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## **LEGAL ISSUES IN REAL ESTATE**

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# LEGAL ISSUES IN REAL ESTATE

## INTRODUCTION AND SCOPE

There are a myriad of legal issues that are raised in any transaction involving real estate. This paper will focus on some of the core legal issues: title, survey, and environmental due diligence. This paper will look briefly at other matters: governmental regulations affecting real property, tax issues, and documentation of the real estate transaction. The intent of this paper is to give the business officer who is responsible for real estate transactions but is not a real estate attorney or real estate specialist an understanding of the basics of each of the core legal topics and an introduction to the other areas. At the end of this paper are title and survey checklists that can serve as a starting point in evaluating title and survey issues in a real estate transaction.

This paper is not intended to give legal advice or to give legal opinions on specific fact situations. It is also not intended to be a comprehensive examination of title, survey and other real property due diligence issues, but rather to give a clear and simplified explanation of some of the major legal issues present in real property transactions. Please consult with competent counsel for legal advice on the topics covered by this paper.

## TITLE

### What Is Title?

Title is the means whereby one holds an interest in real property, be it as the owner of fee simple title, the holder of a leasehold interest or an easement, or some other interest. There is no one document that shows the status of title to real property. A deed reflects ownership of the property, but usually will not reveal the existence or status of liens or other encumbrances against the property, possible defects in title, or other significant matters. Similarly, a lease evidences the leasehold interest but most likely will not reflect all matters that may affect the use and enjoyment of the leasehold estate.

### How Do You Confirm the Status of Title?

The most efficient means of determining the status of title to real property is obtaining and reviewing a commitment for title insurance early in the process. A commitment for title insurance is a title insurance underwriter's proposal for a title insurance policy and reflects the underwriter's conclusions as to encumbrances and other matters affecting title, based on a search of applicable public records.

Title insurance is a contract of indemnity that protects against loss incurred by the named insured if the status of title to the property or interest insured is not as stated

in the title insurance policy. As with all insurance, what the title insurance policy **excludes** from coverage is often as important as what the policy **includes** in the coverage. The policy will cover loss or damage up to the insured amount stated in the policy. A one-time premium is paid for the policy at the time of the closing of the real estate transaction. The premium is based on the amount of the insurance and in some states the premium amount and even the content of the insuring forms are regulated by state law. Title insurance policies may be obtained to insure fee simple ownership, rights in an easement, a leasehold interest, a mortgage or other lien, and other interests in real property, depending on the laws and regulations of the applicable state.

Title insurance is not a panacea, as there are significant exclusions from its coverage. It is also not a substitute for conducting your own due diligence review of the property, including a review of all documents referred to or listed in the title commitment. Further, the title insurance is only as good as the title insurance underwriter behind the policy, so be sure to confirm that the title underwriter has ample reserves.

The following examples help to illustrate what title insurance offers:

Example 1: A university purchases a parcel of land on which it plans to build a new science research building. After the university purchases the property, it learns that past due taxes are owed on the property. The past due taxes are not listed as an exception to coverage in the policy. The title insurance underwriter will then pay the amount of the taxes, up to the policy amount.

Example 2: A university receives a gift of real property as a distribution of a deceased donor's estate. After it accepts the deed conveying the gift property, the university discovers that the deceased donor's family has filed a lawsuit challenging the conveyance for a variety of reasons. The title insurance policy does not contain an exception for such claims of title by the relatives. The title underwriter will hire legal counsel to defend the university's title to the property in order to obtain clear title. If clear title cannot be obtained, the underwriter will indemnify the university, up to the policy amount, for the loss of title.

Example 3: A university purchases a parcel of land on which it plans to build a satellite campus. A gravel road crosses the property. The title policy does not contain an exception for the road, but does contain an exception for "rights of parties in possession" and for "visible and apparent easements." At the time of purchase, the university assumed the gravel road was used solely for internal access within the parcel. It later discovered that the road is used--and has been used for the past 50 years--by adjoining landowners to access their property. Because of the exceptions in the title policy, the title insurance will not cover the loss incurred; the university is faced with the unhappy option of revising its site plan to accommodate the existing road or attempting to strike an agreement with adjoining owners to relocate the road--at the university's expense.

## **What Should You Look for When Reviewing Title Work?**

As the above examples illustrate, it is important to know what the title insurance policy covers and what it does not cover. The policy is issued at the closing of the transaction, but the important work should be done well in advance of the closing. The title commitment is issued in advance of the closing and should be carefully reviewed. If changes to the commitment are negotiated prior to the closing of the real estate transaction, it is wise to obtain a revised commitment on or before the closing. Once the title policy is issued, it should be carefully reviewed to confirm that it accurately reflects the terms of the title commitment.

Below is a list of some of the important matters to consider when reviewing a title commitment. A Title Checklist is attached as Appendix 1 to this paper and covers the items listed below and additional items.

**Access.** It is important to confirm that the title company will insure that the property has legal access to a public road. Even if the property has physical access to a public road, it may not have legal access. There may be documents limiting access. The title commitment should report the existence of any such documents, such as a document creating a controlled access highway or a gas pipeline easement that prohibits roadways from crossing the easement area.

**Documents.** The title commitment **and** all documents referred to or listed in the title commitment should be reviewed and any matters visible on the property but not reflected in written documents should be evaluated. If the review reveals any potential problems, they should be addressed before closing.

**Easements.** If the commitment lists any easements affecting the property, copies of the easement instruments should be obtained and reviewed. Easements for which no written documents exist also pose potential problems. If the commitment states that the policy will not insure against claims by “parties in possession,” then the policy may not provide coverage against an unwritten or unrecorded easement.

An easement granted by a written document may be “blanket” in nature, meaning that it is not limited to a particular location on the tract, but burdens the entire tract. Blanket easements, because they are not limited to a particular location, hamper development of a tract and should be modified to specify the location of the easement. Modifications require the consent of the party in whose favor the easement was granted.

Easements that are restricted to a specific location should be shown on the survey plat in order to confirm whether the easement (1) in fact affects the tract and (2) is located in a problem area, such as where an existing building stands. If a building encroaches on an easement and the easement document does not permit the encroachment, it should be determined whether any potential risk--physical or financial--is posed by such an encroachment. The description of an easement in the title

commitment should tie the location of the easement to its location as depicted on the survey plat.

**Encroachments and Other Matters Reflected on the Survey Plat.** The commitment may except to matters shown on a survey plat of the property, such as a fence line that encroaches into the property, or a roof that protrudes onto adjoining property. All such exceptions should be studied and the risks analyzed.

**Identity of Current Owner.** The commitment will also reveal who is the current owner of the property. If the owner is other than the party with whom you are dealing, then you must confirm who in fact is the owner(s) and what steps are necessary to address the situation.

**Leases.** Often a commitment will except to “rights of parties in possession” or rights of tenants under unrecorded leases. As discussed above, a broad exception for rights of parties in possession is never acceptable. A broad exception for rights of tenants under unrecorded leases is also unacceptable. If there are in fact any leases of the property, then the exception should be revised to specifically list leases applicable to the property. You should carefully review each such lease to confirm that it contains no provisions that will adversely affect your interest in the property. For example, a lease may grant a tenant a right of first refusal to purchase the property or an option to lease additional space at a below-market rental for an extended term.

In Texas, title insurance may be obtained to insure an interest in a leasehold. Similar insurance coverage may be available in other states. If the lease is a ground lease and the ground tenant owns the improvements outright, the improvements may be insured separately from the leasehold interest.

**Liens and Taxes.** If the commitment states that any liens affect the property, such as tax liens, judgment liens or mortgages, those liens should be reviewed to determine if they are still in effect. If a lien is still in effect, it will be necessary to determine what is required to remove the lien--usually payment of the amount that the lien secures--and who will bear the burden of taking the steps necessary to remove the lien. If the lien is no longer in effect, then documentation must be provided to the title underwriter to remove the exception.

**Mineral Interests.** The title commitment should reflect whether the mineral estate has been severed from the surface estate. In Texas, the mineral estate is dominant over the surface estate, meaning that unless the owner of the mineral estate has agreed otherwise, it may drill for oil, gas and other minerals anywhere on the tract. That broad right may pose a problem if a university is planning to construct its new building on the tract. Even if the mineral estate has not been severed from the surface estate, there may be outstanding oil and gas leases, which will also limit the use of the tract. If a severance of the surface and mineral estates has occurred or if any oil and gas leases are outstanding, these matters should be carefully evaluated for possible resolution before the closing.

**Personal Property.** The title commitment does not address the status of title to any personal property located on the real property. If personal property, such as office or medical equipment, is included in the real estate transaction, a separate search of the financing statements filed in the Secretary of State's office and in the County Clerk's office should be made to confirm whether there are any liens against the personal property.

**Restrictive Covenants.** The commitment should list any restrictive covenants that may limit the use of the property. For example, restrictive covenants may limit the property to use for single-family residences, limit impervious cover, or limit the height of buildings on the site. Copies of the documents referenced in the commitment should be obtained and reviewed. If potential problems exist, they should be addressed with the title underwriter before the closing. For example, if the property has been used for commercial purposes for years, notwithstanding that a restrictive covenant limits the property to use for residential purposes, a title underwriter may agree to provide coverage insuring against loss caused by a violation of the restrictive covenant.

## **SURVEY**

### **What Is a Survey?**

A survey consists of a drawing of the property (the "survey plat") and, unless the property is a lot within a recorded subdivision, a narrative description of the boundary lines of the tract, using courses, distances, and references to natural or artificial monuments (the "metes and bounds description"). It is prepared by an individual licensed by the state to perform surveys.

### **Why Should You Obtain a Survey?**

The essence of a real property transaction is that the purchaser, lessee, or lienholder is acquiring, and the seller, lessor or borrower is granting, an interest in the real property that the parties believe to be the subject of the transaction. Only a survey can confirm the boundaries of the property and the other characteristics of the property--the location of easements, improvements, waterways, flood zones, etc. A survey is therefore essential to the transaction.

Moreover, in those states in which a title commitment excludes from coverage discrepancies or conflicts in boundary lines or encroachments or protrusions of improvements, a survey is needed to confirm that no such problems exist so that the title policy may be issued without that exclusion.

### **What Should You Look for When Reviewing a Survey?**

You should obtain a survey that is sufficient for transactions involving the conveyance of land in which a title policy is to be issued. Such a survey must meet

specific requirements, including depicting all improvements, easements and other matters important for land title purposes. The state, a separate professional organization, or a land title association may specify several categories or types of surveys that may be performed. For most real estate transactions in Texas, a “land title survey” is desired--a “boundary survey” shows only boundaries and is not intended to show easements, improvements or other matters that are important in a land sale, purchase or lease transaction.

The American Land Title Association, in connection with the American Congress on Surveying and Mapping and the National Society of Professional Surveyors has developed “minimum standard detail requirements” that apply to land title surveys in states in which American Land Title Association title insuring forms are used. Those standards also specify classifications of land title surveys based on the location of the land (urban, suburban, rural or mountain and marshland).

If you are not familiar with reviewing surveys, it can be a daunting task at first. Knowing what to look for is the key. Some of the major issues are discussed below. A Survey Checklist is attached as Appendix 2 to this paper and covers the items discussed below as well as additional matters. A sample survey that serves to illustrate some of the survey review checklist items appears at the end of the Survey Checklist.

**Access.** The survey plat should show the access that the tract has to a public street. Note, however, that it should not be assumed that a tract has legal access even if the tract abuts the street.

**Adjoining Property.** It is usually desirable to show on the survey plat the adjoining property in order to be certain that there are no strips or gores between the surveyed tract and the adjacent tract. The recording information for the deed held by the owner of the adjoining parcel should be shown on the survey plat.

**Certificate.** The surveyor’s certificate defines the scope and extent of work. It constitutes a representation by the surveyor of the matters stated in the certificate. Certificates generally take one of two different forms: a basic certificate that simply states that the survey meets the requirements of published standards or a detailed certificate listing a variety of specific actions taken and conclusions reached by the surveyor. Each type of certificate has certain benefits. The more detailed form will be appropriate when there are particular issues of interest that the parties want the surveyor to address. Some of the issues that the parties may wish to request that the surveyor specifically address are listed on the attached Survey Checklist. The certificate should be addressed to the parties to the transaction (and often is also addressed to the title company), should be signed by the surveyor, and should state that the survey was made “on the ground”--in other words, a certification that the surveyor actually went to the site to make the survey, as opposed to sitting in his office and redrawing an old survey.

**Compliance with Restrictions, Ordinances and Building Requirements.** The survey plat should be checked for any evidence of violation of restrictive covenants (for example, protrusions over a building setback line) or zoning or site plan requirements (for example, an inadequate number of parking spaces or improvements that exceed the permitted impervious cover limits).

**Easements and Other Matters.** All easements, all building lines imposed by restrictive covenants, the subdivision plat or zoning ordinances, and all other matters on the title commitment that can be shown on the survey plat should be depicted on the survey plat. The survey plat should also show any easements or rights-of-way or other possible evidence of the existence of rights of parties in possession not evidenced by recorded documents, but which are evident from a physical inspection of the tract. Any offsite easements that affect the use of the land, such as access and drainage easements, should be shown on the survey plat.

**Flood Plain.** If some portion of the tract is in the flood plain, the certification should identify the flood plain map used as the basis for that conclusion and state the type of flood hazard area located on the property. The location of the flood plain should be depicted on the survey plat.

**General Matters.** The survey plat should be dated to ascertain that it is a current survey. There should be a legend on the survey plat that identifies the symbols used. The survey plat should also show the property's street address.

**Improvements.** All existing improvements, including parking areas, sidewalks, internal streets, etc., should be shown on the survey plat. If construction is planned, the survey plat should show the proposed location of the improvements. Once the foundation is laid, a resurvey should be made to confirm that the foundation has been placed where intended (and within the property boundaries).

**Metes and Bounds Description.** The course and distance calls on the survey plat should match exactly those stated in the metes and bounds description prepared by the surveyor. The metes and bounds description should substantially conform to the property description contained in prior deeds or other conveyances. Confirm also that the metes and bounds description matches the property description contained in the title commitment.

**Utilities.** The location of utilities serving the tract should be located on the survey plat. A sewer line easement running along the boundary of a tract does not necessarily mean that the owner or occupant of the tract has the right to tap into that line. The same caveat applies to almost any utility crossing the tract. Therefore, the availability and adequacy of utilities to the property should be investigated. Utilities include water, wastewater, storm drainage, natural gas, electricity, telephone and cable service.

## **ENVIRONMENTAL DUE DILIGENCE ASSESSMENT**

### **What Is an Environmental Due Diligence Assessment?**

An environmental due diligence assessment is an analytical method of identifying, evaluating and managing environmental risks. It identifies historical uses that have been conducted on the site, identifies the presence and extent of environmental contamination of hazardous substances, evaluates the risks associated with the contamination, identifies potential environmental issues that may affect any planned development on the site, and determines the most feasible method of managing the environmental risk and complying with environmental regulations applicable to development or use of the site.

### **Why Should You Undertake an Environmental Due Diligence Assessment?**

The primary purpose for conducting an environmental due diligence assessment is to reduce the risk of liability. If the property is to be developed, the environmental due diligence assessment must go beyond identifying existing risks, to also evaluate potential environmental issues that may affect the development process.

Federal and state statutes impose certain liabilities on owners or operators of real property when hazardous or other regulated substances have been deposited, stored, or released on the property. Hazardous and other regulated substances include not only the most dangerous or toxic substances, but also a wide array of chemicals and compounds, many of which are components of household trash or are found in raw materials and wastes. Liabilities related to hazardous and other regulated substances may include costs associated with removal of these substances from the property, including overhead and enforcement expenses. If environmental hazards are identified, the institution should then weigh the risks that may arise with respect to such hazards in determining whether the acquisition is beneficial and appropriate. If no risks are identified, the institution may, under certain circumstances, be able to assert a defense to liability if contamination that was unknown at the time of acquisition is later discovered.

With respect to planned development of the site, there are a myriad of state and federal environmental laws that may affect the time frame, cost and, sometimes, even the ability to develop the site. Some of the areas of concern in the federal environmental law arena are the following:

- Clean Water Act (42 U.S.C. §§ 7401 et seq.). This federal act makes it unlawful to discharge any pollutant except in accordance with the provisions of the act. Included in the act are two federal permitting programs: the National Pollutant Discharge Elimination System (“NPDES”) program implemented by the Environmental Protection Agency, and the dredged or fill material permit program, implemented by the U. S. Army Corps of Engineers. Development activities may trigger NPDES permitting

requirements for discharges of storm water runoff from the construction site into a municipal separate storm sewer system or waters of the United States. Plans to place fill material on the site or dredge a portion of the site may require a permit from the U. S. Army Corps of Engineers.

- National Flood Insurance Program (42 U.S.C. §§ 4001-4127). This act makes federally subsidized flood insurance available to political subdivisions that meet minimum qualifications. To qualify, the political subdivision must adopt flood plain ordinances restricting development in flood plains. An ordinance may require permits for construction in areas that are in designated flood plains.
- Endangered Species Act (16 U.S.C. § 1531 et seq.). This act provides for the determination and protection of endangered species. It prohibits the “taking” of an endangered species. A taking is defined to include modifying an endangered species’ habitat. Because of the broad definition of a taking, real estate development may often result in a “taking” because of the development activity’s effect on the habitat. No taking may occur without a permit, which must be sought from the U. S. Fish and Wildlife Service.

### **What Should Be Included in an Environmental Due Diligence Assessment?**

With respect to existing environmental risks on the property, the standard against which to measure the scope of the environmental due diligence assessment is statutorily prescribed by the federal Comprehensive Environmental Response, Compensation and Liability Act (42 U.S.C. §§ 9601-9657) as “all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice in an effort to minimize liability.”

One key element in any environmental due diligence is a site inspection. The site inspection should be conducted to determine the current use of the property, the environmental condition of the property, whether there are obvious indications of the presence of contamination (for example, stained soil or areas where all vegetation is dead), whether there are any asbestos containing materials on the site, whether there are any wetlands or endangered species habitat on the site, and the topographical contours of the site.

The following is a list of the some of the information that should be gathered in an environmental due diligence assessment; not all of the items will apply to all properties:

- current and prior uses of the property during the last 60 years;
- current and prior owners and operators of the property;

- current status of title of property, including a determination of whether there are any environmental cleanup liens, notices or affidavits against the property that have arisen pursuant to state, federal or local law;
- aerial photographs of the site at periodic intervals over the last 60 years;
- information and documents about the property maintained by governmental agencies; for example, determine whether the property has been listed on the Superfund National Priorities List maintained by the U.S. Environmental Protection Agency and obtain copies of all environmental permits applicable to the property;
- information pertaining to all underground or aboveground storage tanks that are or were located on the property, including the location of the tanks, the substances stored in the tanks, and the dates the tanks were installed and removed;
- information pertaining to all transformers, capacitors and other electrical equipment that are or were located on the property to determine whether polychlorinated biphenyls are present;
- interviews with persons knowledgeable about the property; and
- a site plan that identifies the location of all areas of significant environmental concern.

For environmental due diligence assessments focused on evaluating the existence and risks of contaminants on the site, the American Society for Testing and Materials (“ASTM”) has developed standards in an effort to define what constitutes good commercial and customary practice. Whether an institution first conducts a more limited assessment in the form of a “transaction screen,” or whether it begins with a Phase I environmental site assessment, will be dictated by the particular facts of the transaction. ASTM has established standards for a transaction screen process, designated E 1528, and standards for a Phase I Environmental Site Assessment, designated E 1527 - 97. ASTM may be contacted at <http://www.astm.org>.

It should be stressed that the environmental site assessment must be tailored to the particular facts. Note that the ASTM standards for a Phase I environmental site assessment do not require an inquiry into whether the site has any asbestos containing materials, radon, lead-based paint, lead in drinking water, or wetlands. Note also that a Phase I environmental site assessment is non-intrusive and does not include field sampling or soil and water testing. Depending on the particular facts, the parties may wish to include additional areas of investigation in the initial environmental site assessment.

If the initial environmental site assessment indicates areas of concern, an institution will need to consider various options, which, depending on the facts of the transaction, may include the following: (i) not acquire the property, (ii) acquire the property with the identified risks, (iii) require the seller or lessor to remove the contamination, or (iv) require further investigation.

## **OTHER DUE DILIGENCE MATTERS**

### **Governmental Regulations**

The environmental due diligence assessment is one investigation that is closely related to governmental laws, rules and regulations. The environmental area, however, is not the only area in which governmental regulations affect land transactions. Other areas are discussed below.

**Zoning, Subdivision and Other Land Use Laws.** Zoning, subdivision and other land use laws have the potential to affect the use of the property. Zoning laws restrict uses that may be conducted on the land, as well as dictate the size of buildings, floor to area ratios and a variety of other land use matters. Zoning is often connected with site plan requirements, which may dictate the placement of the buildings, internal roadways and other improvements on the site. An investigation into the land use laws applicable to the site should be made very early in any transaction, as they may have a significant impact on the planned use of the property.

**Fire Codes and Building Codes.** In Texas and across the nation, institutions of higher education are coming under scrutiny for their compliance with fire code requirements. If the institution is acquiring improvements or planning to construct improvements, part of its early due diligence should be a determination of the requirements of any applicable fire and building codes, as those requirements may have a significant impact on the cost of modifications to existing improvements or the design and cost of new improvements.

**Accessibility Requirements.** The federal Americans with Disabilities Act (42 U.S.C. §§ 12101 et seq.) and state disabilities acts seek to remove architectural barriers to the disabled. You should confirm whether existing improvements to be purchased or leased are in compliance with the applicable laws, as modifications to the improvements may be costly and the landlord or seller may be unwilling to bear the cost of such modifications. Applicability to and the effect of the accessibility laws on planned development should also be investigated.

**Health Care Regulations.** Both state and federal laws may prohibit many of the incentives and commonplace practices of the non-health care real estate industry. Strongly consider seeking the advice of a specialist in this area of the law if the transaction involves property used or to be used in the health care industry. For example, below market rent offered to a doctor to induce the doctor to locate in an office

building and refer patients to the adjoining hospital operated by the landlord may violate federal law and result in a void lease if Medicare or Medicaid payments are involved. Two federal laws to investigate are the Stark Anti-Referral Statutes (42 U.S.C. § 1395nn and a portion of the Omnibus Budget Reconciliation Act of 1993) and the Medicare and Medicaid Fraud and Abuse Statute (42 U.S.C. § 1320a). Both acts have leasing "safe harbor" requirements, but the requirements mandate the payment of rent at fair-market value. The advice of a specialist in this area of the law is critical.

## **Taxes**

A variety of tax issues may be implicated in a real estate transaction, including the following matters:

**Property Tax Exemptions.** Property taxes are solely creatures of state law; consequently, the reader should seek the advice of counsel in the state in which the property is located. In some states, property owned by an institution and used for institutional purposes is exempt from the assessment of property tax. If that property is used for a non-institutional purpose, however, it loses its tax exemption. Issues therefore arise regarding what constitutes an institutional purpose. Is a hotel, to be built by a private developer on institutional land and to be used primarily for institutional functions, an institutional purpose? Does the existence of a private club located within a campus building but leased to a private operator affect the exempt status of the entire building? If use by a private entity is anticipated, and if the tax exempt status is of importance to the business projections for the transaction, the potential property tax effects of the transaction should be evaluated.

**Tax Exempt Bonds and the Private Use Issue.** State institutions of higher education often acquire property by issuing bonds, the interest on which is exempt from federal income taxation under Section 103(a) of the Internal Revenue Code. Section 103(b) of the Code, however, contains an exception to that rule for "private activity bonds" that are not "qualified bonds." Thus, if a proposed transaction involves the use of some portion of the bond-financed property by a private entity, even if that entity is a 501(c)(3) corporation, compliance with the Internal Revenue Service regulations must be ascertained. Transactions involving bond-financed property that occur after the bonds have been issued but before the bonds have been retired must also be evaluated to confirm that a change in ownership, use or management does not jeopardize the tax exempt status of the interest paid on the bonds.

**Private Developer Financing and its Effect on Debt Capacity.** Some institutions are seeking new ways to provide services and facilities, including the use of a private developer to construct and operate student housing, campus bookstores, parking garages and similar facilities. Depending on how the transaction is structured, it may have an effect on the debt capacity of the institution, according to a special comment issued by Moody's Investors Service in 1998. A service such as Moody's will look at whether the proposed project is essential to the mission of the institution or is so linked to the institution that the university would be compelled (although not necessarily

legally compelled) to support it should the project run into financial difficulties. If either test is met, then the project will likely be determined to affect the institution's debt capacity. On the other end of the spectrum, if the property is held solely for investment purposes and any debt on the project is non-recourse, the project will likely not be determined to affect the institution's debt capacity. A proposed developer financed project should therefore be discussed with bond counsel in the very earliest stage of a proposed transaction.

**Unrelated Business Taxable Income.** Sections 511 and 512 of the Internal Revenue Code impose a tax on the income of exempt organizations that is derived from any unrelated trade or business regularly carried on. Sales and leases of real property should be evaluated to determine whether they may trigger unrelated business taxable income (called "UBIT" by tax professionals). With respect to sales of real property, the focus will be on whether the proposed activity is "regularly carried on." The specific facts of the proposed transaction must be analyzed. With respect to leases, rent of a set amount or calculated as a percentage of gross proceeds will not constitute UBIT. If rent is calculated on a net basis, after the lessee deducts its expenses, the lessor runs the risk that the rent will be treated as UBIT. If, as a part of the lease, services--other than those customarily provided in connection with similar leases--are provided, the rent may be treated as UBIT. A tax advisor should be consulted before the transaction structure is finalized to determine if UBIT is an issue.

## **TRANSACTIONAL DOCUMENTS**

The documents that are used in a real property transaction **DO** matter. They define the parties' rights and obligations. Pre-printed, standard forms are rarely acceptable, as such forms take a "one size fits all" approach that rarely fits any specific transaction. Forms drafted by the other party's attorney will likely be even less acceptable because that attorney is representing only the interests of his or her client and not your interests. Short, simple letter agreements—tempting though they may be from a time standpoint—are rarely acceptable in real property transactions because of the importance of details and the reality of the litigious nature of our society.

The due diligence reviews of title, survey, environmental matters and other items may reveal issues that should be addressed in the transaction documents. For example, if property to be purchased is subject to leases, an assignment of those leases will be needed; the deed will not convey the seller's interest in the leases. Tenant estoppel certificates should also be obtained. If the due diligence review of the leases reveals that tenants have given security deposits or that brokerage commissions are due periodically during the lease term, the lease assignment must address who has responsibility for those items. Similarly, if a survey reveals a discrepancy in a boundary line, such as a fence located other than on the boundary line, a boundary line agreement with the adjoining property owner to confirm the location of the mutual boundary line may be needed. As another example, an environmental site assessment may reveal existing contamination, in which event indemnifications and assignment of

responsibility for clean up and related matters should be included in the transactional documents. As an initial step, the real estate contract should provide the buyer with a feasibility period in which to study such matters and elect to cancel the transaction.

It is beyond the scope of this paper to go into the details of the various transactional documents. An entire paper could be devoted to leases; indeed, an entire paper could be devoted to ground leases or office leases alone. Similarly, there are many issues that must be considered in preparing a contract for the purchase and sale of real property and the related conveyancing documents. Easements, deeds of trust and other security instruments also pose unique legal issues that must be considered and carefully addressed.

Consider the following questions to test your knowledge of different types of transactional documents:

- What is the difference between a general warranty deed, a special warranty deed, a deed without warranty, and a quitclaim?
- What is the difference between an option contract, a letter of intent and a contract for deed? Does a letter of intent bind the parties?
- Are there any notices that federal law requires a seller of residential property to give at the time the real estate sales contract is entered into?
- What is the difference between a right of first refusal and an option to purchase?
- Does an easement granted for a utility line terminate when the utility line no longer exists in the easement area?
- What is the difference between a covenant of continuous operation and a covenant of quiet enjoyment? (In what type of document would you find both covenants?)
- Does an easement constitute a conveyance of the land described in the document or merely the grant of a right-of-way across or beneath the land?
- If a seller contracts to convey to you all of his “right, title and interest” in certain land, is that satisfactory?

If you find yourself stumped by the above questions, I strongly recommend that you seek the advice of competent counsel well in advance of a transaction to ensure that proper documents may be drafted to accurately reflect the business terms and to properly and fairly protect your interests. The foregoing discussions of due diligence items are irrelevant if you sign a contract that obligates you to complete the transaction without reserving the right to conduct those due diligence investigations and without providing a mechanism for addressing and resolving issues that are identified in that due diligence process.

## **CONCLUSION**

The many and complex topics covered in this paper underscore the need to include a legal specialist in the real estate transaction from the outset. Because of the

degree of detail and the potentially significant liability that may result from overlooked or improperly handled details in real estate transactions, I strongly recommend the use of an attorney with specialized knowledge of real estate transactions. In-house counsel may be called on to perform a variety of legal work and may not have had the opportunity to develop special expertise in real estate. Outside counsel that advise on employment law or other issues may not have expertise in real estate issues.

It is important that the attorney not only be knowledgeable about real estate law, but that the attorney be knowledgeable about the law in the state in which the real property is located. Real estate law varies from state to state; with few exceptions, the law of the state in which the real estate is located will control. Consequently, you should consult with an attorney licensed to practice law in the state in which the real property is located.

# **LEGAL ISSUES IN REAL ESTATE**

## **Appendix 1**

### **Title Checklist**

## TITLE CHECKLIST

Title Item	Notes
<b>1. Access</b>	
<ul style="list-style-type: none"> <li>• Confirm that the title company will insure that the property has legal access to a public road (physical access does not guarantee that the property has a legal right of access).</li> </ul>	
<b>2. Authority</b>	
<ul style="list-style-type: none"> <li>• Confirm in advance with the title company what evidence of authority the title company will require at the closing.</li> </ul>	
<b>3. Documents</b>	
<ul style="list-style-type: none"> <li>• Obtain and review copies of all documents listed in or referred to in the commitment.</li> </ul>	
<b>4. Easements</b>	
<ul style="list-style-type: none"> <li>• Obtain and review copies of all written easements.</li> <li>• Are all easements that are listed in the title commitment also depicted on the survey plat?</li> <li>• Does the easement document prohibit improvements to be placed within the easement tract?</li> <li>• Does the easement document specify the exact location of the easement or is the easement a blanket easement? If the latter, seek an amendment to the easement specifying its location.</li> <li>• Require that any easement appurtenant (e.g., an easement granting vehicular access to the tract) is insured as an insured interest and its location is described by metes and bounds and shown on the survey plat.</li> <li>• Require the deletion of easements</li> </ul>	

Title Item	Notes
<p>no longer in use.</p> <ul style="list-style-type: none"> <li>Require a notation in the description of each easement that ties the location of the easement to its location as depicted on the survey plat.</li> </ul>	
<p><b>5. Encroachments</b> (over setback line established by restrictive covenant or ordinance; over easement; over property line; etc.)</p>	
<ul style="list-style-type: none"> <li>Evaluate what risk is posed.</li> <li>Determine whether insurance against the risk is available.</li> </ul>	
<p><b>6. Identity of Current Owner</b></p>	
<ul style="list-style-type: none"> <li>Does the name of the current owner identified in the commitment match the name listed in the transaction documents?</li> <li>Does the commitment list other owners?</li> </ul>	
<p><b>7. Identity of Proposed Insured</b></p>	
<ul style="list-style-type: none"> <li>Is the name of the proposed insured as stated on the commitment correct?</li> <li>Does it match the name on the transaction documents?</li> </ul>	
<p><b>8. Insured Amount</b></p>	
<ul style="list-style-type: none"> <li>Is it correct?</li> </ul>	
<p><b>9. Leases</b></p>	
<ul style="list-style-type: none"> <li>Require that the exception in the title policy for the rights of tenants in possession be amended to refer to only specifically identified leases.</li> <li>Review all leases to confirm the terms of the leases and to verify that no rights of first refusal or purchase options exist in favor of a tenant.</li> <li>Require tenant estoppel certificates from all tenants.</li> </ul>	

Title Item	Notes
<ul style="list-style-type: none"> <li>Require a certified rent roll from the current owner.</li> </ul>	
<b>10. Liens and Taxes</b>	
<ul style="list-style-type: none"> <li>Does the title commitment reflect that any taxes are delinquent? If so, require that they be paid by the seller before closing.</li> <li>Obtain and review a copy of the tax search or certificate acquired by the title company.</li> <li>Require that the current year's taxes be insured against if tax bills have been sent.</li> <li>Does the title commitment reflect that any liens exist against the property? If so, resolve all such matters before closing. The seller may be able to provide an affidavit as to taxes, debts and liens to enable the title company to remove any such exceptions.</li> <li>If the commitment reflects a lien for which the statute of limitations has expired, seek to have the title company delete the lien as an exception to title.</li> </ul>	
<b>11. Mineral Interests</b>	
<ul style="list-style-type: none"> <li>Does the commitment reflect that the mineral estate has been severed from the surface estate?</li> <li>If the mineral estate has been severed, has the mineral estate owner signed a surface waiver? If not, consider whether it is feasible to obtain one.</li> <li>Are there any mineral leases listed on the commitment? If so, obtain and review copies of all such leases to determine if the leases have expired by their own terms and to evaluate the terms of the leases.</li> <li>If a mineral lease expired at the end of the primary term because of non-</li> </ul>	

Title Item	Notes
<p>production, have the lessor give an affidavit of non-production so that the lease may be deleted from the commitment and the policy.</p>	
<b>12. Parties in Possession</b>	
<ul style="list-style-type: none"> <li>• Never accept an exception for rights of parties in possession. Require that the seller give an affidavit so that the commitment may be amended to refer to only those tenants listed on the rent roll.</li> </ul>	
<b>13. Personal Property</b>	
<ul style="list-style-type: none"> <li>• Title insurance does not insure title to personal property. If any personal property is being acquired as part of a real property transaction, obtain and review any financing statements filed in the Secretary of State's office or in the office of the county clerk to confirm whether any liens exist against the personal property.</li> </ul>	
<b>14. Property Description</b>	
<ul style="list-style-type: none"> <li>• Does the property description stated in the title commitment match the metes and bounds description prepared by the surveyor?</li> <li>• Does the property description stated in the title commitment match the property description in the transaction documents?</li> <li>• If the property is a subdivided lot, does the property description refer to the correct lot and block and the subdivision plat recording information?</li> <li>• If the property is a subdivided lot, obtain and review a copy of the subdivision plat to confirm whether there are any matters on the plat that affect the use of the property.</li> </ul>	

Title Item	Notes
<p><b>15. Restrictive Covenants</b></p> <ul style="list-style-type: none"> <li>• Review copies of all restrictive covenants listed as exceptions to title and identify any potential issues.</li> <li>• Confirm that each restrictive covenant listed in the title commitment in fact affects the property (the surveyor's input may be required).</li> <li>• Are there any existing violations of restrictions? If so, seek to insure against such violations.</li> <li>• Confirm that the restrictions contain no enforceable reverter or forfeiture provision.</li> <li>• Confirm that any maintenance lien is subordinate to the mortgage.</li> </ul>	

# **LEGAL ISSUES IN REAL ESTATE**

## **Appendix 2**

### **Survey Checklist**

## SURVEY CHECKLIST

Survey Item	Notes
<b>1. Access</b>	
<ul style="list-style-type: none"> <li>• Is access to a public roadway shown?</li> </ul>	
<b>2. Adjoining Property</b>	
<ul style="list-style-type: none"> <li>• Is the adjoining property shown and labeled and the recording information for the deed to the adjoining property stated?</li> <li>• Are adjoining roads shown and their widths and names stated?</li> <li>• Does the survey plat show any encroachments from adjoining properties or protrusions onto adjoining properties?</li> </ul>	
<b>3. Certificate</b>	
<ul style="list-style-type: none"> <li>• Does the surveyor's certification appear on the survey plat?</li> <li>• Is the certificate signed by the surveyor?</li> <li>• Is the certificate sealed by the surveyor?</li> <li>• Does the certificate state that the survey was performed on the ground by the surveyor?</li> <li>• Does the certification state that the survey was made in accordance with identified published specifications for a land title survey?</li> <li>• Does the certificate include all specifications determined by the parties to be of importance?</li> <li>• Consider requesting that the surveyor include the following statements in the certification: <ul style="list-style-type: none"> <li>◆ all monuments shown on the survey plat actually exist and the size, location and type of material used is correctly shown;</li> <li>◆ there are no visible encroachments or protrusions,</li> </ul> </li> </ul>	

Survey Item	Notes
<p>except as shown on the survey plat;</p> <ul style="list-style-type: none"> <li>◆ there are no improvements except as shown on the survey plat;</li> <li>◆ there are no visible easements or rights-of-way except as shown on the survey plat;</li> <li>◆ there are no visible discrepancies, conflicts, shortages in area or boundary conflicts except as shown on the survey plat;</li> <li>◆ the size, location and type of improvements are shown on the survey plat and are located within the boundaries of the property;</li> <li>◆ the distance from the nearest intersecting street or road is shown;</li> <li>◆ the property has access to and from a public roadway;</li> <li>◆ all recorded easements and other exceptions reflected on the title commitment are shown on the survey plat;</li> <li>◆ the boundaries, dimensions and other details shown on the survey plat are true and correct;</li> <li>◆ no part of the property is in a flood hazard area, except as shown; the flood plain map used in making that statement is identified; and the type of flood hazard area is specified;</li> <li>◆ the location and size of utility lines are as shown; and</li> <li>◆ all applicable setback lines are as shown.</li> </ul> <ul style="list-style-type: none"> <li>● Is the certificate addressed to all parties in the transaction and to the title company?</li> </ul>	
<p><b>4. Compliance with Restrictions, Ordinances and Building Requirements</b></p>	

Survey Item	Notes
<ul style="list-style-type: none"> <li>Does the survey plat show any evidence of violations of restrictions, zoning, site plan or other ordinances, or other building requirements?</li> </ul>	
<b>5. Easements and Other Matters</b>	
<ul style="list-style-type: none"> <li>Are all easements and other exceptions that are listed on the title commitment shown?</li> <li>Are setback lines shown?</li> <li>Do any of the improvements go beyond the setback lines?</li> <li>Does the drawing reflect any easements or other matters that are not listed on the title commitment?</li> <li>Are offsite easements that affect the use of the tract, such as access and drainage easements, shown?</li> </ul>	
<b>6. Flood Plain and Water Features</b>	
<ul style="list-style-type: none"> <li>Is the portion of the property within the flood plain shown?</li> <li>Are bodies of water and wetlands features shown?</li> </ul>	
<b>7. General Matters</b>	
<ul style="list-style-type: none"> <li>Have you received one or more originals of the survey plat and metes and bounds description?</li> <li>Does the legend on the survey plat identify the surveyor, give the date of the survey and give the scale of the survey drawing?</li> <li>Is there a north arrow?</li> <li>Is the property description printed on the survey plat?</li> <li>Is there a legend that explains the symbols used on the survey drawing?</li> <li>Are the monuments for the corners shown on the survey plat and identified as to size and type?</li> <li>Is the point of beginning shown and labeled?</li> </ul>	

Survey Item	Notes
<b>8. Improvements</b>	
<ul style="list-style-type: none"> <li>• Are the improvements shown and labeled?</li> <li>• Are special features, such as height of buildings, number of parking spaces, curbs, driveways and sidewalks, etc. shown?</li> <li>• Does the drawing show all parking areas, identify and label the number of spaces, and identify handicapped parking spaces?</li> <li>• Do the improvements, as shown on the survey plat, comply with applicable restrictions and zoning and other ordinances?</li> <li>• Are any fences shown? If any fence shown is not on the boundary line, determine ownership of the fence.</li> <li>• Are proposed improvements shown?</li> </ul>	
<b>9. Metes and Bounds Description</b>	
<ul style="list-style-type: none"> <li>• Does the description match that in the title commitment?</li> <li>• Are there any discrepancies between the surveyor's metes and bounds description and the property description contained in prior deeds or conveyances?</li> <li>• Does the description identify the city, county and state in which the property is located?</li> <li>• Does the description contain a statement of the point of beginning and conclude by returning to the point of beginning?</li> <li>• Does the description identify the basis of bearings?</li> <li>• If the property is a subdivided lot, does the description refer to the lot and block number and include the recording information from the subdivision plat?</li> <li>• Are the courses and distances stated on the survey plat and do they match the courses and distances stated in</li> </ul>	

Survey Item	Notes
<p>the metes and bounds description?</p> <ul style="list-style-type: none"> <li>• Does the description contain the proper references to adjoining properties, including references to deed recording information where appropriate?</li> <li>• Is the total gross square footage (and net square footage, if appropriate) stated? Consider whether there is a need to show net square footage or square footage of easements, flood areas, encroachments, or other special features.</li> </ul>	
<b>10. Multiple Tracts</b>	
<ul style="list-style-type: none"> <li>• If the property consists of multiple, contiguous parcels, is one single perimeter shown? (A single perimeter confirms that there are no gaps between the parcels.)</li> </ul>	
<b>11. Utilities</b>	
<ul style="list-style-type: none"> <li>• Are utility lines shown and labeled as to type and size?</li> </ul>	