FIELD GUIDE FOR DUE DILIGENCE ON INCOME PRODUCING PROPERTIES

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CHAPTER 17

Table of Contents

Table of Authorities

Page(s)

Cases

Other Authorities

State Rules

I. INTRODUCTION

Due diligence is a process. Through this process, the client and its counsel obtain, assess and evaluate available information pertinent to an income producing property ("IPP") which the client proposes to acquire, develop, lease, or use as security for a loan. Counsel is then expected to use this analysis to evaluate the legal liabilities and risks presented by a given IPP, and to advise the client as to how to the transaction might best be structured, if indeed it should be allowed to proceed at all. Without overstating the point, we feel that the "process" concept of due diligence is important because of the flexibility implied. Some proposed IPP acquisitions will naturally be more complicated than others, just as some acquiring clients will desire a great deal of attorney involvement, while others will want far less. Therefore, the requisite "due diligence" performed by an attorney must be able to either expand or contract within the parameters of a given transaction, while still striving to protect the client adequately. The purpose of this paper is to explore not only the establishment of the attorney's role in the due diligence process, but to discuss various aspects of IPPs that an acquiring client may, or should, investigate. In doing so, however, this paper is intended to serve less as a scholarly treatise than as a practical "field guide," and for that reason, very few cases or statutory provisions have been cited. Instead, the authors have drawn upon their own practical experiences and experiences of other real estate attorneys. The authors would also like to acknowledge their debt to the excellent materials presented at the 1996 ACREL Mid-Year Meeting, especially those articles prepared by Attorney Roger D. Schwenke (Tampa, Florida), and by Attorneys M. Jay DeVaney and David S. Pokela (Greensboro, North Carolina) and the recent article by Jonathan Thalheimer, *A Primer on Platting and Zoning*, Real Estate Law: Transactions In-Depth (SMU School of Law 2000).

II. ESTABLISHMENT OF ATTORNEY'S ROLE

A. Context. *See* the following articles for discussions of "as is clauses," the Seller's duty to disclose, the Buyer's duty to do due diligence, and common clauses drafted in contracts for the acquisition of income producing properties: Sorenson, *Fraud and Disclosure Disputes*, 15th Annual Advanced Real Estate Law Course (1991); Baucum, "*As Is" Clauses in Earnest Money Contracts*, 11th Advanced Real Estate Drafting Course (2000); Barton, *Commercial Purchase and Sale Agreement: A Comparative Analysis of Suggested Initial Drafts of Contracts for Sellers and Buyers*, 11th Advanced Real Estate Drafting Course (2000); Jolley and Oxman, *Discussion of Typical Model Contracts Used by National Buyers, With Representations They Request and Require, Including Diligence Issues*, 11th Advanced Real Estate Drafting Course (2000); Becker,*"I Can't Believe They Are Selling It So Cheap*!" - *A Checklist of Pitfalls for Would Be Real Estate Monguls*, Advanced Real Estate Course (1993); Hargis, *Property Condition/Inspection Clauses: Drafting Liability*, Advanced Real Estate Law Course (1994); Waters, *Differentiating Among Representations, Warranties, Covenants and Conditions*, Mortgage Lending Institute (1997); Parker, *Evolving Standards of Environmental Due Diligence In Real Estate Transactions*, Advanced Real Estate Course (1994); Locke, *Shifting of Risk, Contractual Provisions for Indemnity, Additional Insureds, Waiver of Subrogation, and Exculpation*, Advanced Real Estate Law Course (1995); Haywood and Vanderburg, *the ABC's of Land Use Regulation, Reviewing the Basics of Zoning and Subdivision*, University of Texas 32nd Annual Mortgage Lending Institute (1998); Triplett, *Acquisition of Multi-Family Residential Real Estate*, Advanced Real Estate Law Course (1995); Wallenstein, *The New State Bar Mortgage Opinion Letter Format*, Advanced Real Estate Law Course (1996); Dahlstrom, *Land Use and environmental Due Diligence*, Advanced Real Estate Law Course (1996); Misthal, *ADA Due Diligence in the Acquisition and Ownership of Real Estate*, Advanced Real Estate Law Course (1996); Woody, *Representing the Relocating User*, Advanced Real Estate Law Course (1996); Alderman, *Current Status of DTPA Waivers, "As-Is" Transactions and Representation and Warranties*, Advanced Real Estate Law Course (1996); Cox, *Duty of Disclosure and the*

Deceptive Trade Practices Act, Texas Land Title Institute (1993); Rider, *Environmental Due Diligence Documents*, Advanced Real Estate Drafting Course (1995); Locke, *Indemnity, Releases and Insurance*, Advanced Real Estate Drafting Course (1997); Spradling, *Survey and Title Insurance Issues*, Mortgage Lending Institute (1993); Tomek and Triplett; *Negotiating Improved Commercial Sales Contracts*, Mortgage Lending Institute (1993); Gosdin, *Title Checklist* , South Texas College of Law Real Estate Conference (1997).

There exists a tension between a Seller's desire to protect itself against liability for erroneously made representations, warranties or disclosures to the Buyer or the failure to disclose matters which a court would later determine it had a duty to disclose and a Buyer's desire to seek assurances from the Seller as to the Seller's experience with the property and its knowledge as to facts material to the Buyer's intended use of the property. This tension results in the battle to obtain representations, warranties, covenants, indemnities and disclaimers as each party tries to shift risk to the other party. In this context, the modern "free look" contract has evolved. *See* for example the "Option Fee" provision built into the standard State Bar, TREC and TAR forms attached in the Appendix.

A duty to disclose arises principally in three contexts: (1) out of the relationship of the parties; (2) from the facts of a given situation; or (3) under statute. In any of these contexts, it may be couched as "fraud," "fraudulent concealment," "intentional concealment" or "negligent concealment," but the crux of the claim is the defendant's "duty to disclose."

The disclosure rule is stated in *Doyle v. Union Pacific Railway Co.*, 147 U.S. 413, 37 L.Ed. 223 (1893). In *Doyle* the United States Supreme Court wrote that:

> [t]he general rule, both in law and equity,... in respect to concealment is, that mere silence in regard to a material fact, which there is no legal obligation to disclose, will not avoid a contract, although it operates as an injury to the party from whom it is concealed. But the relation generally which raises the legal obligation to disclose acts known by one party to the other, is where there is some especial trust and confidence reposed, such as where the contracting party is at a distance from the object of negotiation, when he necessarily relies on full disclosure; or where, being present, the buyer put the seller on good faith by agreeing only to deal on his representations. In all these and kindred cases, there must be no false representations, nor purposed concealments; all must be truly stated and fully disclosed.

The Texas Supreme Court addressed the issue of a vendor's duty to disclose latent defects in *Smith v. National Resort Communities, Inc.*, 585 S.W.2d 655 (Tex. 1979). In that case, a lake lot developer, NRC, did not disclose that the Lower Colorado River Authority retained an overflow easement on all properties abutting Lake Travis to the 715 foot contour of elevation or that the purchaser's lot was below that elevation. Citing a law journal article by Professor Keeton, the court found that "a seller of real estate is under a duty to disclose material facts which would not be discoverable by the exercise of ordinary care and diligence on the part of the purchaser or which a reasonable investigation and inquiry would not uncover." *Id.* at 658. *See also Bullock*, 180 S.W. 940 (Tex. Civ. App.-Texarkana 1915, no writ), and *Grace v. Parker*, 337 S.W.2d 518 (Tex. Civ. App.-Austin 1960, *writ ref'd*) - holding that a home builder knows and is required to know the manner in which he constructed his house and has a duty to communicate any material and unobservable departures from the plans.

However, a Buyer cannot ignore facts that are available to it through the exercise of ordinary care. *Smith*, 585 S.W.2d at 658; *Thigpen v. Locke*, 363 S.W.2d 247 (Tex. 1962); *Courseview v. Phillips Petroleum Co.*, 312 S.W.2d 197 (1957). *but, see Colvin v. Allsworth*, 627 S.W.2d 430 [Tex. Civ. App.-Houston [1st Dist] 1981, *no writ*).

The Texas Supreme Court approved an "as is" disclaimer in a commercial sale in *Prudential Ins. Co. of America v. Jefferson Associates, Ltd.,* 896 S.W.2d 156 (Tex. 1995). Under the decision in *Prudential* the following conditions appear as prerequisites for an effective "as is" sale:

1. The Seller must disclose all known defects. The "as is" clause would be ineffective and unenforceable if the Buyer is induced by the fraudulent misrepresentation or concealment of information.

2. The Seller cannot obstruct the Buyer's ability to inspect the property.

3. The "as is" clause must be an important basis of the bargain. It cannot be an incidental provision or a part of the "boiler plate" of the provision.

4. The Buyer and Seller must have relatively equal bargaining positions.

B. Necessity of Initial Conference

One of the most important steps in the due diligence process has far less to do with the IPP to be acquired than it does with the relationship between the attorney and client. This step entails sitting down with the client to hash out just what - in connection with the upcoming due diligence - are the client's goals, time constraints, acquisition standards, and desired level of legal assistance. Of course, this first step is most crucial where the client and attorney are working together for the first time, but should not be wholly overlooked even where the client and attorney share a considerable history together, as each new IPP presents a new challenge. Too often, clients are far more concerned with 'closing the deal' than they are with risk exposure, a mind set which casts the due diligence attorney as less of an asset than an impediment (and an expensive impediment at that). By holding an initial due diligence conference, the lawyer can not only familiarize himself with a given client's expectations, but also attempt to educate the client as to the costs, delays, and potential difficulties which the selected course of due diligence may entail. Ideally, the matters agreed upon in this initial consultation should then be documented in an engagement letter, which not only specifies what the attorney believes the client expects of him, but also what the attorney understands that he will NOT be responsible for.

C. Scope of Work to be Performed

Of the various issues to be worked out between client and attorney, prior to beginning due diligence, the most important of these concern the SCOPE of the required services, and the TIME FRAME in which they are to be provided. Beginning first with the issue of scope, it has already been noted that some clients will limit the attorney's role to mere review of title and survey matters, while others will rely far more heavily on counsel, in investigating such matters as environmental compliance, compliance with the Americans With Disabilities Act, engineering reports, permit verification, and/or compliance with local ordinances (parking, sign, zoning, impervious cover, etc.). Undeniably, the greater the attorney's level of participation, the higher the client's overall cost of acquiring the IPP, at least in the short term. For this reason, it remains an open question whether a client will consent to the degree of due diligence recommended by the attorney, but at least by openly discussing the issue, the two will know where they stand if and when it is discovered that there is a major flaw in the IPP. Therefore, as to the scope of due diligence, the client and the attorney should discuss (and later memorialize in writing) the following items:

1. the degree of due diligence appropriate to the IPP to be acquired, regardless of whether or not the attorney is to be responsible for providing and/or overseeing such services;

2. the due diligence items for which both sides have agreed that the attorney will be responsible for handling;

3. the due diligence items for which the attorney will not be responsible;

4. the manner in which the results of the attorney's due diligence work will be conveyed to the client (oral briefing, pre-closing memo, post-closing memo, opinion letter from counsel, etc.)

D. Time Frame Expectations

The second vital issue to be settled between client and attorney concerns the time frame in which the attorney's work is to be completed. To again engage in broad stereotyping, most clients are interested in wrapping up an IPP acquisition yesterday, while the due diligence attorney often finds his hands tied by third parties (such as government officials, or environmental consultants) who simply can't or won't operate at the pace desired by the client. For this reason, REALISTIC time constraints should be discussed by all participants in the due diligence effort, and at a very early stage of the deal. This is especially relevant as to third-party consultants, so as to ensure that such consultants not only have time to properly prepare their reports, but that both the client and attorney have time to adequately review them. Therefore, we often recommend to our clients that they confer with their consultants (as to deadline-feasibility) PRIOR to negotiating a closing date.

III. MANAGEMENT OF THE DUE DILIGENCE PROCESS

A. Attorney as Manager

The attorney's role in the IPP due diligence process may be that of manager. As manager, the attorney will be expected to establish, monitor, and complete the entire due diligence process in a timely, cost-effective, and orderly manner. In this role, he will be responsible not only for completing his own tasks, but for allocating duties to those third parties (largely non-lawyers) who will address those aspects of due diligence where the lawyer lacks specific expertise. Such third parties may include contractors, surveyors, engineers, accountants and/or environmental consultants. In any due diligence situation, regardless of whether the attorney's relationship to such consultants is that of employer, manager, or merely fellow-expert, counsel needs to be aware of the other members of the "due diligence team," and to familiarize himself with their respective responsibilities and deadlines. This is because it can often be the case that the attorney will not be able to complete his due diligence duties until the consultants have completed theirs.

B. Attorney-Client Privilege

Often, an attorney who is managing an IPP due diligence effort will be directly responsible for hiring the third-party consultants. One advantage of this lies in the fact that most real estate attorneys are far more acquainted with the available pool of local experts, at least in comparison to those clients who do not frequently acquire IPPs. Too, a second advantage which may accrue through attorney-hiring is that the communications between the client and the consultant (and, incidentally, between the consultant and the attorney) may well be protected by the attorney-client privilege. While a full discussion of the attorney-client privilege is beyond the scope of this paper, you should be aware that Texas Rule of Evidence 503(a) (4) has been held to protect client communications made to professionals who were hired by attorneys on behalf of such clients. *Parker v. Carnahan*, 772 SW2d 151, 157 (Tex. App. - Texarkana 1989, error denied) (accountant); *Bearden v. Boone*, 693 SW2d 25, 28 (Tex. App. - Amarillo 1985, no writ) (investigator). Furthermore, the attorney-client privilege appears to apply even where it is the client who actually pays for such services, so long as the attorney does the hiring. See Goode, Wellborn and Sharlot, 1 Texas Practice Section 503.4, at page 345. Although no Texas case has applied T.R.E 503(a)(4) to third-party real estate consultants, favorable results have been reached in other jurisdictions. *Conforti & Eisele, Inc. v. Division of Bldg. and Const.*, 405 A.2d 487 (N.J. Super. Ct. Law Div. 1979); *San Diego Ass'n v. Superior Court of San Diego Co.*, 373 P.2d 448 (Cal. 1962); *Wilson v. Superior Court, Contra*

Costa County, 307 P.2d 37 (Cal. App. 1st Dist. 1957); *Cold Metal Process Co. v. Aluminum Co. of America*, 7 F.R.D. 684 (D. Mass. 1947).

Therefore, it appears likely that the attorney-client privilege will extend to client communications made to third-party consultants hired by the attorney. If, on the other hand, the consultants are hired by the client, there is then absolutely no chance of gaining such protection. Even where applicable, however, note that the attorney-client privilege may be destroyed where the protected information has been - or is later intended to be - disclosed to outside parties. Likewise, the T.R.E. 503(a)(4) privilege only applies to confidential communications made to an attorney or his agent (i.e. the consultant/expert) "for the purpose of facilitating the rendition of professional legal services to the client." At present, Texas law has not fully explored just what range of client assistance activities fall within T.R.E. 503(a)(4); likewise, the business of protecting confidential information from disclosure (which would destroy the attorney-client privilege) is somewhat more complicated than it might first appear. While these matters are, again, beyond the scope of this paper, we would recommend that, in those IPP transactions where it is clear from the outset that the client would benefit from extending the attorney-client privilege to the involved third-party consultants, the attorney managing the due diligence process should make sure that all members of the "team" both understand and comply with those steps necessary to uphold the privilege.

C. Importance of Checklist

Our final comment concerning the attorney's role in managing the IPP due diligence process concerns that most obvious of items, the checklist. Because each IPP acquisition is unique, the managing attorney should prepare a customized checklist of to-do items which accurately reflects the responsibilities assigned to him in the initial due diligence conference. Furthermore, and most especially in those cases where the attorney has been charged with overseeing the work of third-party consultants, this checklist should encompass both the WHAT and the WHEN of those due diligence duties to be accomplished by others, including the client himself. A sample form of such checklist and other related forms have been attached in the Appendix. While we of course hope these prove helpful, we caution against blind adherence to any sort of "master checklist," and again suggest that a more transaction-specific list be created for each distinct IPP acquisition.

IV. DUE DILIGENCE ISSUES IN GENERAL

A. Entry Issues

1. Indemnity by buyer to seller
2. Coordination with seller
3. Disturbance of tenants
4. Obligation to restore trees / groundcover
5. Nondisclosure and confidentiality provisions

B. Reports

1. Advisability of relying on seller reports
2. Recertifying reports
3. Privity with seller's consultants
4. Attorney/client privilege

C. Number and Type of Reports

1. Mechanical
2. Electrical
3. Plumbing
4. Structural
5. Environmental
   a. soil analysis
   b. asbestos
   c. radon
   d. underground storage tanks
6. Americans With Disabilities Act/Fair Housing Act
7. Local code and ordinance compliance

Frequently, the Building Inspection Department of the relevant municipality will be able to provide a history of what permits have been issued for a given IPP, what code violations have occurred there, and whether such violations have been corrected. Often, the Inspection Department is also responsible for issuing a renewed certificate of occupancy. Note, however, that just because advice comes out of City Hall,

this does not relieve the attorney of his duty to double-check that such advice is correct. Overworked and underpaid municipal employees can and do give out mistaken information concerning matters vital to IPP transactions; worse, it is rare indeed that the misinformed party can prevent the City from contradicting the erroneous advice, even where reliance has occurred.

A common place to begin IIP due diligence is to obtain a zoning compliance letter from the governing municipality The zoning verification letter form for the City of Austin and several zoning comfort letters from the City of Austin and other municipalities are contained in the Appendix.

Caveat: You cannot rely on a letter from the municipality because it is clear that the municipality cannot be estopped from asserting a different position on the basis of the letter. *See Edge v. City of Bellaire*, 200 S.W.2d 224 (Tex.Civ.App.-Galveston 1947, *writ refused*); *Swain v. Board of Adjustment of City of University Park*, 433 S.W.2d 727 (Tex.Civ.App.-Dallas 1968, writ refused n.r.e.), *cert denied* 396 U.S. 277, 90 S.Ct. 563, 24 L.Ed.2d 465 (1970), *reh denied* 397 U.S. 977, 90 S.Ct. 1085, 25 L.Ed.2d 274 (1970); *City of San Angelo v. Deutsch*, 126 Tex. 532, 91 S.W.2d. 308 (Tex. 1952); and *City of Hutchins v. Prasifka*, 450 S.W.2d. 829 (Tex. 1970).

Edge v. City of Bellaire involved a building permit that was issued to build a restaurant addition in a residential neighborhood. The Court held that:

> While it is unfortunate that the officials of the City of Bellaire issued a permit to appellant, Gordon Edge, to erect a business establishment within the zoning area, the conduct of these officials, however harsh and unjust its effect might have been on appellants, can not be used to prejudice or destroy the rights of the public to require the enforcement of the zoning ordinance, which was valid on its face ... since in enforcing an ordinance valid in all respects, the officials of the City were discharging a governmental function and the City and its citizens cannot be found or estopped by unauthorized acts of its officers in the performance of that function. *City of Bellaire*, at 228.

In *Swain v. Board of Adjustment of City of University Park*, the City of Highland Park had passed a zoning ordinance in 1929, zoning the property residential. In 1933, the property owner filed an application with the Board of Adjustment to operate a gas station, a prohibited use. The application was eventually granted and the property was used continuously as a gas station. In 1965 the City Engineer sent a letter requiring that the use be discontinued and the Board of Adjustment agreed. The owner argued that this was not a nonconforming use since the City itself, acting through its agency, had previously granted an exception to the use of the property and such action removed the subject property from the classification of nonconforming use. The Court held that (i) the original 193' 3 grant by the Board of Adjustment was outside its power and was void, and that the use as a gas station was illegal, not nonconforming; (ii) that no vested rights were acquired by the use of the property contrary to the purpose of the ordinance; and (iii) that the people of the City of University Park, acting through their governing authority, are not estopped to assert their rights under the zoning ordinance by virtue of the continued use pursuant to a void permit. *City of University Park* at 732, 733.

City of San Angelo v. Deutsch involved a tax lien that had been placed on the property. Prior to placing a lien on the property, Deutsch checked to see that all taxes had been paid. The tax records of the City showed that they had been paid and Deutsch made the loan. After Deutsch had checked the records, the draft pursuant to which the taxes had been paid was dishonored and the tax collector changed the entry. Upon default

and foreclosure, Deutsch discovered that the taxes had not been paid. Deutsch sued the City for removal of the tax lien. Deutsch alleged "that by reason of [the City] having represented by the entries in its public records that the taxes were paid and having caused the public and defendant in error to believe that the taxes had been paid the City is now estopped to assert or claim such taxes as a lien upon the property." *City of San Angelo* at 309. The Court held that as a general rule

> cities are not liable for the unauthorized or negligent acts of their officials in the performance of the City's governmental functions. The decisions in this state have consistently protected the public from liability and loss on account of mistakes, negligence, and unauthorized acts of public officials in the performance of public or governmental duties. Mistakes or unauthorized acts of officials charged with the custody and disposition of public land do not estop the state or deprive it of its property. *City of San Angelo* at 309.

The Supreme Court has reaffirmed the rule regarding estoppel in *City of Hutchins v. Prasifka*. In *Prasifka* in 1958, the City adopted a comprehensive zoning ordinance which classified the area in question as residential. In 1965, the city council enacted another comprehensive zoning ordinance; and in it, the land in question retained its classification as residential. The 1965 ordinance also provided that "the governing body may from time to time enact, supplement, or change by Ordinance the boundaries of the districts or the regulations herein established." On November 7,1966, the city council, upon the recommendation of the city planning commission, passed a resolution to reclassify the plaintiffs' (Prasifka's) tract from residential to manufacturing. The reclassification of the Prasifka tract to manufacturing was erroneously made on the map maintained in the city hall. No ordinance was enacted changing the classification from residential to manufacturing. The Prasifkas purchased the tract in question on or about September 18, 1967, after being advised by the city secretary that "the zoning classification (manufacturing) shown on the map was correct so far as she knew." *City of Hutchins* at 831. After Prasifka had purchased the property in reliance upon the map, the City corrected the map. The Supreme Court held that "the general rule has been in this state that when a unit of government is exercising its governmental powers, it is not subject to estoppel" and the case was remanded to the trial court to grant a permanent injunction restraining and enjoining use of the property in violation of the ordinance. *City of Hutchins* at 835.

D. Sample Process

For some of our clients, particularly the larger, out of state clients purchasing property in the Austin area, our firm's paralegal will prepare due diligence binders for the income producing property being purchased. Our paralegal will begin by contacting appropriate persons at the City of Austin and at the County of Travis, depending on the precise location of the property. If the property is located within the corporate limits of the City of Austin, we will obtain a zoning letter. In addition, we will determine whether a site plan was issued in connection with the development. The site plan will be compared to the survey to make sure that the property was constructed in accordance with the approved site plan. We will also request a letter from the City of Austin indicating whether the property has ever been cited for violations and, if so, whether those violations have been corrected according to the City of Austin's records. We will also obtain certificates of occupancy if they have not already been furnished by the seller. We work with our paralegal to provide in the due diligence binders copies of relevant ordinance and code provisions which address such items as density, parking, signs, setbacks, height limitations, floor to area ratios and impervious coverage restrictions. We will then analyze the property to determine whether it appears from the information available to us there is any problem or potential problem. We always point out to our client that such an

analysis is not any absolute guarantee that there are no problems and that there is no legal right to rely upon information, written or oral, provided by city or county employees. One of the most recurring problems we run into with respect to income producing properties is parking. Many times the number of parking spaces decreases over time through restriping or placement of sheds or trash facilities in parking spaces. Also, sometimes the tenant mix of a building will change and cause the existing parking to be inadequate. In such cases, we explore such remedies as the ability to restripe the property and/or to get a variance from the parking requirements.

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