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Due Diligence Considerations When Acquiring Distressed Real Estate

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This article is the second in a multi-part series based on the Lowndes white paper, "Selling & Acquiring Distressed Real Estate in Florida." Each installment will examine key legal and strategic considerations for acquiring distressed assets in the state. The next article will address key provisions to include in a loan document purchase agreement.

If you are considering buying distressed real estate, taking the time to thoroughly evaluate the property is one of the most important steps you can take to protect your investment. This process, known as due diligence, involves gathering the information a reasonable buyer would want to know before entering into a purchase and sale agreement.

While this article doesn't cover every aspect of due diligence investigations, it highlights several key issues to keep in mind in different acquisition methods. In a short sale, for example, even if the seller makes representations or warranties in the contract, the buyer cannot rely on the seller being around or financially able to honor them after the closing. If the lender is the one selling the property, it is unlikely that the lender will provide many, if any, warranties or representations. If you are buying the property at a foreclosure auction, you should expect no guarantees at all.

Because of these risks, it is the buyer's responsibility to perform all due diligence investigations thoroughly and in advance. Many of the due diligence items mentioned below should be addressed and resolved before a buyer's earnest money deposit becomes non-refundable under the terms of any purchase agreement.

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Physical Condition of the Property

Buyers should always inspect the physical condition of the property and assess its current market value, based on that condition. Distressed properties frequently require repairs and may have building or health code violations. It is important to contact the appropriate government departments to check for any such issues and to estimate the costs of renovation and remediation.

Distressed properties may also have environmental issues. Many buyers choose to obtain a phase one environmental site assessment, which helps identify potential environmental risks. This assessment can be used to establish the buyer's entitlement to an "innocent purchaser" defense under applicable environmental laws if contamination is later discovered.

Government agencies are more likely to hold a buyer responsible for environmental problems if the buyer failed to perform basic environmental due diligence before acquiring the property.

Loan Documents

If you are planning to buy loan documents to complete a foreclosure, be aware that lenders will rarely share anything other than basic information. This usually includes payment history, copies of the loan documents, and the lender's title insurance policy and endorsements.

If the lender originated the loan, you may be able to obtain copies of the phase one environmental site assessment, surveys, plans, and some of the other due diligence documents reviewed by the lender when underwriting the loan.

Some lenders may allow you to examine the lender's loan files, though this is often subject to maintaining the privacy of confidential information about the borrower and guarantors. Keep in mind that these files may be incomplete, especially if the loan was held by a succession of lenders. Communications between the lender and borrower may have occurred by e-mail and may not be included in the file.

If the foreclosure has already been initiated, the borrower may have filed pleadings that raise defenses or counterclaims. In this case, the buyer's attorney should review the court file and assess any risks posed by these defenses and counterclaims, as they could significantly delay a foreclosure.

If the foreclosure has not yet been initiated, the buyer may not be aware of any allegations unless they are disclosed by the lender's files, assuming you are given the opportunity to review them. Ultimately, your best approach is to negotiate for as much information as possible from the lender and adjust your offer to reflect the potential risks posed by limited disclosure.

Land Use & Entitlements

If the distressed property is undeveloped or intended for redevelopment, it is important to determine what development entitlements exist. You'll also want to determine whether they run with the title to the property or if they can be acquired as part of the purchase.

Properties governed by a Planned Development (PD) zoning ordinance or local government Development Agreement with the owner can present unique challenges. These documents establish entitlements and impose conditions on development. In certain cases, developers obtained entitlements in the names of affiliates, and

those rights may not automatically transfer with the property, especially if they were not included in the description of the mortgaged property.

These situations can be difficult to resolve without the borrower's cooperation. Additional issues involving concurrency, road and utility capacity, school capacity and moratoriums should also be investigated.

Leases & Tenants

If the property is occupied by tenants, it is important to review their leases and any agreements they may have signed with the lender. Leases that provide below-market rent or other "sweetheart" deals should be foreclosed and extinguished, if possible.

Whether a tenant's rights can be extinguished in a foreclosure depends on the priority of the lender's mortgage. This is normally established by the dates they were entered into, with the first in time having priority. However, this order can be adjusted if the lender and the tenant enter into a Subordination, Non-Disturbance, and Attornment Agreement (SNDA) at the initial loan closing, or if the lease includes a self-operating subordination clause, making the lease junior to the mortgage even if the lease would otherwise have had priority.

An SNDA is often used when a lender wants to make a prior lease subordinate to its mortgage and requires the tenant to agree to recognize a new owner, such as a foreclosure buyer, as its landlord. In return, the tenant usually insists on a non-disturbance provision, which ensures that the lender (and any future owner) will honor the lease so long as the tenant is not in default. This means that even if the lease is technically junior to the mortgage, it may not be extinguished in a foreclosure unless the tenant is in default, which will require some investigation.

It may not be possible to eliminate the rights of all tenants in a foreclosure, and some lenders choose not to foreclose on certain leases even when they have the right to do so. If you are acquiring the loan documents and completing the foreclosure yourself, you may have the option to selectively extinguish junior leases during the process. However, if you are buying a Final Judgment and the foreclosing lender did not extinguish junior leases, you may still be able to do so after the fact, but that is a complicated process.

This process, known as "re-foreclosure," involves setting aside the Final Judgment, amending the foreclosure complaint to name any new parties, serving process on the new parties, and overcoming any defenses they may raise. Because this can take significant time and money, a complete analysis of leases during the due diligence period is particularly important if you are buying a Final Judgment or winning bid**.**

Status of Title

As part of the due diligence process, a prospective buyer should carefully review the status of the property's title. A title insurance company or agent can examine the title and issue a title insurance commitment. This document itemizes all matters affecting the title, including taxes and other liens, recorded restrictions, easements and similar title exceptions.

If you are purchasing loan documents from a lender, it is still important to have the title examined. In this case, the title insurance company can issue an "assignment of mortgage endorsement" to the lender's title insurance policy. This endorsement insures that the assignment of the mortgage to you is valid as of when it is recorded at closing.

If the foreclosure has been concluded and you are buying a Final Judgment, a winning bid, or bidding at the foreclosure sale, the title company should examine the foreclosure proceedings. This ensures that the process was property conducted and that no title issues exist due to procedural deficiencies.

A prudent buyer should review the title insurance commitment and all exceptions and encumbrances before proceeding. If you are acquiring loan documents, you should obtain an assignment of mortgage endorsement to the lender's title insurance policy. Once you take title to the property, you should also secure an owner's title insurance policy. Be sure to factor the cost of title insurance premiums when negotiating the purchase price.

Security Interests Granted by the Lender

When acquiring loan documents, a Final Judgment, or a winning bid, you are not technically acquiring real property, but rather personal property. However, for tax purposes, the Florida Department of Revenue equates a winning bid with real property for documentary stamp tax purposes.

It's important to understand that a lender may have pledged its interest in the loan documents, Final Judgment, or winning bid by granting a security interest to a third party. If the security interest is not released, you will acquire the loan documents, Final Judgment, or winning bid subject to the rights of the third party.

A security interest in loan documents may be perfected by giving the secured party possession of the original Promissory Note, so it is important for the purchaser of loan documents to obtain possession of the original Note whenever possible.

Additionally, a secured party may file a Uniform Commercial Code (UCC) Financing Statement with the Secretary of State in the state where the lender entity was formed. In Florida, this office is called the Florida Secured Transactions Registry. This filing names the lender as the debtor, identifies the secured party, and describes the collateral (i.e., the loan documents, Final Judgment or winning bid) in which it has a security interest.

Because UCC filings and federal tax liens are recorded at the state level and not in the county public records, a standard title search will not reveal them. As such, you should consider obtaining a UCC and federal lien search on the lender from these offices.

This is more likely to be an issue with loan documents, which lenders typically hold for longer periods, than with Final Judgments or winning bids. However, if the lender is willing to represent in the contract that it has not granted any prior liens, pledges, or security interests in the loan documents, and if the lender is financially stable, a buyer may decide to rely on that representation instead of doing separate searches.

Unpaid Real Estate Taxes & CDD Assessments

Unpaid real estate taxes and Community Development District (CDD) assessments can frequently be issues with distressed property acquisitions. Under Florida law, both taxes and CDD assessments constitute a first lien on the property. This means they survive a mortgage foreclosure, and the buyer will be responsible for paying them after acquiring the property if they want to keep it.

A title insurance commitment will typically disclose unpaid taxes and assessments. High balances can affect what a buyer is willing to pay. However, municipal or county liens, such as those for unpaid utility bills, may not appear in a standard title search if they are not recorded in the public records. These liens are often granted by city or county code and require separate searches, which the title company can perform for an extra fee.

In Florida, real estate taxes become delinquent if not paid by April 1 of the following calendar year. Once delinquent, the County Tax Collector can issue a Tax Certificate, which allows a third party to pay the taxes and later apply for a Tax Deed. If the property owner does not repay the taxes, interest, and costs, the Tax Certificate holder can take title to the property through a Tax Deed sale, typically after two years have passed from the date the taxes became delinquent.

CDD assessments pose similar risks. CDDs can enforce their liens in two ways:

1. Through the County Tax Collector – If the CDD assessments are included on the property tax bill, they follow the same process as unpaid real estate taxes, including the issuance of a Tax Certificate and potential Tax Deed sale.
2. Through judicial foreclosure – A CDD can elect to institute judicial foreclosure proceedings, similar to mortgage foreclosure, and sell the property at a foreclosure sale to recover unpaid assessments.

If a property has significant past-due CDD assessments, it may be possible to negotiate a settlement with the CDD. In some cases, the CDD's bondholders may accept less than the full amount owed if they believe a negotiated deal will yield more than a tax or foreclosure sale.

Additionally, it may be possible for the buyer to purchase the CDD bonds at a discount. The buyer can then direct the CDD to foreclose on the property and acquire it by bidding the amount owed under the bonds. Given that a CDD foreclosure will extinguish a first mortgage, this may be a valid option to acquire distressed property under the right circumstances. However, a CDD foreclosure will not extinguish county real estate taxes, since they have equal priority of lien as the CDD assessments.

Because properties within CDDs can present potentially significant complications, any investor considering such an acquisition should seek legal advice on the issues presented by the particular property.

Past-Due Condominium or Homeowners' Association Assessments

If the property is subject to a condominium or homeowners' association, it is important to determine whether the current owner is behind on assessment payments. In Florida, a buyer may be liable for some or all of the past-due amounts owed by the previous owner, depending on the association's governing documents and applicable law.

There may also be violations of the Declaration of Condominium or Declaration of Covenants that affect the property. Some condominium associations have the right to approve or reject prospective buyers, or even a right of first refusal to purchase the property themselves. Reaching out the association early in the process can provide clarity and comfort on these matters. If problems are uncovered, they will need to be addressed before closing or reflected in the negotiated purchase price.

In some cases, buyers may be able to obtain title insurance coverage against potential violations of covenants and restrictions affecting the property as part of the owner's title insurance policy that the purchaser obtains at closing.

Conclusion

Conducting due diligence when acquiring distressed real estate in Florida can be complex, but is essential to ensure a successful investment. Each parcel of distressed real estate presents varying risks and rewards depending on the particular facts, parties and circumstances involved. Working with an experienced real estate attorney well-versed in distressed real estate transactions can help ensure your transaction aligns with your interests.

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