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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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1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Strafford Webinar

AVOIDING DEAL KILLERS IN REAL ESTATE SALE TRANSACTIONS

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. There are several Federal statutes providing the basis for environmental liability and state laws similarly impose liability for environmental matters. A brief description of Federal statutes follows[1]:

Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) 42 USC § 9601 et seq. CERCLA is the primary federal governing statute providing for liability for clean-up of hazardous substances. Liability can be imposed upon the current owner or operator of a facility, any former owner or operator, any person who arranged for the disposal, treatment, or transportation of hazardous substances at the facility, and/or any person who transported hazardous substances to the facility. 42 USC § 9607(a). CERCLA liability is strict, and parties may be held to be jointly and severally liable for all removal costs of hazardous substances or remedial action at the contaminated site, excluding petroleum product contamination. 42 USC § 9601(14).

Resource Conservation and Recovery Act (RCRA) 42 USC § 6901 et seq. RCRA regulates the handling of hazardous waste from generation to disposal. 42 USC § 6901. The U.S. Environmental Protection Agency (EPA) was created and is charged with creating regulations and standards that require anyone generating, transporting, treating, storing, or disposing of hazardous waste to comply and report to the EPA. Note that if there is a release of hazardous wastes or substances, or if such a release is threatened, CERCLA liability provisions are activated. 42 USC § 9601.

Toxic Substances Control Act (TSCA) 15 USC § 2601 et seq. TSCA gives the EPA the authority to control the manufacture, processing, distribution, and use of chemical substances and mixtures for commercial purposes. It is illegal for an individual to fail to maintain records and submit reports pursuant to the Act.

[1] Attorneys Title Guaranty Fund, atgc0399, vol23.

The Clean Air Act (CAA) and the Clean Water Act (CWA) 42 USC § 7401 et seq.; 42 USC § 300f et seq. The most pertinent part of the CAA for property owners and real estate attorneys deals with asbestos. See also 40 CFR 61. It sets forth special notice, work practice, and disposal requirements where asbestos is present in buildings, and owners or operators plan to renovate or demolish buildings. Real estate development attorneys should note the requirement to comply with § 404 of the CWA, which regulates the filling of wetlands with discharge of dredged or fill material and requires a permit from the Army Corp of Engineers.

State laws are similar in most states. California, for example has the following basic legal and regulatory framework:

- Two primary state agencies:

1. The California Department of Toxic Substances Control (DTSC); and

2. The State Water Resources Control Board via its Regional Water Quality Control Boards (RWQCBs).

- Three primary statutes:

1. *California's CERCLA counterpart, the Carpenter-Presley-Tanner Hazardous Substances Account Act (HSAA)*, provides that current owners in California are liable for investigation and cleanup of hazardous wastes on their property. Liability under the HSAA is enforced by DTSC and is strict, without regard to intent, knowledge, or the degree of care which was exercised by the owner or operator.

2. California's RCRA counterpart, the *Hazardous Waste Control Law (HWCL)*, imposes requirements on the closure of hazardous waste facilities and may obligate the owner to remove hazardous waste from the facility and take actions to prevent any hazardous waste remaining onsite from adversely affecting human health or the environment. The HWCL is administered by DTSC.

3. The *California Porter-Cologne Water Quality Control Act (Water Code)* regulates discharges of waste to surface water and groundwater within California. RWQCBs may issue investigation and cleanup orders to any past and present owner who has, or is suspected to have, discharged waste that could affect the quality of surface water or groundwater.

- Three primary mechanisms to limit new owner liability

1. *California Land Use and Redevelopment Act (CLRRA)* creates a process in which prospective purchaser may enter into agreement with DTSC or RWQCB to clean up vacant, contaminated property – or brownfields – and receive immunity for response costs and other damages. Two key requirements are that All Appropriate Inquiries (AAI) be conducted in compliance with 40 CFR Part 312 and ASTM E1527-05, and the purchaser must enter into an agreement with either the DTSC or RWQCB.

2. Prospective Purchaser Policies, pursuant to which DTSC and RWQCBs will generally not pursue site mitigation enforcement against prospective purchasers who become site owners if certain conditions are met. Should certain, additional conditions be met, the prospective purchaser may even seek a contract (Agreement) with DTSC or RWQCB in which the agency would covenant not to sue the buyer for pre-existing contamination as long as certain remedial actions and other conditions are met.

3. California's *Unified Agency Review Program* allows new owners to request that a single regulatory agency be designated to oversee the investigation and remediation of the property. After the owner completes the agreed-upon investigation and remediation, the administering agency will issue a certificate of completion, which will prohibit all state agencies from taking any action against the owner for hazardous materials released at the property, except under limited conditions.

(b) Due Diligence. Because federal and state laws impose significant liability for owners and responsible parties for environmental contamination, there is substantial emphasis placed on environmental issues in purchase transactions. Sellers typically resist making environmental representations while purchasers attempt to require at least "knowledge" representations and routinely perform environmental due diligence to discover relevant facts regarding possible contamination. Often the analysis includes a study of the range of costs that may be incurred to address contamination prior to and after acquiring the property. Conducting such due diligence may afford a purchaser with some limited legal protections from liability for preexisting contamination; however, it is important to remember that, even if there may be some liability protections, the existence of contamination at a property can give rise to tort liability for personal injury or property damage, and may make it difficult, or even impossible, to sell the property at a later date.[2] To avoid a "deal killer" it is often necessary to extensively negotiate environmental provisions, especially in a transaction where there is a known environmental issue or risk.

[2] RELX Group, Environmental Due Diligence in Real Estate Transactions.

2. Known Versus Unknown Conditions. The negotiations of environmental provisions will be very different for situations where there is a known environmental condition versus situations where an environmental problem is discovered during due diligence. In the former situation, there will often be substantial existing information and reports and possibly a clean-up procedure already in place. The following are a few samples provisions resulting from these negotiations:

B. Sample Provisions.

1. For Situations With No Known Environmental Issue:

__ Conduct of Inspections. Subject to the provisions of Section __ below, during the Due Diligence Period, Purchaser shall be permitted to make a complete review and inspection of the physical, legal, economic and environmental condition of the Property, including, without limitation, any leases and contracts affecting the Property, Books and Records maintained by Seller or its agents relating to the Property, pest control matters, soil condition, asbestos, PCB, hazardous waste, toxic substance or other environmental matters, compliance with building, health, safety, land use and zoning laws, regulations and orders, plans and specifications, structural, life safety, HVAC and other building system and engineering characteristics, traffic patterns, and all other information pertaining to the Property. Except as specifically provided for in this Agreement, without any other representation or warranty, Seller shall cooperate in Purchaser's review and provided Purchaser with the opportunity to review leases, financial reports, Books and Records and other third party inspection reports and similar materials in Seller's possession relating to the Property (excluding the Excluded Assets and any appraisals, internal valuations or similar proprietary materials that may be in Seller's possession (collectively, the "Proprietary Materials")). During its inspection of the Property, Purchaser shall not unreasonably disturb the operations of any tenant or licensee of Seller, or the access rights of any licensee, invitee or other person or entity having a legal right to enter and/or occupy the Property. Additionally, in no event shall Purchaser perform any invasive testing activities at the Property without Seller's prior written consent, which may be granted or denied in Seller's sole and absolute discretion

2. For Situations Where Environmental Issues are Discovered During Due Diligence:

(a) Agreement for Additional Testing:

__. Environmental Due Diligence. Seller hereby consents to the environmental testing and investigations described in the Work Plan attached hereto as Schedule 1 ("Work Plan"). Purchaser shall not conduct any environmental testing on the Property other than as provided under the Work Plan. The Due Diligence Period is hereby extended to __________, 2018 solely for the purpose of Purchaser's conduct of the testing described in the Work Plan.

(b) Agreement for Holdback in Escrow:

__. Holdback. Purchaser and Seller hereby acknowledge and agree that there may exist, as of the Effective Date, certain environmental matters affecting the Real Property requiring the installation of a vapor mitigation system (the "Vapor Mitigation System"). At Closing Purchaser and Seller shall enter into a holdback agreement, the form of which is attached hereto as Exhibit G (the "Holdback Agreement"), pursuant to which the Parties shall direct Escrow Holder to retain in escrow at Closing a portion of the Purchase Price equal to _________________ Dollars (__________.00) (the "Holdback Amount"). The Holdback Amount shall be held, invested, and released by Escrow Holder in accordance with the terms and conditions of the Holdback Agreement. Pursuant to the Holdback Agreement, from and after the Effective Date, and continuing after the Closing, if necessary, Seller shall, at its sole cost and expense, take all such actions necessary to complete the installation of the Vapor Mitigation System, and obtain a letter of completion or similar closure letter solely with respect to the condition addressed by the Vapor Mitigation System (the "Completion Letter"). Purchaser covenants that (i) in the event Purchaser desires to conduct any testing or remediation, or place, construct or install any environmental remediation system, on, in or under the Property, Purchaser shall obtain the prior written approval of Seller of such actions, and (ii) any environmental remediation system installed at the Property by or on behalf of Purchaser shall not negatively impact the Vapor Mitigation System. The terms of this Section shall survive Closing and the delivery of the Deed.

3. Where there is an Environmental Indemnity or Insurance Policy:

__. Environmental Indemnity. Lessee acknowledges that Lessor has informed Lessee that certain Hazardous Substance remediation is currently taking place at the Project and that Lessor and, after the execution hereof, Lessee, are beneficiaries of that certain Environmental Indemnity Agreement dated ___________ (the "Indemnity Agreement"), executed by _______________, as indemnitor ("Indemnitor"). Lessee shall be entitled to the benefit of the indemnity under the Indemnity Agreement by Indemnity to tenants of the Project, subject to the terms and provisions of the Indemnity Agreement, familiarity with which is hereby acknowledged by Lessee. Lessee further acknowledges and agrees that Lessor has made no representations or warranties whatsoever with respect to the Indemnity Agreement or Lessee's status thereunder or the financial or other capability of Indemnitor to perform its obligations thereunder. Lessee also acknowledges that, notwithstanding anything to the contrary contained in this Lease, with respect to any contamination and remediation that is the subject of the Indemnity Agreement, Lessee shall look solely to Indemnitor and Lessor shall not be responsible for claims or costs of whatever nature incurred or suffered by Lessee as a result of or involving the existing Hazardous Substances on the Premises and/or Project arising out of the activities of Indemnitor.

II. ZONING, BUILDING CODE, AND LAND USE ISSUES

A. Land Use Covenants and Conditions.

1. General Land Use Covenants. A buyer understands that its valuation of a property that it seeks to purchase is largely dependent on its ability to use or develop the property as it intends. When the future use of a property is identical to a seller's current use, there is often little reason for concern. However, when a buyer plans to change the use of a property, the buyer must be satisfied that its intended use is permitted by local zoning ordinances and/or approved by governmental authorities. Accordingly, a buyer will want to be assured that the purchase agreement provides an opportunity for the buyer to obtain any required approvals and/or permits from the applicable governmental authorities before the deal closes. A buyer often requests that a purchase agreement include a sufficient time period for it to obtain all approvals and requires a seller to agree to cooperate with buyer in the process. A seller, motivated on closing the deal, often seeks to have the purchase agreement narrowly specify buyer's desired change/approval and requires a buyer to take diligent and timely efforts to pursue any approvals.

2. Unanticipated Land Use/Entitlement Issues. While a buyer and seller often anticipate the course of an entitlement approval process, it is sometimes impossible for the parties to foresee certain land use issues that arise during a buyer's due diligence. For example, a buyer may learn that it needs to obtain additional permits or approvals as part of its entitlement process, which may require a buyer to modify its entitlement plan at increased cost and/or cause a delay in its desired entitlements. When an unforeseen land use issue arises, a buyer often requests an extension period or concession on price so it can have additional time to better understand or adequately deal with such an issue or absorb the increased cost. A seller, seeking to keep the deal alive, may agree to an extension, but may request an additional deposit or fee in consideration for the extension. These negotiations may be extensive. If a buyer and seller are unable to agree on the extension, release of deposit or fee or price concession, the transaction may fall apart.

B. Sample Provision.

1. Within a period not to exceed [_______ (__)] months after the expiration of the Feasibility Period ("**Entitlement Period**"), Seller (with Buyer's cooperation and reasonable approval with respect to Buyer's required entitlements), will have obtained (with the

expiration of any applicable appeals periods) all discretionary approvals from all governmental bodies with jurisdiction over the Property (the "**Entitlement Approval**"), including but not limited to: (a) approval to construct a residential housing development of market rate, for-sale residential units with an average net livable square footage no less than [____], currently contemplated as no fewer than [_____] units; (b) approval of a General Plan Amendment ("**GPA**"); (c) approval of Residential Plan Development from the applicable municipalities and other governmental bodies with jurisdiction over the Property including any necessary permit allotments to allow Buyer to pull permits within [_______ (__)] months ("**Allotments**") of the expiration of any applicable appeals period ("**RPD Approval**"). If, prior to the expiration of the Entitlement Period, Buyer determines in good faith that there is substantial likelihood of obtaining the Entitlement Approval with additional time, Buyer shall have the right to extend the Entitlement Period for an additional [____ (__)] months by written notice to Seller and Escrow Holder. As such, Buyer shall determine the extent of (and be responsible for the costs associated with) architectural, engineering and site plan design necessary to obtain the Entitlement Approval, and Seller shall be responsible for all additional costs of pursuing and processing the Entitlement Approvals, including without limitation, all costs and expenses related to CEQA, geology, biology, environmental and traffic reviews and requirements, and obtaining utility will serve commitments, and any other items requested by the various governmental bodies. Buyer and Seller acknowledge that Seller's active involvement and cooperation will be critical in obtaining the Entitlement Approval within the specified time frames set forth herein and Seller therefore agrees to reasonably cooperate in good faith and to use all commercially reasonable efforts to assist Buyer in satisfying the condition set forth in this Paragraph. If Seller has not obtained the Entitlement Approvals within the Entitlement Period, Buyer shall in its sole discretion have the right to cancel this Purchase Agreement and shall be entitled to the full refund of the deposit. Within the Entitlement Period (or, if earlier, satisfaction of the condition set forth above, as evidenced by written notice from Buyer to Seller).

III. <u>AS-IS CLAUSES</u>

A. <u>Why Buyer should consider accepting an "As-Is" Clause?</u>

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.)) And generally 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. 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".

In California and most other states, the Seller has a common law duty to disclose material facts to the buyer except where such facts are obvious or are already known by the buyer. Breach of this duty is considered fraud. (See *Nece v. Bennett*, 212 Cal. App. 2d 494, 496, 28 Cal. Rptr. 117 (1963) (duty to disclose required installation of offsite improvements in the sale of a motel; "In the sale of property a vendor may be held guilty of fraud where he knows of facts that materially affect the desirability of the property and which he knows will probably not be discovered"; see also, *Kallgren v. Steele*, 131 Cal. App. 2d 43, 45, 279 P.2d 1027 (1955) (in the sale of a resort, the seller's failure to disclose that part of the improvements were within a public right of way was found to constitute fraud under Civ. Code, § 1710)). Accordingly, in California it appears that an "as is" or other exculpatory clause cannot protect the seller from claims for nondisclosure or misrepresentation of materials facts known to the seller. (See Civil Code Section 1668; see also *Katz v. Department of Real Estate*, 96 Cal. App. 3d 895, 901, 158 Cal. Rptr. 766 (2d Dist. 1979)(an "as is" provision, "generally speaking … means that the buyer takes the property in the condition visible to or observable by him …. It … does not in itself protect … or absolve [a seller] from liability for … passive concealment." (See also, *Loughrin v. Superior Court*, 15 Cal. App. 4th 1188 (1993)) 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: "the use of the phrase 'as is' relieves a seller of real property from liability for defects in [its] condition. The only exception… is when a seller…intentionally conceals material defects…")

As noted by one court, "While the 'as is' provision does not relieve a seller of all responsibility of disclosure, it is a factor to be considered with all other circumstances in determining whether the buyer has been misled." *Driver v. Melone*, 11 Cal. App. 3d 746, 752, 90 Cal. Rptr. 98 (1970).

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. 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 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. 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; LEGAL ACCESS

A. CC&Rs and Reciprocal Access/Easement Agreements. In connection purchases of real estate, especially for development or re-development, purchasers will pay careful attention to covenants, conditions and restrictions ("CC&Rs") affecting the property. Potential lessees often also need to analyze CC&Rs as restrictions may frustrate proposed uses.

1. Overview:

A. CC&RS and Reciprocal Access/Easement Agreements provide a framework of the operation and regulation of property, and often contain provisions regarding (i) restrictions on the use of a property or properties, (ii) shared access and parking; (iii) shared maintenance and related member and association payments and duties, (iv) enforcement powers, and (v) assessment obligations and lien/collection rights.

B. CC&RS and Reciprocal Access/Easement Agreements are traditionally created by a developer of a property and recorded against all units/lots of the development. Since CC&Rs and Reciprocal Access/Easement Agreements are recorded, they normally "run with the land" and bind all successive owners of a condominium or lot against with the restrictive covenants were recorded.

2. Key Issues:

A. Creation: In large development deals, a seller may be obligated to finalize and record CC&Rs. Purchase Agreements may require a seller to include certain items in the CC&Rs (e.g., parking, assessments, and beneficial covenants for subsequent property owners), some of which require governmental approval and consequently could delay a closing (as well as constitute a condition precedent for any closing).

B. Access: CC&Rs and Reciprocal Access/Easement Agreements typically provide a property owner access via easement. In drafting and analyzing easements that provide access to property owners, a buyer must analyze the scope of the easements (e.g., does a grantee of an easement agree to not unreasonably interfere with a grantor's use of its property?), location (e.g., can a surveyor accurately locate an easement?), exclusivity (e.g., are invitees and other users allowed?), repair/maintenance (e.g., which party is responsible for repairing and maintaining the easement area?), and tort liability (e.g., indemnity, insurance, and tax obligations).

d) Construction and Architectural Compatibility:

i. Limitations: CC&Rs are likely to contain use, design, and access restrictions. A buyer of a property must confirm that its intended use of the property will conform with the permitted use under the CC&RS.

ii. Control: CC&Rs are also likely to require that property owners (and their tenants) obtain the approval of a declarant or other property owners before they materially alter a property. CC&Rs typically provide for each party to review and approve the plans and specifications for each party's work, thereby creating architectural compatibility for all of the construction work. This control could inhibit and delay a buyer's proposed development of a project.

B. Sample Provisions.

1. Creation: Seller will finalize and record a Declaration of Covenants, Conditions & Restrictions (the "Declaration") upon recordation of the Subdivision Map. Seller shall have sole control over finalizing and recording of the Declaration, which shall be at Seller's sole cost and expense. Notwithstanding the foregoing, Buyer shall have the right during the Due Diligence Period to propose revisions to the Declaration. Seller agrees to reasonably consider Buyer's proposed revisions to the Declaration to the extent that such revisions are primarily intended to ensure (i) compatible uses in the immediate vicinity of the Property; (ii) full access and enjoyment of the Property during the course of development of other projects within the development; (iii) fair and reasonable sharing of assessments; (iv) that no business which requires the issuance of a license pursuant to Chapter ___ of the __________Municipal Code shall be permitted; (v) all on-street parking located on the north side of ___________ Street (from ______________ Road to ___________Street), the west side of __________ Street (from ________________ to _____________), the south side of _____________ Drive (from __________ Street to _____________) and the east side of ___________ Street (from _______ to____________) shall be designated "limited common elements" for the permanent non-exclusive use of the Project, along with the right of the owner of the Project to install parking signage and enforce towing for violations restrictions applicable to such "limited common elements", and (vi) to the extent required by the City as a condition to issuing certificates of occupancy, additional off-site parking shall be designated "limited common elements" for the use of the Project, along with the right of the owner of the Project to install parking signage and enforce towing for violation of restrictions applicable to such "limited common elements." Once agreed upon by Seller, none of the foregoing may be amended in the Declaration without the consent of Buyer in its reasonable discretion, this Section above or in the Declaration (collectively, the "Buyer Declaration Requirements").

Buyer shall have the right to approve any other changes to the draft Declaration during the Due Diligence Period; *provided, however,* that if the proposed changes do not relate to or affect a Buyer Declaration Requirement, then Buyer agrees not to unreasonably withhold or condition its approval. Buyer shall have ten (10) days from receipt of notice from Seller of any such change to approve or disapprove such change. If Buyer fails to approve or disapprove such change within such ten (10) day period, then Buyer shall be deemed to have approved the change."

2. Access: For the benefit of the Property, and for the benefit of owners in the Project, there shall be non-exclusive reciprocal easements of access to, use and enjoyment of, and ingress and egress through and over, and access to, the Private Street, _______________ Center, ___________ Plaza, and each Lot shall be so burdened by such easements. Easements as designated may be used by all Owners and the members of their families, their servants, guests,

tenants and invitees, for pedestrian walkways, vehicular access and such other purposes reasonably necessary to the use and enjoyment of their Lots and the Common Areas in the Project. This also includes related landscaping across the Project all along the public Streets. Such easements shall be appurtenant to and shall pass with the title to every property.

3. <u>Construction and Architectural Compatibility</u>: No construction, alteration, removal, relocation, repainting, demolishing, landscape changes, grading excavation, addition, installation, modification, decoration, redecoration or reconstruction of an improvement in the property shall be constructed, erected, placed, altered, maintained or permitted to remain on any lot subject to the Declaration showing the lot layout including, but not limited to all ingress and egress for persons and vehicles, all vehicle parking, all exterior elevations with materials and colors therefor, roof equipment screening, transformer locations, exterior signs, rubbish enclosures, exterior hardscape, landscape, and irrigation, walls and fences, square footage, the nature, kind, shape, height, width, color, materials and location of the same shall have been submitted to the architectural review committee and approved in writing by the architectural review committee. Changes in approved plans which materially affect building size, placement or external appearance shall similarly be submitted to and approved by the architectural review committee.

VII. <u>SOILS OR RIPARIAN ISSUES</u>

A. <u>Legal Rights and Obligations Regarding Soils and Riparian</u>. In connection purchases of real estate, especially for development or re-development, buyers will often require extensive due diligence regarding the quality of soils and support for the new development.

1. <u>Rights to Subjacent Support</u>. Subjacent support is the support that the surface of the earth receives from its underlying strata. An owner of the surface of land has an absolute right to the perpendicular (subjacent) support of the its property in its natural condition from the subjacent area. The owner of the subsurface owes an absolute duty of subjacent support to the owner of the surface without regard to issues of foreseeability, due care, or negligence. Earlier decisions indicated that the rules governing the right to subjacent support are for all practical purposes the same as those governing the right to lateral support, and the statutory provisions of the California Civil Code relating to the support of land make no distinction between the two. The California statute does not alter the much stricter, common law absolute duty to provide subjacent support; this duty is owed by the owner of the subsurface to the owner

of the surface, and the subsurface owner's potential liability is strict, without regard to negligence.[3]

2. Water Rights. The right to take water in its natural state, whether on or below the surface, constitutes an interest in real property, and is either part of, or appurtenant to, the land. The owner does not have ownership of the physical water but merely a right to use it, sometimes referred to as a "usufructuary" right. When the water is diverted from its natural course for uses on the land, it remains real property, but when separated from the land, the water becomes personal property. In California is the owner of all surface and groundwater, not as a proprietary owner, but in relation to the riparian land, and not for export to other lands. Riparian rights only arise from a natural watercourse and not an artificial channel or body of water, such as an artificial, man-made lake or pond.[4]

B. Sample Provisions.

VIII. LOW BASIS SELLER

In this section, the seller is referred to as the "taxpayer". Gain on real estate (other than "dealer property") held for more than one year (or if the taxpayer owns a "carried interest", more than 3 years) is taxed at long term capital gains rates. Currently, the long-term federal capital gains rate is 20% for individuals in the top bracket. (IRC §1(h)) However, gain on the sale of "dealer property" is taxed as ordinary income. (*Malat v. Riddell*, 383 U.S. 569, 572 (1966)) Gain is also taxed in the state where the property is located and under the 2017 Tax Act and deduction of state income tax is now limited (until 2026) to $10,000 per year. (IRC §164(b)(6)) Finally, unless the taxpayer is a real estate professional and the property is held in a trade or business, gain will also be subject to the net investment income tax of 3.8% if the taxpayer is an individual whose earnings exceed certain thresholds. (IRC §1411)

A. Section 1031 Like-Kind Exchange.

1. 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))

[3] Miller & Starr, California Real Property, Section 17:17.
[4] Miller & Starr, California Real Property, Section 9:29.

2. 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))

To maximize its cash out financing, the taxpayer should select a replacement property that will qualify for a credit tenant loan. That is, the replacement property should be subject to a long term, absolute net lease to an investment grade rated tenant. Credit tenant loans generally allow a debt service coverage ratio of 1:1 and have no loan to value (LTV) limitation. (See generally, Practising Law Institute, "*Net Leases and Sale-Leasebacks*" at §4:1 (2018)) Thus, credit tenant loans may be structured at LTVs as high as 90% or higher.

3. 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)) The major title companies all have subsidiaries that act as qualified intermediaries (QIs). The QIs will prepare the required documentation (an exchange agreement, an assignment to the QI and a notice of such assignment to the counterparty).

c. Seamless, low cost process. Almost all exchanges are completed under the safe harbor allowing for direct deeding of the relinquished property (from the taxpayer to the buyer) and direct deeding of the replacement property (from the seller to the taxpayer). Thus, the exchange is practically invisible to the counter-parties except that prior to closing, the counterparties must be notified of the assignment of the Purchase Agreement to the qualified intermediary. (Treas. Reg. §1.1031(k)(1)(g)(4)(v)) Most QIs charge about $1000.

4. 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.

1. 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)) Any recapture income is recognized as ordinary income during the year of sale. (IRC §453(i)) The installment sale method does not apply to the sale of dealer property (unless the property is a time share or residential lot). ((IRC §453(l)) The installment note may be guaranteed by a third person (including in the form of a standby letter of credit) without triggering gain recognition. (IRC §453(f)(3); Treas. Reg. §15a.453-1(b)(3)(i)) However, immediate recognition of gain is triggered if the installment note is payable on demand or is readily tradable. (IRC §453(f)(4)) The installment note may be, and generally is, secured by a mortgage encumbering the property. (IRS Publication 537 (2017))

2. Monetizing the Installment Obligations. Suppose the installments cover a 30-year period. If the taxpayer is able to borrow against the installment obligations, then the taxpayer can cash out while deferring the recognition of gain for decades. 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)) Despite this provision, some attorneys have created a structure that they believe allows the taxpayer to borrow against the installment obligations without recognizing gain.

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

4. 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.**

1. Summary. Added by the Tax Cuts and Jobs Act of 2017. 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. (See IRS Notice 2018-48, 2018–28 Internal Revenue Bulletin 9, July 9, 2018) Investing in a QOF provides three tax benefits:

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

(ii) 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.

(iii) 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.

2. 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.

3. 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.

4. <u>Comparison to a like-kind exchange</u>. Advantages: (a) the investments of a QOF are not limited to real estate, but may include 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 not 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.