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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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Today's faculty features:

Ken Miller, Shareholder, **Gorman & Miller**, Santa Monica, Calif.

Mitchell C. Regenstreif, Partner, **DLA Piper**, Los Angeles

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AVOIDING DEAL KILLERS IN REAL ESTATE SALE AND PURCHASE TRANSACTIONS

Webinar
October 25, 2018

Panelists:
Ken Miller
kmiller@gormanmiller.com

Mitchell C. Regenstreif
mitchell.regenstreif@dlapiper.com

I.

<u>CONTAMINATION; ENVIRONMENTAL ISSUES</u>

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.

<u>ZONING, BUILDING CODE AND LAND USE ISSUES</u>

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 (7th 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 more effective protections available: estoppel certificates, insurance, zoning letters, property condition reports, Phase One Environmental Reports, etc.

B. <u>Customary carveouts to "As is" Clause. Two Examples:</u>

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.]

<u>Explanation</u>: 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 typical 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

Arizona	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)
Arkansas	Unimproved and unenclosed land: 7 years of adverse possession and paying real estate taxes. (Arkansas Code Title 18 §18-11-102)
California	5 years of adverse possession and paying real estate taxes (CCP §325)
Florida	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)
Idaho	20 years of adverse possession and paying real estate taxes (Id. Statutes §5-210)
Maine	For uncultivated lands in incorporated places: 20 years of adverse possession and paying real estate taxes (M.R.S. Title 14 §816)
Montana	5 years of adverse possession and paying real estate taxes (Montana Code § 70-19-411)
Nevada	5 years of adverse possession and paying real estate taxes (N.R.S. §11.150)
New Mexico	10 years of adverse possession and paying real estate taxes (New Mexico Statutes §37-1-22)
Utah	7 years of adverse possession and paying real estate taxes (Utah Code §78B-2-214)

D. <u>Will the title insurance company issue an encroachment endorsement?</u>

<u>ALTA Endorsement 28.1-06</u>: 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; LEGAL ACCESS

A. CC&Rs and Reciprocal Access/Easement Agreements

1. Overview

2. Key Issues

   A. Creation

   B. Access

   C. Construction and Architectural Compatability

B. Provisions for Creation or Modification of CC&Rs

VII

SOILS AND RIPARIAN ISSUES

A. Legal Rights and Obligations Regarding Soils and Riparian

1. Rights to Subjacent and Lateral Support

2. Water Rights

B. Provisions and Conditions for Maintenance or Testing

VIII. LOW BASIS SELLER

A. Section 1031 Like-Kind Exchange - Part I.

Summary. Generally, if the taxpayer exchanges any form of U.S. real estate for any other form of U.S. real estate, all gain on the sale is deferred so long as the taxpayer trades up or equal in value and equity. (See generally, IRC §1031) However, both the relinquished property and the replacement property must be held by the taxpayer for investment or for productive use in a trade or business. (IRC §1031(a))

Refinancing the Replacement Property. The taxpayer can "monetize" (cash out) its position in the replacement property by borrowing against the replacement property after the exchange. "Even where a new loan is obtained at the time or immediately following a taxpayer's acquisition of replacement property in an exchange, receipt of cash by the taxpayer should not be treated as boot." (See Comments Concerning Open Issues In Section 1031 Like-Kind Exchanges, Section A-2b, published in Thomson Reuters, "Tax-Free Exchanges under Section 1031" (2018))

Section 1031 Like-Kind Exchange - Part II

Advantages:

a. Gain is deferred indefinitely (as long as the taxpayer holds the replacement property) and the taxpayer's heirs inheriting the property receive a step-up in basis on the taxpayer's death.

b. Detailed rules and well-established safe harbors under the deferred exchange regulations help create tax certainty. (See Treas. Reg. §1.1031(k)(1))

c. Seamless, low cost process.

Disadvantage: The taxpayer must identify the replacement property within 45 days of closing and must close the acquisition of the replacement property within 180 days of closing on the relinquished property. (IRC §1031(a)(3)).

B. **Installment Sales under IRC Section 453 – Seller financing (Part I).**

Summary. Where the buyer pays part of the purchase price for real estate in installments and the taxpayer does not elect out of installment sale treatment, taxable income for each taxable year after the sale is equal to the payments received in that year multiplied by the gross profit ratio, which is the gross profit divided by the contract price. (IRC §453(c); Treas. Reg. §15a.453-1(b)(2)) "Gross profit" means the selling price less the adjusted basis of the property. (Treas. Reg. §15a.453-1(b)(2)(v)) "Contract price" means the selling price less qualifying indebtedness, assumed or taken subject to by the buyer, which does not exceed the seller's basis in the property. (Treas. Reg. §15a.453-1(b)(2)(iii))

Monetizing the Installment Obligations. If the taxpayer is able to borrow against the installment obligations, then the taxpayer can cash out while deferring the recognition of gain for many years. If the loan proceeds are used for trade or business expenses (or subject to certain limitation, investment purposes), then the interest on such loan will be deductible and will offset part or all of the taxable income on the installment payments. (IRC §163) However, if the contract price exceeds $150,000, then the taxpayer must recognize gain as soon as it borrows money which is "directly secured …by any interest in such installment obligation." (IRC §453A(d)(4))

Installment Sales under IRC Section 453 – Seller financing (Part II)

Advantages: As compared to a like-kind exchange, the taxpayer need not acquire a replacement property. Seller financing may be attractive to the buyer.

Disadvantages: Gain is recognized every year that payments are received as compared to a 1031 gain in which no gain is recognized until (and unless) the replacement property is resold in a taxable sale. The taxpayer is assuming payment risk. The buyer may not wish to pay in installments.

C. Qualified Opportunity Zones (Part I).

Summary. Provides capital gains relief to taxpayers who invest gains from sale of an investment (including real estate) into a Qualified Opportunity Fund (QOF), which uses the invested cash to invest in a Qualified Opportunity Zone (QOZ). A QOZ is a population census tract that is a low-income community that is designated by the treasury as a QOZ. (IRC §1400Z-1(a)) The first 8700 QOZs were designated in April, 2018. Investing in a QOF provides three tax benefits:

1. Capital gains rolled over into a QOF are deferred until the sale of the fund or until Dec. 31, 2026.

2. The rolled-over gain is reduced by 10 percent if the investment in the QOF is held for 5 years and an additional 5 percent if the investment is held for 7 years.

3. The gains earned by the QOF are exempt from capital gains tax if the taxpayer's investment in the QOF is held for more than 10 years.

Qualified Opportunity Zones (Part II)

Some Details. The taxpayer must reinvest gain within 180 days of sale into a QOF in order to defer such gain. (IRC §1400Z-2(a)(1)(A)) The rolled-over gain is adjusted and taxed upon sale of the QOF or on December 31, 2026, whichever comes first. The "adjusted gain" means the lesser of: (a) the roll-over gain less the taxpayer's adjusted basis in the QOF and (b) the FMV of the taxpayer's interest in the QOF less the taxpayer's adjusted basis in the QOF. (IRC §1400Z-2(b)(1)) The taxpayer's adjusted basis in the QOF is equal to zero plus 10% of the roll-over gain (if the taxpayer holds its interest in the QOF for at least 5 years plus another 5% (for a total of 15%) of the taxpayer's roll-over gain (if the taxpayer holds its interest in the QOF for at least 7 years. (IRC §1400Z-2(b)(2)(B)) If the taxpayer holds its investment in the QOF for at least ten years, then the taxpayer may sell its interest in the QOF free of tax. ((IRC §1400Z-2(c)) A QOF must hold at least 90% of its assets in QOZ property.

Qualified Opportunity Zones (Part III)

Example: Suppose that on November 1, 2018 a corporation sells an office building for $2 million realizing $1 million in gain which it invests in a QOF within 180 days of the sale. Assume the corporation still holds its investment in the QOF on December 31, 2026 at which time its investment in the QOF has appreciated in value to $1.5 million. Since the corporation has held its QOF investment for at least 7 years, its basis in the QOF is equal to 15% of its rolled-over gain or $150,000. As a result, the adjusted rolled over gain (upon which it is taxed) is equal to the lesser of: (a) $1 million minus $150,000 (or $850,000) and (b) $1.5 million less $150,000 (or $1,350,000). Accordingly, in 2026 the corporation will be taxed on $850,000 in gain. If the corporation holds its investment in the QOF for at least ten years, it can sell that investment free of capital gains tax.

Qualified Opportunity Zones (Part IV)

Comparison to a like-kind exchange. Advantages: (a) the investments of a QOF are not limited to real estate, but may includes investments in "qualified opportunity zone businesses" (IRC §1400Z-2(d)) and (b) investment in a QOF results not only in deferral but also in a reduction in taxable gain. Disadvantages: (a) tax deferral resulting from a QOF investment ends on December 31, 2026; tax deferral resulting from a like-kind exchange ends only when the replacement property is sold and (b) there is no step in basis on death as to the "rolled-over gain" resulting from a QOF investment; following a like-kind exchange, the taxpayer's basis in the replacement property is stepped up at death.