed to determine proper party authority:

1. *Partnerships/Limited Liability Companies/Joint Ventures* – These entity types are the most common parties to a real property transaction largely due to the flexibility they allow with respect to the organizational structure and the management of the entity. Each of these entity types will have a governing document known as the limited partnership agreement (in the case of limited partnership), the company agreement (in the case of the limited liability company) or a joint venture agreement (in the case of the joint venture). When any of the principals of these entities are unrelated, then the governing document will likely require the consent and approval of all principals for the sale of the real property. As a prospective buyer, one should make sure that logistics are being coordinated to assure that all principals of the seller are available to execute the proper consent.
2. *Tenants in Common* – This structure has gained popularity with the rise of the 1031 exchange of real property as each tenant owns its respective share in a real property and is therefore permitted by the Internal Revenue Code to defer gain from the sale of another real property and invest such gain along with other tenants in a Tenant in Common transaction. The governing document for the Tenant in Common will be the Tenants in Common Agreement which will usually provide for a Property Manager who manages the Property in accordance with a Management Agreement. Typically, the Property Manager cannot sell or encumber the property without the approval of all Tenants in Common. Again, a buyer or seller should make sure that the other side is prepared to offer unanimous consent of the Tenants in Common in advance to avoid any surprises or fire drills at closing.
3. *Trusts* – This entity type can become problematic because, in addition to verifying the party authority of the entity, the title company must also verify that the sale of the real property is in line with the purpose of the trust. Sometimes a trustee may be willing to execute a deed on behalf of the trust, but a beneficiary under the trust may argue that it violates the trust's purpose. In such situations, the title company and buyer should require a unanimous consent of the beneficiaries to the sale of the property and have the trustee and beneficiary represent that the sale of the property is in compliance with the purpose of the trust. This

should properly protect a buyer from any potential title claim by any current or contingent beneficiary of the selling trust.

4. *Probated Estates* – Although any discussion of Trusts and Estates Law is beyond the scope of this presentation, it should be noted that a title company will require a signed order from the probate judge approving the sale of any asset which is part of a probated estate, including without limitation, the sale of real property. In the course of due diligence, it is a good idea for a buyer to order a copy of the probate records from the appropriate court to determine whether or not the real property has been the subject of any previous litigation. Sometimes there is history surrounding the real estate and a review of the probate court records will give a buyer a clear picture of any party authority issues that the buyer or the title company will encounter.

## **F. UCC SEARCHES AND JUDGMENT LIENS**

Typically, in order to obtain financing a buyer/borrower will need to offer a first lien security interest to its lender on the property being acquired as well as any and all personalty located at the property including, without limitation, fixtures located on the property and all other assets owned by the buyer/borrower. While a title commitment should reveal any and all liens which attach directly to the real property, including fixture liens and some judgment liens, it will not reflect UCC-1 financing statements covering personalty collateral owned by the buyer/borrower or tax liens or judgment liens which were not properly recorded in the real property records. A buyer is also concerned about potential liens on the selling entity when acquiring personalty collateral including, without limitation, heavy equipment or other moving vehicles of the seller. There is a risk that record searches will not turn up all liens which relate to the assets of an entity party being searched which is why most lenders will require that a borrower form a special purpose entity to acquire the property. Forming a special purpose entity will also mitigate the lender's exposure to a potential bankruptcy which would pull the real property into a bankrupt debtor's estate.

Even with the existence of a special purpose entity, UCC and judgment lien searches are usually a customary part of the due diligence process of a lender; and these searches are usually conducted through the title company or a third party search company that specializes in this task. The searches can be expensive depending on their scope, and a newly-formed special purpose borrower should request that a lender waive county-specific judgment lien searches to avoid unnecessary costs.

One of the traps that exist when running UCC searches is the possibility that a financing statement was filed under a slightly different name than the legal entity name of the seller or buyer. There are some frightening cases that exist, including *SPEARING TOOL AND MANUFACTURING CO., INC., United States of America, Appellant, v. Crestmark Bank; Crestmark Financial Corporation*, 412 F.3d. 653 (11<sup>th</sup> Cir. 2005). In *Spearing Tool*, Crestmark Bank, which had a credit facility with Spearing Tool secured by all of Spearing Tool's assets, periodically submitted lien search requests to the Michigan Secretary of State, using Spearing Tool's exact registered name. *Spearing Tool*, 412 F.3d. 653, 655. Because Michigan has limited electronic-search technology, searches disclosed

only liens matching the precise name searched — not liens such as the one filed by the Internal Revenue Service (IRS) which were filed under slightly different or abbreviated names. *Id.* Consequently, Crestmark continued to advance funds on their credit facility to Spearing Tool for six months after the IRS filed a federal tax lien for Spearing Tool's failure to pay employment taxes. *Id.* Ultimately, Spearing Tool filed Chapter 11 Bankruptcy and the questions of lien priority was litigated with the 11<sup>th</sup> Circuit approving the Bankruptcy Judge's determination that the federal tax liens were superior and reversing the District Court's determination. 412 F.3d. 657. This case illustrates that lenders and buyers, where applicable, need to cast a broad net when conducting UCC searches. Fortunately, the Texas Secretary of State does provide what is termed the "Wild Card Search" which will search slight different variations of an entity name in the hopes of catching all liens that may be filed against the debtor party. As a buyer, if you are acquiring personalty from a Seller then you need to make sure that proper searches are being performed, and you should have the title company or another search company performs the searches so that they are done in a precise manner.

**G. SPECIFIC CONSIDERATIONS DEPENDING ON ASSET TYPE**

1. Office/Industrial
  - (a) Certified Rent Roll/Required Estoppels;
  - (b) Parking; and
  - (c) O&M issues and transferable service contracts.
2. Raw Land
  - (a) existence of utilities and infrastructure and costs involved in adding such;
  - (b) mineral rights and water rights reservations and applicable surface waivers of same;
  - (c) locations of existing utility easements; and
  - (d) existence of Declaration or REA.
3. Existing Retail
  - (a) Use prohibitions, anti-competitive measures;
  - (b) Management and Leasing agreements; and
  - (c) REA and Declaration.

**EXHIBIT A  
SAMPLE DUE DILIGENCE CHECKLIST**

No.	Title of Document	Responsible Party	Received	Comments
<b>II. DOCUMENTS REPRESENTING AND EVIDENCING THE AUTHORITY OF SELLER TO ENTER INTO THE TRANSACTION</b>				
1.	Evidence of authority of Seller/Buyer <sup>1</sup> : (a) Limited Liability Company Agreement (b) Certificate of Limited Liability Company (c) Certificate of Existence (d) Certificate of Good Standing (e) Resolutions			
2.	Evidence of authority of General Partner or Manager/Managing Member of Seller/Buyer (if any): (a) Limited Liability Company Agreement (b) Certificate of Limited Liability Company (c) Certificate of Existence (d) Certificate of Good Standing (e) Resolutions			
<b>III. DUE DILIGENCE ITEMS</b>				
1.	Current Survey, with certificate and evidence of flood plain <sup>2</sup>	S		

<sup>1</sup> Depending on the number of levels of the buyer or seller's entity structure, the title company and the buyer's lender will require a number of different organizational documents and resolutions on behalf of such entity.

<sup>2</sup> A buyer should determine how much of the property lies in a flood plain and renegotiate the purchase price to the extent they decide to move forward on a property where a significant portion of the property lies in a flood plain.

No.	Title of Document	Responsible Party	Received	Comments
2.	Site Plan	P		
3.	Evidence of Zoning	P		
4.	Building Permit	P		
5.	Certificate of Occupancy – Building	S		
6.	Certificate(s) of Occupancy – Tenants	S		
7.	Rent Roll	S		
8.	Copies of Leases	S		
9.	Copies of Lease Guaranties	S		
10.	Existing Estoppel Certificates	S		
11.	SNDA's	S		
12.	Tenant Financials	S		
13.	Tenant Insurance	S		
14.	Operating Statements	S		
15.	Tax Statements	S		
16.	General Ledger	S		
17.	Aged Accounts Receivable	S		
18.	Statement of Security Deposits	S		
19.	As-Built Survey	P		
20.	Access – anticipated street widening/closings	P		
21.	Geotechnical Report	P		
22.	Phase I Environmental Report			
23.	As-built Plans and Specifications	P		

No.	Title of Document	Responsible Party	Received	Comments
24.	Evidence of Liability Insurance	P		
25.	O&M Manual – HVAC equipment & controls	S		
26.	O&M Fire Protection Systems	S		
27.	O&M Elevator	S		
28.	Service Contracts: (a) Gas (b) HVAC (c) Janitorial (d) Landscape (e) Outside Sweeping (f) Pest Control (g) Trash Removal (h) Window Washing	S		
29.	Warranties: (a) Core/Shell (b) HVAC Equipment (c) Roofing (d) Fire/Safety (e) Parking Lot (f) Contractor	S		
30.	Personal Property Inventory <sup>3</sup>			

<sup>3</sup> When a buyer is acquiring equipment and other personalty of the Seller, it is important that a UCC search is obtained to determine whether any purchase money financing exists on the equipment and what needs to be cleaned up prior to closing.

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