

The STAPLES of Due Diligence

presented by:

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Goals and Objectives

- Provide an overview of how and why to conduct due diligence in connection with real estate acquisition, leasing, or expansion.
- Provide baseline understanding of survey, title, appraisal, land use, and environmental issues relating to various types of properties
- Identify potential opportunities for CPAs to assist clients in conducting diligence.

What is Due Diligence?

- With respect to real estate matters, it generally fits into 5 categories:
 - Survey
 - Title
 - Appraisal
 - Physical Condition
 - Land Use
 - Environmental Concerns

Why Do Diligence?



Why Do Diligence? (cont.)

- In North Carolina, *Caveat Emptor* controls.

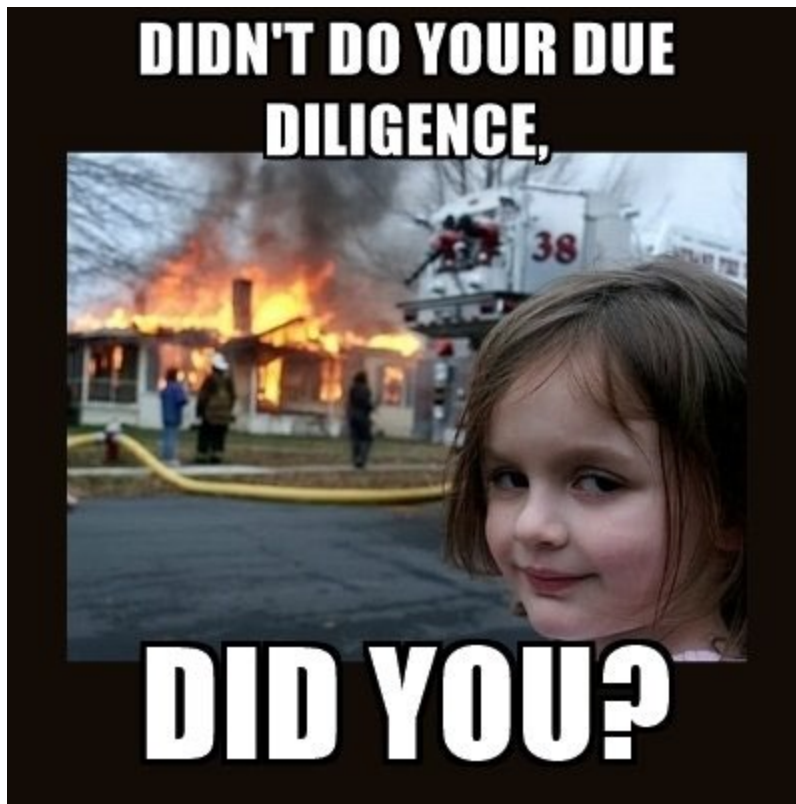
“Ordinarily, in the absence of inquiry by the [purchaser], the [seller] is not under a duty to disclose facts materially affecting the value of the property when no fiduciary relationship exists between them, certainly when such facts are a matter of public record, and the [seller] does not, by word or deed, divert a full investigation by the [purchaser] Thus, a purchaser of real estate cannot maintain an action for fraud for misrepresentations concerning the value of the property or its condition and adaptability to particular uses when the purchaser has an opportunity to make full investigation and is not induced to forego investigation by artifice or fraud on the part of the seller.”

-Clouse v. Gordon, 115 N.C. App. 500, 507,
445 S.E.2d 428 (1994)

Why Do Diligence (cont.)

- To determine if a property matches expectations.
 - Are assumptions about the property correct?
- To determine if the property will adequately serve intended purpose
- To determine if the price paid for the property is correct
- To minimize surprises.
- To save money!

Consequences of Due Diligence



Unexpected headache
or
DISASTER

When is Diligence Due

- Any time a large investment in real estate is about to occur.
 - Acquisition of new raw land
 - Acquisition of new developed property
 - Leasing property
 - Undertaking capital improvements
 - And MORE



How Much Diligence is Due

It depends on the context!



Order of Due Diligence

- No real answer.
- Requires a cost-benefit analysis to determine areas of biggest concern weighed against the cost of the type of diligence
 - Are physical, title, environmental, or other issues most likely to prove problematic?

The first STAPLE - SURVEY

- There is more to surveying than showing where the 4 corners of the property are.





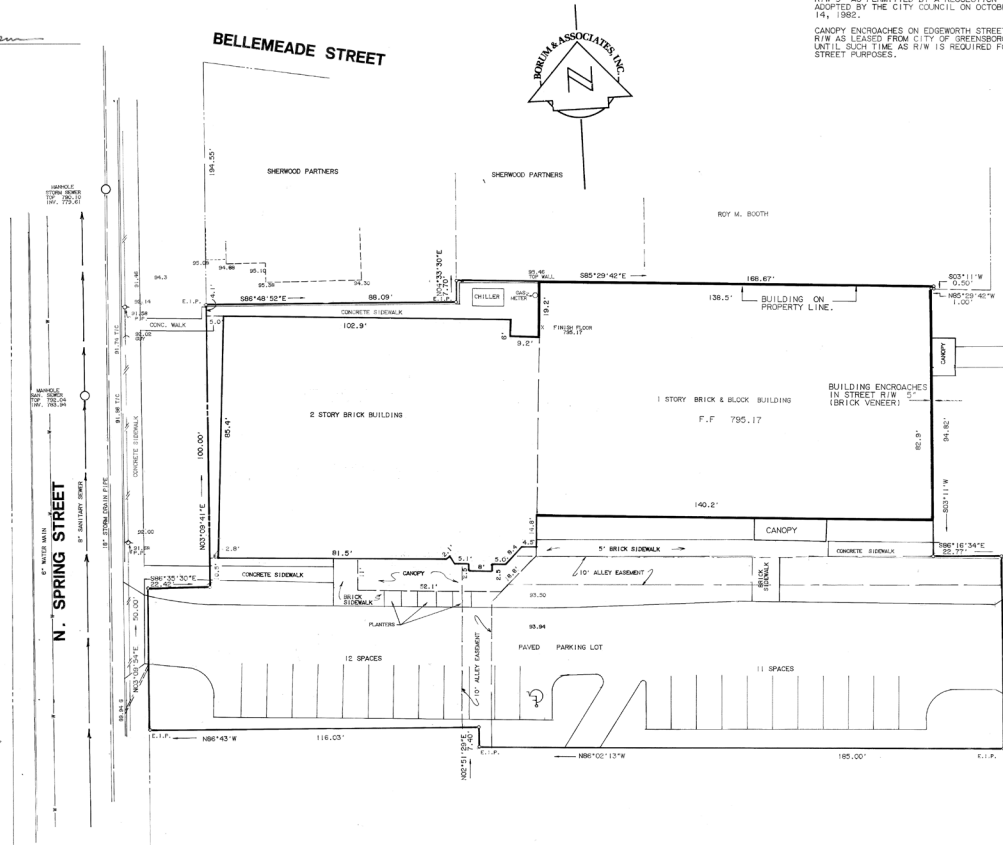
As-Built Surveys

I CERTIFY ON THE DATE OF THIS DRAWING, I SURVEYED THE PROPERTY SHOWN ON THIS DRAWING, AND THAT THE PROPERTY LINES AND LOCATION OF STRUCTURES ARE ACCURATELY SHOWN HEREON, THAT NO STRUCTURE LOCATED ON THIS PROPERTY ENDOCHES ON ANY ADJACENT STREET OR PROPERTY, AND THAT NO STRUCTURE ON ADJACENT PROPERTY ENDOCHES ON THE PREMISES SURVEYED.

THIS PROPERTY IS NOT LOCATED IN A SPECIAL FLOOD HAZARD AREA AS DETERMINED BY THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT.



Marvin L. Borum



NOTE:

BUILDING ENDOCHES ON EDGEWORTH STREET R/W 5' AS PERMITTED BY A RESOLUTION ADOPTED BY THE CITY COUNCIL ON OCTOBER 14, 1980.

CANOPY ENDOCHES ON EDGEWORTH STREET R/W AS LEASED FROM CITY OF GREENSBORO UNTIL SUCH TIME AS R/W IS REQUIRED FOR STREET PURPOSES.

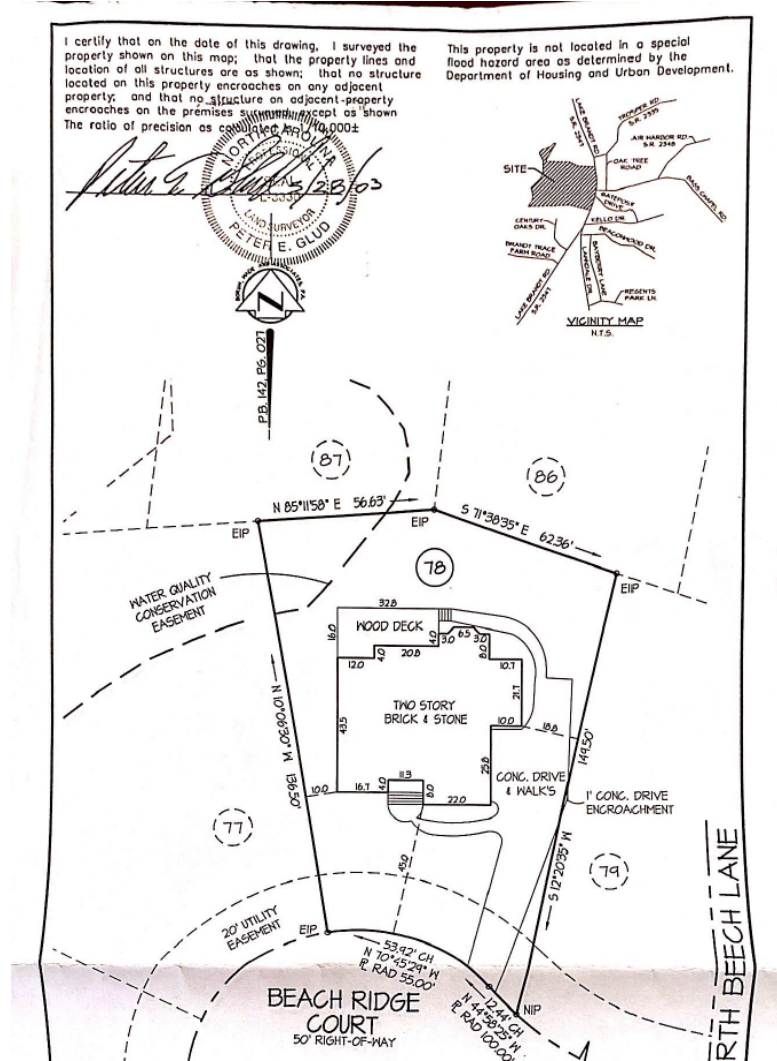
N. EDGEWORTH STREET

REV. 11-30-83
REV. 01-24-84
REV. 7-25-88

PROPERTY OF
235 N. EDGEWORTH ASSOCIATES
N. EDGEWORTH STREET & N. SPRING STREET
GREENSBORO, NORTH CAROLINA
SCALE: 1" = 20'
DATE: FEB. 9, 1988
MARVIN L. BORUM AND ASSOCIATES
ENGINEERS PLANNERS SURVEYORS
205-B PARKWAY GREENSBORO, N.C. 27401
P.O. BOX 14219 GREENSBORO, N.C. 27415
PHONE: 878-0471 • 878-3115

CARRUTHERS & ROTH, PA
ATTORNEYS AT LAW

Boundary Surveys

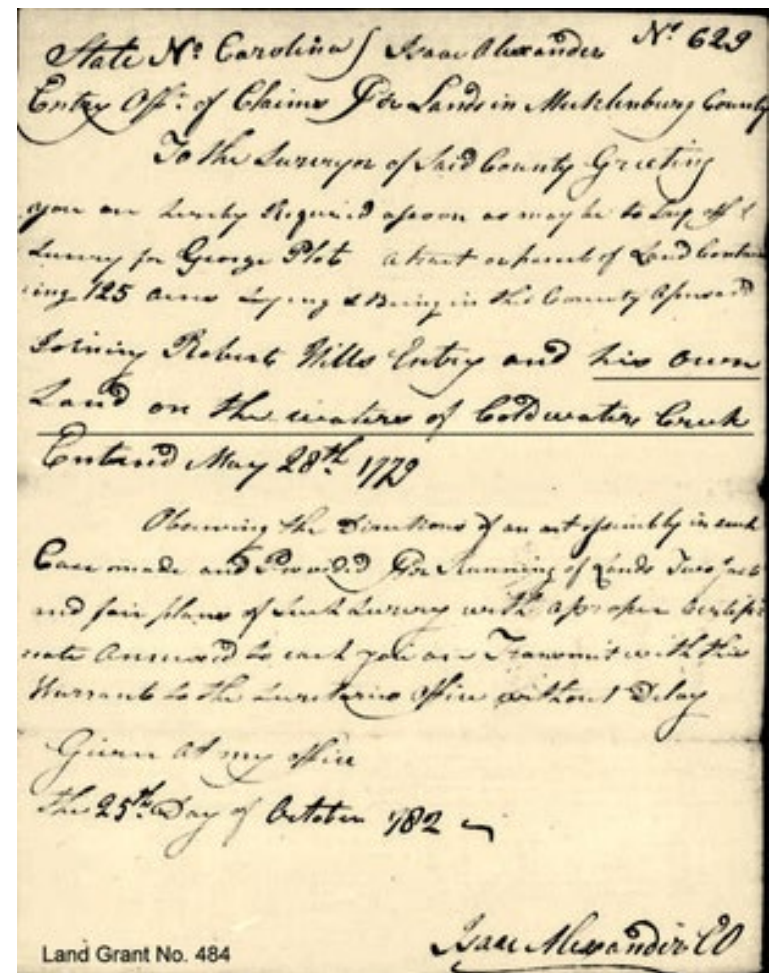


Additional Thoughts on Surveys

- The type of property and proposed use of the property will drive what type of survey is appropriate.
- ALTA surveys will help comprehend title matters and should be obtained any time construction/expansion is contemplated and the property is encumbered by easements.

STAPLE: Title

- You probably understand that attorneys “search” title, but what does that mean?
- Confirmation that your seller or landlord actually owns the property, but so much more.
- Does the Seller/Landlord own all of the Property? Does the description of the property match expectations? Are there other owners?
- What about the quality of title?

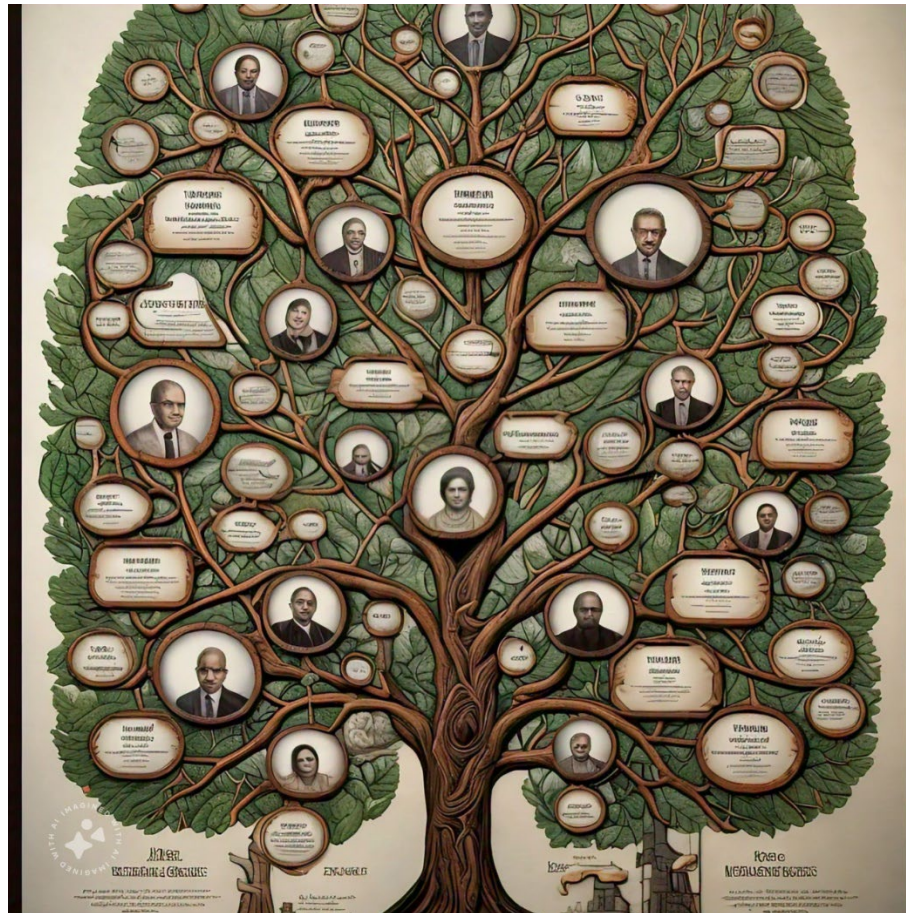


Title (cont.)

- Caveat Emptor applies to matters of title in most cases.
- Sellers will typically give a “special warranty deed” whereby they promise to give buyer as good of title as they received.
 - If they never owned it, the deed may be worthless and would be without recourse under the warranties of title.

Title (cont.)

If dealing with
old family
land, attorney
searching title
must exercise
extra caution



Exceptions to Title

- Far more likely that issues of title have nothing to do with who owns the property.
 - Are there easements that restrict where improvements can be built?
 - Are there use restrictions, restrictive covenants, memorialized leases, rights of first refusal, or other similar issues?
 - What about judgments or liens?

Exceptions to Title (cont.)

- If looking to occupy a business park or planned community, substantial review of any and all declarations of restrictive covenants and easements are necessary.
- In addition to encumbrances, it is also important to consider whether all necessary rights to use the property are available:
 - Access, utilities, water runoff rights, etc.

STAPLE: Appraisals

- What is a property worth?
- Is lender requiring an appraisal in order to perform its underwriting?
- How much time will the appraiser need to prepare the appraisal, and how much time will lender need to review before it can approve a loan?
- Note: Lender's due diligence standards may not align with borrower's.

STAPLE: Physical Inspections

- If buying improved real estate:
 - Are components in good working order?
 - Is there deferred maintenance?
 - When were updates most recently performed?

Physical Inspections (cont)

■ Obvious big-ticket items:

- Roof
- Parking Lot
- HVAC
- Elevators
- Electrical
- Trade Fixtures



Physical Inspections (cont.)

- Seller/Landlord likely does not have an affirmative duty to disclose defects.
- Buyer/tenant needs to ferret out even unlikely defects
- Private utility lines and drainage under the property
- Does property comply with zoning, ADA, and workplace safety requirements?

Physical Inspections (cont.)

- What about inspection of things outside of the four walls of the building:
 - Does the Property have a private driveway?
 - Is there a retention pond, a utility lift station, or other less common building component?

Physical Inspections (cont.)

- If dealing with undeveloped land, does the soil support development?
- Are utilities available?
- Will likely require early consultation with engineer.

STAPLE: Land Use



Land Use

- Does intended use for property depart from existing use?
- Is property adequately zoned for use?
- Does the proposed use require a site plan approval?
- Is there sufficient legal access, parking, and utilities?

Land Use (Cont.)



- Does the property have restrictive covenants that limit uses?
- Are there permissible uses of adjacent properties that could be problematic or competitive

Land Use (cont.)

- Does the Property share amenities, services, or access with any other properties? If so, who is responsible and at what cost?



STAPLE: Environmental

- Environmental laws and regulations apply at the federal and state level.
- Greatest potential for environmental liability arises under two federal acts
 - Comprehensive Environmental Response, Compensation, and Liability Act of 1980, commonly known as “Superfund” or “CERCLA” and
 - Resource Conservation and Recovery Act of 1976, commonly known as “RCRA”

Environmental Due Diligence (cont.)

- General rule: if buy contaminated land without undertaking certain steps, owner becomes liable for the cost of clean-up.
 - Liability continues even after transferring the real property.
- Practical concern: once buy property, future buyers will likely conduct due diligence and discover issues.

Environmental Due Diligence

- Under CERCLA, a buyer or tenant can obtain an innocent landowner defense by undertaking due diligence.
- Must obtain a clean Phase I environmental report.
 - Clean means there are no Recognized Environmental Conditions (“RECs”), Controlled Recognized Environmental Conditions (“CRECs”), or Historical Recognized Environmental Conditions (“HRECs”)

Environmental Due Diligence (cont.)



- If one or more RECs, HRECs, or CRECs are discovered, additional testing will be required.
- Some remediation may be required.

Environmental Due Diligence (cont.)

- Environmental issues are not always what they seem.
 - Petroleum contamination is often a minor issue.
 - Other, seemingly innocuous issues, like the operation of a dry-cleaner, can result in big clean-up.
- The cost of remediation often depends more on the location of ground water and what types of property are nearby than anything else.
 - Highly dependent on luck.

When Should Due Diligence be Complete?

- As early as possible.
- Before substantial funds are spent.
- But due diligence costs money too!
 - Need to prioritize the risks.
- If dealing with a purchase agreement that includes an inspection period, before the expiration of such a period.

How to Negotiate Problems

- If Due Diligence discoveries impact the buyer's costs, who should pay for them?
 - Are the issues user-specific?
 - Are there other potential buyers or tenants?
- Environmental issues, deferred capital expenditures and existing problems are seller problems no matter who their buyer is.

Thoughts for Sellers and Landlords

- Keep in mind that Caveat Emptor is the standard
- Buyers may look for representations and warranties.
 - If grant the reps and warranties, such a seller or landlord may create unnecessary additional liability.

Representations and Warranties

- Representations and warranties are typically statements that can be made at time of closing.
- However, purchase agreements and transfer documents may have language that survives longer than anticipated and may not be based on knowledge at the time the document was signed.
- Because representations and warranties are based on historic operations which may not line up with future events, they are ripe for triggering unanticipated defaults.

When are Reps Made and Enforced?

- Representations may be about the condition of the property as of the date a contract/lease is signed.
 - However, many purchase agreements include a survival period that says buyer can sue on failed representation for months or years after closing.

A Note Regarding Brokers

- Although sellers and landlords don't have to disclose defects, brokers are held to a higher standard.
 - If working with a real estate broker, broker must disclose material facts to all parties in a transaction.
 - Seller's broker may have to disclose information that would otherwise have to be discovered by a buyer.

The Due Diligence Starting Lineup

- To complete thorough due diligence, a team of experts is required.
- The size and nature of the project will drive who is involved, and to what extent.
- Likely to include:
 - Attorneys
 - Surveyors
 - Environmental Consultants
 - Lenders
 - Appraiser
 - Contractors
 - Land use consultant (or zoning letter)

Who is the Coach

- The Due Diligence Team needs a coach.
- Someone who knows the ins and outs of the project/intended use and can understand the various due diligence reports.
 - Often times, this is the company CFO, CPA, or COO.
 - Might be the principal of the company, the attorney, or the engineer.

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Questions?

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