

## **Avoiding Deal Killers in Real Estate Sale and Purchase Transactions**

Structuring Contract Terms to Clear Environmental Hurdles, Land Use Approval Challenges, and Encroachment Issues

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# **AVOIDING DEAL KILLERS IN REAL ESTATE SALE AND PURCHASE TRANSACTIONS**

**Webinar**

August 25, 2020

**Panelists:**

Jim Anderson

Mitchell C. Regenstreif

DLA Piper LLP



# I.

## CONTAMINATION; ENVIRONMENTAL ISSUES

- A. What is the Proper Allocation of Risk for Environmental Problems?
  - 1. Legal Obligations; Due Diligence
    - (a) Federal and State Law
    - (b) Due Diligence
  - 2. Known Versus Unknown Conditions

## II.

### ZONING, BUILDING CODE AND LAND USE ISSUES

- A. Land Use Covenants and Conditions
- B. Provisions for Entitling Property

### III. AS-IS CLAUSES

#### A. Why Buyer should consider accepting an “As-Is” Clause?

1. “As-is” clauses have become customary in “national” commercial real estate sales.

2. In California and most other states, an “as is” clause will not excuse “passive concealment” by the Seller. (See generally, Practising Law Institute, Friedman on Contracts at §2:4.1 (7<sup>th</sup> ed.)) In other words, in such states, an “as is” clause does not eliminate the Seller’s duty to disclose to the buyer material facts known to the Seller but not the Buyer. (But see *Shapiro v. Hu*, 188 Cal. App. 3d 324, 333-334, 233 Cal. Rptr. 470 (1986) (as is clause protected Seller from liability for non-disclosure of bulge in basement wall that was hidden by paneling)) By contrast, in New York and certain other eastern states, the seller has no duty to disclose material facts to the buyer in the sale of real estate. (See cases cited in *Stamborsky v. Ackley*, 572 N.Y.S. 2d 672 (1991)) In all states, including New York, a Seller may be held liable for fraud for “active concealment”.

3. Buyer may have trouble collecting any claim for breach of representation as the seller is often a shell entity whose only asset is the property. Compare the following statutes:

a. California: “Causes of action against a dissolved limited liability company, whether arising before or after the dissolution of the limited liability company, may be enforced against ...members of the dissolved limited liability company to the extent of the limited liability company assets distributed to them upon dissolution of the limited liability company.” (Cal. Corp. Code §17707.07(a)(1)) (A “dissolution” under this section includes a de facto dissolution. (*CB Richard Ellis, Inc. v. Terra Nostra Consultants*, 230 Cal.App.4th 405 (2014) (approving jury instruction that read: “Dissolution of a limited liability company occurs when it ceases operating in the ordinary course of its business, with the intention, on the part of its members, not to resume the ordinary course of its business”))

b. Delaware: “A member who receives a distribution in violation of subsection (a) of this section [requiring that creditors be paid before members], and who knew at the time of the distribution that the distribution violated subsection (a) of this section, shall be liable to the limited liability company for the amount of the distribution.... A member who receives a distribution in violation of subsection (a) of this section, and who did not know at the time of the distribution that the distribution violated subsection (a) of this section, shall not be liable for the amount of the distribution.” (Emphasis added. Del. Code §18-804(c))

In other words, while a creditor can recover liquidating distributions from members of a California LLC whether or not the member was aware of an existing creditor claim, a creditor cannot recover liquidating distributions from members of a Delaware LLC without establishing that the member was aware of the creditor’s claim at the time of the distribution. (Law of the state of formation governs the liability of a member for the liabilities of the LLC. (Cal Corp. Code §17708.01(a)(2)))

4. There are often other protections available to buyers through their due diligence: estoppel certificates, insurance, zoning letters, property condition reports, Phase One Environmental Reports, etc.

## **B. Customary carveouts to “As is” Clause. Two**

### **Examples:**

1. In a net lease transaction, the Seller is typically expected to make certain representations regarding the Lease. For example: (A) the copy of the Lease provided by Seller to Buyer is a true, correct and complete copy of the original, (B) the Lease is in full force and effect, (C) no concessions, abatements or adjustments have been granted to Tenant except as specified in the Lease, and (D) to Seller’s actual knowledge, there is no current default in the performance of the obligations of any party under the Lease. [If Seller is not the original landlord, then this entire representation would generally have a knowledge qualifier.]

Explanation: Although these representations are generally covered by a tenant estoppel certificate, these representations are so critical in a net lease deal that Buyers typically require them before undertaking due diligence.

2. In the sale of ownership interests in the title holding entity, the Seller is typically required to make representations regarding the absence of entity level liabilities. For example, in the sale of a CVS store structured as an entity sale (of the LLC title holder), the Seller typically represents as follows:

“To Seller’s actual knowledge, the LLC has no liabilities or contractual obligations other than: (a) the obligations of the LLC with respect to the Mortgage Loan and Loan Documents, (b) the obligations of the LLC under the Lease and the other Permitted Exceptions, (c) the obligations of the LLC with respect to taxes relating to the LLC or the Property, (d) the obligations relating to the maintenance of the status of the LLC as a Delaware limited liability company and the maintenance of the LLC’s qualification to do business in the State where the Property is located, and (e) customary unsecured trade debt, which will not exceed \$100.00 as to the LLC as of the Closing Date.”

Explanation: there are no third party reports or searches that can uncover liabilities that are not the subject of a pending lawsuit or a recorded judgment or lien.

## IV. ENCROACHMENTS

A. Is the encroachment material?

B. Has the adjacent property owner consented to the encroachment or is consent likely through an encroachment agreement?

Terms of encroachment agreement: (1) term: perpetual v. limited (2) nature of right: covenant running with the land v. license (and if a license, is it assignable?) (3) obligations of encroaching party to maintain encroachment area (4) consideration: (a) annual or one-time fee (b) payment of real estate taxes allocated to the encroached area (5) describe encroachment area and identify benefitted and burdened parcels (6) consent of the mortgage holder on the burdened parcel

C. Is the encroached land likely to have been acquired through adverse possession?

Most likely impediments to adverse possession are: (1) the encroachment has not been in place for the statutory period or (2) the applicable state adverse possession statute requires that the possessor have paid real estate taxes on the property in question for the statutory period.

## States Where Payment of Real Estate Tax is an Element of Adverse Possession

<b>Arizona</b>	10 years of adverse possession (A.R.S. §12-526); or 5 years of adverse possession and paying real estate taxes plus recorded deed (A.R.S. §12-525)
<b>Arkansas</b>	Unimproved and unenclosed land: 7 years of adverse possession and paying real estate taxes. (Arkansas Code Title 18 §18-11-102)
<b>California</b>	5 years of adverse possession and paying real estate taxes (CCP §325)
<b>Florida</b>	For claims not founded on a written instrument, judgment, or decree: 5 years of adverse possession and paying real estate taxes (Flor. Statutes Title 8 § 95.18)
<b>Idaho</b>	20 years of adverse possession and paying real estate taxes (Id. Statutes §5-210)
<b>Maine</b>	For uncultivated lands in incorporated places: 20 years of adverse possession and paying real estate taxes (M.R.S. Title 14 §816)
<b>Montana</b>	5 years of adverse possession and paying real estate taxes (Montana Code § 70-19-411)
<b>Nevada</b>	5 years of adverse possession and paying real estate taxes (N.R.S. §11.150)
<b>New Mexico</b>	10 years of adverse possession and paying real estate taxes (New Mexico Statutes §37-1-22)
<b>Utah</b>	7 years of adverse possession and paying real estate taxes (Utah Code §78B-2-214)

**D. Will the title insurance company issue an encroachment endorsement?**

**ALTA Endorsement 28.1-06:** The Company insures against loss or damage sustained by the Insured by reason of:

- a. An encroachment of any Improvement located on the Land onto adjoining land or onto that portion of the Land subject to an easement, unless an exception in Schedule B of the policy identifies the encroachment;
- b. An encroachment of any Improvement located on adjoining land onto the Land at Date of Policy, unless an exception in Schedule B of the policy identifies the encroachment;
- c. Enforced removal of any Improvement located on the Land as a result of an encroachment by the Improvement onto any portion of the Land subject to any easement, in the event that the owners of the easement shall, for the purpose of exercising the right of use or maintenance of the easement, compel removal or relocation of the encroaching Improvement; or
- d. Enforced removal of any Improvement located on the Land that encroaches onto adjoining land.

## V. and VI.

# CC&R RESTRICTIONS; ACCESS AGREEMENTS

- A. CC&Rs and Reciprocal Access/Easement Agreements
  - 1. Overview
  - 2. Key Issues
    - A. Creation
    - B. Access
    - C. Construction and Architectural Compatibility
- B. Provisions for Creation or Modification of CC&Rs

## VII.

# LEASES AND TENANCY ISSUES

- A. Estoppel Certificates
  - 1. Reliance on Rent Roll vs Estoppel
  - 2. Remedies
- B. Other Tenant Issues (Lease Defaults; Tenant Financial Condition)

Black's Law Dictionary defines "estoppel certificate" as "[a] signed statement by a party, such as a tenant or a mortgagee, certifying for the benefit of another party that a certain statement of facts is correct as of the date of the statement, such as that a lease exists, that there are no defaults and that rent is paid to a certain date. Delivery of the statement by the tenant prevents (estops) the tenant from later claiming a different state of facts." (Black's Law Dict. (6th ed. 1990) p. 551, col. 2) "An estoppel certificate binds the signatory to the statements made and estops that party from claiming to the contrary at a later time." (Cal. Practice Guide: Real Property Transactions (The Rutter Group 1999) P 7.292, p. 7-73 (rev. # 1 1997).)

In the case of *Plaza Freeway v. First Mt. Bank*, (2000) 81 Cal. App. 4th 619), the termination date of the lease was not known with certainty by the landlord and the tenant. The tenant signed an estoppel certificate in favor of the plaintiff/landlord at the time of purchase. The trial court held that the expiration date was approximately eight months later than stated in the estoppel certificate. The court of appeal reversed and held that as a “written instrument” the estoppel certificate bound the tenant and estopped the tenant from taking a different position than set forth in the estoppel certificate.

So what does this mean for our current analysis?

## **VIII.**

### **BUYER'S CAPITAL/FINANCING ISSUES**

**Most Contracts Contain No Finance Contingency; Current Conditions May Present Problems**

## Due Diligence Issues for Lenders and Equity Providers of Buyer

- A buyer's lender or equity provider might have stricter due diligence requirements than Buyer
- Providing flexibility in terms of access and information seller must provide to satisfy these other parties (e.g., making sure Estoppel Certificates run to the benefit of Buyer's lender and equity providers)
- Building in sufficient time to satisfy not only Buyer's due diligence, but time to satisfy due diligence by these other parties
- Carve-outs to confidentiality provision allowing for disclosure of property information to lenders and investors

## Securing Funds by Buyer

- If Buyer is funding a portion of the purchase price with financing, Buyer should obtain loan commitment during contract negotiations or during due diligence
- If Buyer needs investors to provide a portion of the purchase price, Buyer should enter into joint venture or other appropriate agreements with such investors during due diligence
- When relying on 3<sup>rd</sup> party funds for a portion of the purchase price, Buyers should try to build in some flexibility in the closing date (such as a short extension right) in case there is a last minute issue with 3<sup>rd</sup> party funding

# THANK YOU

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