

# Dodging Deal Killers

## Anticipating and Solving Problems Related to Properties Being Sold or Purchased

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# Dodging Deal Killers

## Introduction

**Sellers: Don't hide a problem; disclose it.**

**Buyers: Look under every rock and get appropriate contingencies and get Reps and Warranties.**

**Both: Dealing with Property defects:**

- Find out as much as possible;
- Consult an expert;
- Develop a plan to cure or minimize;
- Ascertain the approximate cost and timetable to implement the plan; and
- Implement the plan pre-closing if possible; or
- Negotiate a price reduction or buyer holdback or credit against the purchase price to compensate for taking the Property with the defect.

## **1. Contamination; Environmental Issues**

### **Problem:**

- Significant environmental contamination on or directly affecting the Property.
- No DEQ or WDE (Washington Dept. of Ecology) “no further action” (NFA) letter.

### **Concerns:**

- Stepping into major liability for someone else’s mess.
- Remediation costly, time consuming and difficult.
- Stigma of the contamination will scare off lenders and buyers.
- Remediation may interfere with day to day use.

## **Contamination; Environmental (cont.)**

### **Approach to Solution:**

- Hire an environmental consultant or environmental attorney (for each side).
- Obtain any existing Phase One or other documentation on the contamination.
- If none, commission a Phase One/Phase Two environmental assessment.
- The parties' consultants should agree on a scope of work and then negotiate with DEQ.
- Get bids or estimates to quantify the cost of remediating and the estimated time frame.

## **Contamination; Environmental/Approach (cont.)**

- Determine if there is any “deep pocket” third party liable.
- Negotiate both (i) a holdback of the remediation cost out of Seller’s closing funds and (ii) potentially an adjustment of the purchase price.
- Ensure Buyer’s lender will hold its interest rate on the new loan pending remediation if done pre-closing.
- Determine whether insurance may be available to Seller covering his loss.

## **2. Defective or Incomplete Land Use Approval**

### **Problem:**

- **Outstanding and unsatisfied pre-conditions to the original (land use) development approval of the Project.**

### **Concerns:**

- **City/County could force compliance at any time and**
- **It may be difficult, costly or impossible to comply.**

### **Approach:**

- **Identify all prior land use decisions and conditions of approval.**

## **Defective or Incomplete Land Use Approval/Approach (cont.)**

- **Gather information and documentation re compliance from:**
  - **Planning staff.**
  - **ALTA surveys and title reports.**
  - **Zoning reports such as PZR Reports.**
  - **City/County file review.**
  - **History, marketing materials, development files.**



## **Defective or Incomplete Land Use Approval/Approach (cont.)**

- **Evaluate materiality of outstanding/unsatisfied condition of development approval.**
  - **Fatal non-compliance.**
  - **Non-fatal non-compliance.**
  - **Confer with Lender's counsel on situation.**
- **If material, evaluate feasibility of obtaining retroactive compliance pre vs. post-closing.**

### **3. “As Is,” “Your Problem Not Mine” Seller**

#### **Problem:**

#### **Seller who:**

- **Insists on selling the Property entirely on an “AS IS” basis;**
- **Refuses to make any representations or warranties; and**
- **Either has inadequate files or refuses to allow Buyer to review his files.**

**Concerns: Seller likely suspects or knows there is a major defect in the Property.**

## As Is (cont.)

### Approach

- **Some minimal Representations (“Reps”) are expected of Seller:**
  - Has marketable title;
  - Seller entity authorized to sell;
  - Knows of no substantial defects in condition of Property or in land use approvals for its development;
  - Has received no notices of non-compliance not cured; and
  - Caveat: Okay for Seller to qualify most Reps. “TB of K.”

## **As Is/Approach (cont.)**

- **AS IS language acceptable as long as:**
  - Buyer is given access to and an opportunity to copy all Seller's files (excepting tax returns); and
  - Seller represents that the files are substantially complete and accurate.
- **Presence of a strong AS IS disclaimer**
  - Forces meticulous and thorough due diligence.
  - Necessitates a longer contingency period.

## **As Is/Approach (cont.)**

- **Terminate if Seller won't either:**
  - Allow file access; or
  - Give a Rep or Warranty that there are no substantial undisclosed defects.
- **The AS IS clause, etc., should be vetted by each party's attorney.**

## 4. Encroachment

**Problem:** Project buildings or improvements encroach on a Property boundary line, into a required setback or recorded easement way.

**Concern:** Cloud on title and potentially a loss of use and financial.

**Approach:**

- Cure the encroachment by demolition of the improvement;
- Payment in settlement; or
- Litigation with neighbor.

## **Encroachment /Approach (cont.)**

- **Don't have to straddle the Property boundary to encroach.**
  - **An improvement can encroach on an access or utility easement or it can encroach on and thereby violate a setback.**
  - **Whatever, need to have a surveyor draw and measure.**
  - **Encroaching into a zoning setback is a problem, but can often get a retroactive variance/adjustment.**
  - **A setback imposed by CC&R's may be a bigger problem.**

## **Encroachment/Approach (cont.)**

- When an encroachment is in the form of improvements built over a utility easement, Seller may have to move the improvements.**
- Find out if the easement is still in use or has been abandoned.**
- Query, whether Seller had an encroachment endorsement on his title policy when purchased?**



## **Encroachment/ Approach (cont.)**

- **Boundary line encroachments. Consider:**
  - **Work with title examiner to clear up boundary line overlaps/gaps.**
  - **Confer with County Surveyor re encroachments identified by a survey.**
  - **Compliance with County/City ordinances prohibiting recording of surveys evidencing boundary line encroachments.**
  - **Need a property line adjustment, easement, or boundary line agreement with adjacent property owner to resolve encroachment.**

## **5. URM or Otherwise Seismically Challenged Property**

### **Problem:**

- Where the building(s) are of unreinforced masonry (“URM”) or other seismically deficient construction; and/or
- Where located in a seismically vulnerable area or on unstable soils.

### **Concerns: If a URM:**

- Can’t get advantageous Freddie Mac, Fannie Mae, “Conduit,” and Chase loans.

## **URM/Concerns (cont.)**

- **What loans are available (often from Banks) will:**
  - have a lower LTV ratio and higher DSC;
  - higher interest rate;
  - shorter rate-fixed period;
  - shorter amortization; and
  - will require personal guarantees.
- **Earthquake insurance, if available:**
  - Will be surplus lines only (less regulated);
  - Have higher deductibles;
  - Have less breadth of coverage; and
  - Will be more expensive.

## **URM /Concerns (cont.)**

- **Building inspector might force major seismic upgrades if it is determined:**
  - a dangerous building;
  - substantial work being done; or
  - there is a “change of use.”
- **Building potentially dangerous to tenants,**
  - discouraging occupancy; and
  - creating possible tort liability for the owner.

## **URM (cont.)**

### **Comment:**

- **It is technically feasible to seismically upgrade most URMs and seismically deficient buildings.**
- **Financial feasibility is a reflection of both the cost of the seismic upgrade and the rental value of the renovated space.**
  - **Portland has high rents, high seismic risk vs. (say) Pendleton with low rents and low risk.**

## **URM (cont.)**

### **Approach:**

- **Determine if the building is a URM/seismically challenged.**
  - **Portland has a circa 1991 City Engineer’s inventory.**
- **Determine whether the building is in a seismic risk area.**
  - **The Oregon Coast is in Seismic Zone 4 and most of the 1-5 corridor is in Seismic Zone 3 or 4.**
  - **Consult the Oregon Dept. of Geology (“DOGAMI”) webpage to learn of any nearby faults and unstable soils.**
- **If a URM or inadequately reinforced, consider having an engineer perform an ASCE 31 or an ASCE 41 analysis and get a “PML” (Probable Max Loss) calculation.**

## **URM/Approach (cont.)**

- **If the Building of historic quality, significant tax incentives may apply, e.g.**
  - **Oregon's 10 year historic property tax assessment freeze;**
  - **The Federal 20% historic tax credit; and**
  - **A charitable façade donation.**
- **Portland is fairly flexible about seismic upgrades especially for historic properties. See Portland CC 24.85.**

## **URM/Approach (cont.)**

- **To determine if seismic upgrading is financially feasible:**
  - **Obtain upgrade design proposals and preliminary bids from several masonry contractors.**
  - **Project the post construction income and expense of the Building.**
- **Result: Reduce purchase price to reflect earthquake risk and upgrade cost.**



## **6. Use, Alterations and Redevelopment of Existing Buildings**

### **Concerns:**

- **Before committing to acquire a project, perform due diligence re: building permits, proposed use, alterations, change of use or redevelopment of the building.**

### **Approach:**

- **Check all permits in the Building Department's file and consult with City/County Planning Dept.**
  - **Copies of building permits, formal Pre-Application Conference, informal assistance, written report from City/County planning staff.**

## **Use, Redevelopment (cont.)**

- If work appears to have been performed after original construction, check to be sure it was permitted.**
- If not permitted, retain a competent engineer or architect to negotiate with the Building Department to get the work permitted.**
- Uniform Building Code violations, problems:**
  - Plumbing, electrical or structural work done without a permit, may be defective, dangerous and could “red tagged” at any time;**
  - Lender may refuse to loan until situation rectified; and**
  - Casualty insurer may refuse to insure.**

## **Use, Redevelopment/ Approach (cont.)**

### **– Illegal Units**

- **Apartment complex has unpermitted (“illegal”) units (e.g. common area converted to units) and Seller thinks the illegal units are worth the same as legal ones.**
- **Consult an architect and/or city/county planning departments re legality of units and what is needed legalize units.**
- **Price of the illegal units should be discounted to reflect the time, money and risk won’t be able to make legal.**

## **Use, Redevelopment (cont.)**

### **– Exactions**

#### **○ Governing Law:**

**❖ Whether condition of development requiring dedication of land is an unconstitutional “taking” under U.S. Constitution based on *Nolan/Dolan* analysis requiring condition have requisite “nexus” and “proportionality” to impact from development.**

**○ Exactions distinguished from requirement that owner undertake monetary obligation for off-site improvements.**

## **Use, Redevelopment (cont.)**

- Legal lot determination**
  - Governing Law
  - Legal lot and permitted use distinguished
  - Establishment
- Change of Use**
  - Governing law
  - Establishment

## **Use, Redevelopment (cont.)**

- Nonconforming Use (NCU)**
  - Governing Law
  - NCU and Vested Rights distinguished
  - Establishment and Scope
- Nonconforming Development**
  - Governing Law
  - Nonconforming Development and NCU distinguished
  - Establishment and Scope

## **Use, Redevelopment/ Approach (cont.)**

- Outdoor Signs/Cell Towers/Roof Antenna**
  - Value of lease vs. limitations on future use.**
  - Review lease terms.**
  - Negotiate termination of lease if necessary.**

## **7. CC& R Restrictions**

### **Problem:**

- **Title clouded by 70 years or older (pre-WW II) CC & R's imposing:**
  - **Ethic, religious and/or racial restrictions on ownership or occupancy (generally unenforceable) as well as.**
  - **Density and/or height limitations, minimum square footage of improvements, minimum lot size, stringent setbacks, design review and/or limited approved uses (generally enforceable).**



## Old CC & R's/Approach:

### Concern: Uncertainty whether enforceable.

- Constitutionally unenforceable restrictions against ownership or occupancy by individuals of various racial and ethnic groups **NOT THE ISSUE.**
- Other restrictions are likely enforceable:
  - Limiting uses allowed beyond applicable zoning;
  - Imposing larger set-backs than applicable zoning;
  - Imposing minimum lot and house/ building size;
  - Specifying construction materials and design;  
or
  - Imposing design review.

## Old CC & R's/Approach (cont.)

- **Some restrictions can we waived:**
  - **If benefitted parties consent in writing; or**
  - **If the benefitted parties have tacitly or formally waived their rights.**
- **Consult an attorney or title company to determine benefitted owners.**

## **8. Legal Access.**

### **Problem:**

- **Project lacks adequate legal access to arterial street (an authorized “curb cut”), or extent of current access diminished due to state, county or city policies or permit conditions.**

### **Concerns:**

- **Bad access diminishes building value; no access eliminates value.**
- **Can be difficult and expensive to negotiate access if you don’t have it.**

## **Legal Access (cont.)**

### **Approach:**

- **Consult a land use attorney and traffic consultant/engineer if necessary.**
- **If lack legal access, Query: did the Seller have an access endorsement on the title policy received at purchase?**
- **Consult with appropriate road jurisdictions.**
  - **City streets or County roads. Talk with City or County Transportation Dept. about Transportation Plan and policies and access permits.**

## **Legal Access/Approach (cont.)**

- State highways. Talk with Regional Office of Oregon Department of Transportation (ODOT) re ODOT access permit.**
  - ODOT may require combining driveway cuts for adjoining parcels with same owner.**
  - ODOT may eliminate street parking and loading zones.**

## **Legal Access/Approach (cont.)**

- **Recent changes in state laws and ODOT regulations affecting state highway access**
  - ❖ **ORS 374.310 and 374.312, as amended by SB 1024 (2010) re access based on objective standards and less stringent access management rules, measures and spacing and mobility standards; and**
  - ❖ **SB 264 (2011) changed process based on objective standards and procedural changes.**

## **Legal Access/Approach (cont.)**

### **❖ ODOT Access Rules now provide the following:**

- Reasonable access based on economic development needs;
- Safety based on Objective Standards;
- Change of Use based on spacing, channelization, and site distance standards;
- ODOT has burden of proving problems; and
- Approval with deviations from spacing, channelization and sight distance.
- Expedited permitting.
- New appeals process with collaborative and dispute review process.

## **9. Soils or Riparian Issues**

### **Concerns:**

- **The Property has soils issues, e.g.**
  - **The Property or immediate uphill neighbor's Property is on an unstable slope prone to landslides; or**
  - **Building is built on an old creek bed predisposed to liquefying in an earthquake; and/or**
  - **The creek is still active, periodically flooding the Building's basement.**
- **Or, there are apparent wetlands or riparian areas.**
- **Any of these soils issues may be difficult or very expensive to solve.**



## **Soils or Riparian Issues (cont.)**

### **Approach:**

- **Consult a soils/geotechnical engineer and test.**
- **If a limited but important area has unstable soils, one has options, including the installation of “mini pilings” or infusing the sub soil with very liquid concrete.**
- **Any suspected riparian area should be inspected by a biologist or other riparian specialist.**
- **In some situations, a compromised riparian area may be eliminated in exchange for mitigation in the form of riparian credits acquired from another property.**

## **10. Flood, Tsunami, Storm/Wind Vulnerability**

### **Problem:**

**Some structures on the Property are:**

- **In the 100 year floodplain;**
- **In a tsunami evacuation/ impact zone; or**
- **Are surrounded by large, diseased or surface rooted trees, making them vulnerable to windstorm “blow down.”**

## **Flood, Tsunami, Storm/Wind Vulnerability (cont.)**

### **Approach:**

- **Obtain flood inundation maps from the FEMA.**
  - **Engage engineer if within Flood Hazard Area to consider:**
    - ❖ **Federal, State, County, City permits;**
    - ❖ **FEMA Elevation Certificate;**
    - ❖ **“No Net Rise” Certificate; and**
    - ❖ **“Balanced cut & fill.”**

## **Flood/Approach (cont.)**

- **Obtain tsunami evacuation maps from DOGAMI and/or NOAA.**
  - **If the Property is below 50 feet above sea level on the Oregon Coast, risk high.**
- **Check with the National Weather Service on records for high winds.**
  - **Wind risk compounded by overhanging trees. If possible, cut down or prune offending trees.**

## **Flood/Approach (cont.)**

- **Obtain flood, tsunami, earth movement or wind storm casualty insurance, often in the form of a “DIC” policy (Difference in Condition).**
  - **Often this type of coverage is limited in scope, has high deductibles and has a fairly low maximum payout.**
  - **Sometimes deductible must be exhausted before for any payment due.**
  - **Written on a “surplus lines basis,” meaning that the insurer deals in high risk policies and is not regulated by the state (either as to rates charged or risk taken).**

## 11. Prohibitive Prepayment Penalty

### Problem:

- Seller has a prohibitively large prepayment penalty on his existing mortgage loan.
- Often a “yield maintenance” formula applies, but is really “yield enhancement” as assumes lender can only reinvest the repayment at same term T-Bill or similar low rates
  - Ignores the 200 bp or larger spread above the index.

## **Prohibitive Prepayment Penalty (cont.)**

### **Questions:**

- **Does Seller have a right of “defeasance” of the existing mortgage loan?**
  - i.e. the right replace the Property as collateral with a basket of T-Bills paying the same income stream?
- **If not, does the Seller have a right of “assumption,” i.e. to sell the Property and have the Buyer assume to existing financing?**
- **Assumption made unattractive when (i) the Lender is unwilling to release the Seller or when (ii) the existing mortgage loan is (say) only a 50% LTV such that Buyer will need secondary financing.**

## **Prohibitive Prepayment Penalty (cont.)**

### **Approach:**

- **Get an estimate of the actual prepayment penalty at a target closing date and assuming a certain market interest rate. Have your accountant check calculation.**
- **Will Lender will forgive some or all of the penalty if the Buyer, rather than assuming the existing loan, obtains a new acquisition loan from Lender?**
- **Any leverage to avoid the prepayment penalties because Lender has misrepresented something or misbehaved?**



## **Prohibitive Prepayment Penalty/Approach (cont.)**

- **If defeasance is an option, how costly?**
- **If defeasance is cost effective, retain a defeasance consultant and an attorney experienced with defeasance (as legal opinions typically required).**
- **Beware: Likely a default to bypass the Lender with “wraparound” financing.**

## **12. Under-Performing Property**

### **Problem:**

- **The Property has been poorly managed and has below market rents, substandard tenants, a high vacancy rate and much deferred maintenance.**
- **The Property's current net operating income ("NOI") is too low to allow a 65% to 70% loan especially with lender-imposed repair reserves, i.e. Property will not meet the required "debt service coverage" ratio (say) 1.35 to 1.**

## **Under Performing Property (cont.)**

### **Solution:**

- **Negotiate a Master Lease/Option of the Property from Seller.**
  - **Stated Term (say) 5 years, but in reality Buyer intends to exercise the option within a year.**
  - **Seller will want a large option payment (say 10-25% of the sale price) but Buyer protected as all applies to the purchase price.**
  - **Rent, on a “triple net” basis, the monthly rent payment to be approximately equivalent to a mortgage payment for the remainder of the sale price (after deduction the option payment).**

## **Under Performing Property/Solution (cont.)**

- Option to purchase that expires in (say) 9-12 months.**
- Buyer/ Lessee given authority to:**
  - renovate the property;**
  - cure deferred maintenance;**
  - evict unsatisfactory tenants assuming on month-to-month rental;**
  - raise tenant rents as allowed; and**
  - tighten financial controls on property operation.**

## **Under Performing Property/Solution (cont.)**

- Goal: in 9 to 12 months, to increase the NOI and the appraised value so that will be able to get 65-75% loan at a favorable interest rate.**
- Note: Seller cannot have a right to compel purchase or else he will risk a “deemed sale” in eyes of IRS on lease execution.**
- An advantage: Seller has 9-12 extra months to find a Section 1031 exchange “replacement” property.**

## 13. Low Basis Seller

### Problem:

- Seller has a low tax basis in the Property, which will result in a large taxable gain to him on the sale.

### Approach:

- Make the sale contingent on Seller accomplishing a IRC Section 1031 tax deferred exchange.
- “Replacement” properties need to be sufficient in cost to allow equivalent debt and an equity payment sufficient to absorb all Seller’s cash proceeds from the sale.
- An additional wrinkle: Seller may need a large non-refundable earnest money deposit to tie up his replacement Property.

## **Low Basis Seller (cont.)**

### **Specific Steps:**

- **If an exchange, defer gain recognition.**
- **To qualify need:**
  - **To employ an exchange accommodator (“Qualified Exchange Intermediary”);**
  - **To take no proceeds, all going to the accommodator;**
  - **To identify replacement properties within 45 days of sale and close within 180 days; and**
  - **To have adequate funds to tie up the replacement property.**

## **Low Basis Seller/Specific Steps (cont.)**

- **Structure the PSA for the sale of “relinquished” property so that accommodator receives from Buyer a large non-refundable earnest money deposit which the accommodator can in turn deposit in the escrow as an earnest money deposit on the “replacement” property.**
- **Draft the PSA for the replacement property with an exchange contingency so that the deposit is refundable if Seller’s (the tax payer) sale fails.**



## **14. Investor Gets “Cold Feet”; Need \$\$ to Close**

### **Problems:**

- **Buyer’s major investor, intending to contribute (say) 50% of the equity capital for the purchase, gets “cold feet,” such that Buyer needs either a replacement investor or else needs subordinated/mezzanine debt to provide the needed cash to close.**
- **Also, Lender must bless the new investor or subordinated debt Lender.**

## **Investor gets Cold Feet (cont.)**

### **Options for Buyer:**

- **Terminate the transaction without forfeiture if have broadly phrased “financing” contingency;**
- **Terminate the transaction, but forfeit the earnest money deposit if no suitable and un-waived contingency applies;**
- **Get an extension from Seller and attempt to find a substitute investor by, if necessary, providing the investor a preferred return [Note: securities law issues];**
- **Obtain subordinated financing from a mezzanine or “hard money” lender, assuming your 1st mortgage lender approves; or**
- **Flip the deal to a new buyer if PSA assignable.**