

Due Diligence in Real Estate Transactions

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DUE DILIGENCE IN REAL ESTATE TRANSACTIONS

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In every conveyance of real estate, whether it be a residential home purchase, commercial or residential lease, the purchase of a commercial property or the purchase of vacant land for development, the prospective purchaser or renter, and, if applicable, the lending institution, must conduct some level of due diligence toward investigating the quality, both physical and intangible, of the real estate being conveyed. The due diligence process is one of the most important, yet challenging aspects of investing in real estate. If it is not conducted thoroughly and with a sharp eye, a purchaser or investor can end up with bad deals that cost them significant amounts of money.

In general, there are three forms of due diligence in real estate transactions: financial, legal and physical. Smart purchasers pay careful attention to all three. Financial due diligence is generally more applicable to commercial transactions and consists of acquiring and reviewing financial documentation, such as current and historical financial statements of the property, property tax bills, federal tax returns, utility bills and other proof of expenses. Legal due diligence is crucial in all real estate transactions and involves acquiring and reviewing all legal documentation related to the property, including leases, title and survey, and allows purchasers to determine anything that might legally impact the property, such as rights of occupancy, liens, encroachments and/or restrictions on use or development. Physical due diligence refers to

arranging for, obtaining and reviewing documentation that shows the physical condition of the property, including on-site physical inspections.

A great deal of the process of real estate due diligence often begins before the offer to purchase, or even a letter of intent outlining the terms of the proposed purchase, is executed, including visiting the site and having discussions with real estate brokers, attorneys and sellers. This preliminary process should never be skipped over or given limited attention, as it can be invaluable in establishing the informal connections necessary to obtain the information that will be imperative later in the due diligence process. It can also give rise to questions or investigative paths which might otherwise seem like a waste of time, but which ultimately shed light on the uniqueness of a particular transaction. In addition to the obvious factors, such as the length of the contingency period and access to certain information in the seller's possession, it is important to recognize the warning signs as to representations and warranties and the condition of seller's property-related information. A seller's negative reaction on these issues often implies red flags regarding the property condition.

One of the main reasons for preliminary due diligence is so that the buyer can properly assess the property's value in order to prepare a strategic offer. Generally, many of the documents that allow a buyer to explore a property's net worth and, in the case of commercial transactions, profitability are not available to the buyer until after an offer has been made. However, in the case of commercial properties, income production is crucial in determining a fair purchase price. The key factor in this regard is net operating income, or the total income the property

generates minus operating expenses (not including taxes and interest). For residential properties, especially single-family residences, comparable sales data, real estate appraisals and local real estate trends are the best methods of valuing the property.

Once an offer has been made and accepted by the seller (pending the due diligence period), and the buyer has placed a down payment in escrow, the stipulated due diligence period begins in earnest. It is during this period that the buyer has the opportunity to ensure he/she/it knows exactly what is being purchased. As mentioned, due diligence inspections should involve financial, legal and physical inspections of the real estate, including an assessment of environmental related conditions, the status of the seller's title to the property, zoning requirements and any existing violations thereof, and property-related contracts, leases and surveys. Most of the relevant documentation can and should be obtained from the seller, such as the deed, information on current tenants (if applicable), existing uses of the property, zoning approvals or other documents indicating allowable uses of the property, any seller inspections, land and improvement surveys, current title insurance and other insurances, any notices of pending legal or governmental action affecting the property, environmental assessments, any special assessments or taxes, copies of any property bills, service contracts, all construction plans in the seller's possession and any warranties related to the property, including warranties for any construction.

Beyond the document review, the buyer should conduct its own independent investigations of the property. In some cases, the buyer may request and negotiate that the seller conduct and/or pay for all or a

portion of certain third-party inspections and assessments the buyer desires. Below is a more detailed discussion of some of the more-important inspections buyers should perform when analyzing the fruitfulness of their investment. This is not an exhaustive list; rather, it provides some initial considerations for a prospective buyer in determining whether the pending transaction is worthwhile.

Title Review:

One of the first things a prospective buyer should review is title to the subject property, which should be, unless purchasing a distressed property, free and clear of any liens or other claims against it. "Title" in this instance refers to the transferable right to the property, which the buyer must ensure the seller actually has. Title is often mistaken with the deed, which is the document used to transfer the property to another. Generally, a bona-fide seller makes sure they can convey clear title before putting the property on the market, but that is not always the case. The title review process involves reviewing all claims against the property; known as a title search. To protect themselves in the event a claim against the property is missed during the title search which is later revealed after the transaction has closed, buyers will want to purchase title insurance, which makes the policyholder liable for any such claims.

A reputable title insurance company should be selected and engaged during the due diligence period. The title company will provide a preliminary title report prior to closing on the real estate, which will include a description of the land, the type of estate, the current holder of title to the property and any claims against the property. When

reviewing the preliminary title commitment, the buyer should pay particular attention to any exceptions or exclusions from the title, which will set forth any known claims or rights against the property by others, such as taxing agencies, municipal authorities and/or utility companies. The preliminary title report should also list any liens, restrictions, special assessments and/or other charges against the property, all of which should be carefully examined by a real estate attorney to ensure the buyer is clear as to what is being purchased, what rights the buyer will have and what, if any, rights others may have. If the title insurance company finds a claim, such as a lien, against the property, the seller should be informed and typically must redress it before closing can occur. However, in the case of distressed properties, the buyer may have to agree to satisfy existing liens at closing in order to obtain a title commitment.

Real Estate Survey:

Regardless of the type of property being purchased, surveying allows the buyer to see exactly what the land underlying the property consists of. A survey will show whether any person, entity or other property has an easement (a right of passage through, over or under any part of the land the buyer plans to purchase) or an encroachment (a portion of someone else's property intruding on the subject parcel). There may also be other covenants, conditions and/or restrictions tied to the land, all of which are essential to know before making a purchase.

Easements and restrictions can cause more headaches for a buyer than zoning regulations, especially if the buyer plans to develop, renovate

or expand any improvements on the property. The buyer should obtain a survey from ALTA, the American Land Title Association, which is prepared by a licensed surveyor in accordance with the Association's strict standards. Typically, title insurers will want to see the results of an ALTA survey before issuing a commitment. The survey will include information on encroachments on the subject property, encroachments the subject property has on neighboring properties, and easements affecting the subject property. Any survey obtained, whether through the seller or by the buyer, should be current. If financing is involved in the purchase of the property, many lenders will not accept a survey more than six (6) months old.

Zoning:

Zoning certifications are available from planning offices of the jurisdiction in which the property is located. The buyer should ensure that any existing buildings or uses of the property are currently in compliance with applicable zoning regulations. Further, the buyer should inquire as to any notices in the seller's possession regarding any planned zoning changes that may adversely affect the intended use of the property. In some instances, zoning can result in assessments, exactions and impact fees, all of which can directly impact how much net income the buyer can expect to generate from an investment property. For residential properties, it is important to understand exactly what is and is not permitted on the property. For example, in some zoning districts, operating a home-based business in a leased apartment or residential property may result in fines. Thus, it is critical that the buyer know and

understand the applicable zoning laws and regulations before purchasing the property and have a grasp on any proposed changes on the horizon.

Physical Property Inspections:

All building and home inspections should be completed by a certified third-party to ensure the property is up to code and structurally sound. Buyers should request a current inspection from the seller or stipulate that one take place during the due diligence period. Inspections will typically cover roofs, HVAC, electrical, heating, plumbing, pest infestation, chimney inspections, water quality, exterior and interior structural elements and other pertinent areas. Time permitting, the buyer should plan to attend the home inspection in order to get a complete understanding of the inspector's findings and ask any questions. While the inspector will provide a copy of his/her inspection report, certain issues may be difficult to see without the inspector pointing them out and/or require additional information or commentary to completely understand. Also, many inspectors can provide a rough estimate as to the cost to correct any discovered issues, although a licensed professional should be consulted to provide official quotes for any necessary work.

Environmental Inspections:

Environmental inspections are crucial, especially for commercial properties. The subject property may have suffered environmental damage from previous use or contained hazardous materials in violation of applicable federal and state environmental laws and regulations. Even

if any environmental issues do not arise to the level of a legal violation, they may still impact the buyer's intended use of the property. For commercial properties, environmental assessments begin with a Phase I Environmental Report, which will indicate whether there are any serious problems requiring remediation. Such reports not only include appraisals from licensed professionals, they also include reviews of state and federal compliance agencies of the property in question. If any problems exist, a Phase II investigation involving further testing typically follows.

Residential property purchases also involve environmental assessments by licensed professionals generally selected by the title company. While Phase I and Phase II reports are not required, it is in the buyer's best interest to obtain the most thorough environmental review available to ensure the buyer will have is in appropriate condition for its intended use and will not be found in violation of any applicable laws or regulations after purchase, which can carry hefty fines. It is important to note that a buyer can also be held liable for damage done to a neighbor's property from existing environmental conditions left by the previous owner.

Real Estate Appraisals:

One of the most critical aspects of the real estate purchasing process, real estate appraisals, will be a key determinant in any evaluation of the property's value. Typically, an appraisal is what the seller uses to determine the asking price, what lenders will use when determining how much they will lend, and, in many instances, what taxing agencies will use when assessing real estate taxes. Appraisals

assess the physical condition of the property, zoning records, geographical and demographical information, net income production (in the case of commercial properties), cost of replacement and sales of comparable properties to value real estate. The buyer should make sure any appraisals provided by the seller are current and obtain his/her/its own appraisal during the due diligence period to corroborate any provided by the seller. It is important to make the appraiser aware of the buyer's intended use of the appraisal and the property. Also, the buyer should be clear on the method of valuation, date of valuation and independence of the appraiser when reviewing the appraisal. Regardless of the type of property being purchased, a licensed appraiser should always be engaged.

Conclusion:

The goal of the due diligence process is to ensure the property you think you are buying is indeed the property being conveyed. It is important to remember that each transaction has its own unique set of obstacles and considerations, so buyers should give each purchase the unique attention it deserves. Competition in local real estate markets can have the effect of lessening due diligence periods and compelling many buyers to take shortcuts in order to meet sellers' closing demands. However, the consequences of shortcuts can be extremely damaging, and the parties must be aware of the risks. The due diligence process is far from simple, and neglect in any area can be disastrous for a prospective buyer. Selecting the right real estate professionals, including an experienced real estate attorney, who have a proven record, the right

resources and an effective process in place is well worth the effort and any added cost in the long run.

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