Due diligence considerations for multi-national/multi-state commercial real estate transactions — with an emphasis on title insurance

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ABSTRACT
This paper discusses the due diligence aspects of the purchase of a portfolio of commercial properties located in multiple states and countries in connection with a corporate merger. It is written from the perspective of the in-house real estate counsel of the acquiring company. Items to be discussed include the selection and management of the team of due diligence professionals, eg outside counsel, title insurance company, land surveyor, building inspector and environmental engineer. Particular attention will be paid to the interaction of due diligence team members and to the title insurance aspects of the due diligence process.

Keywords: due diligence, multi-national, multi-state, commercial real estate transactions, title insurance

THE TASK AT HAND — ASSEMBLING THE DUE DILIGENCE TEAM
This paper is a primer for in-house counsels who have been tasked to handle the due diligence aspects of multi-state and/or multi-national commercial real estate acquisitions. Emphasis will be placed on the title and title insurance aspects of the due diligence process. In the USA, real estate transactions are primarily governed by state as opposed to federal law. In addition, with very few exceptions, the title to real estate is determined by an examination of recorded as opposed to registered deeds. Deeds are recorded in the ‘public’ land records that are maintained at the county and/or municipal levels of state government pursuant to the various ‘recording acts’ that have
been enacted by the state legislatures. (There are no state-wide or nation-wide land record databases that can be used to search the title to real estate in the USA.) In general, the main purposes of the recording acts or statutes are:

- to establish a priority system for the resolution of conflicting claims to real property; and
- to protect a *bona fide* purchaser who acquires an interest in that property.

Furthermore, there are four ‘types’ of recording acts or statutes in the USA: race, notice, race-notice and period-of-grace statutes.

Under the ‘race’ type of recording statute, priority is given to a subsequent purchaser who records their deed before a prior interest is recorded. The ‘notice’ style of recording statute gives priority to a subsequent purchaser who acquires an interest without notice of the prior interest. Under the ‘race-notice’ version, priority is given to a subsequent purchaser who acquires an interest without notice of the prior interest, but only if the subsequent purchaser also records that subsequent interest before the owner of the prior interest records that prior interest. Finally, under the so-called ‘period-of-grace’ type of recording statute, a subsequent purchaser will not prevail over a prior unrecorded interest if the prior interest is recorded within a specified grace period after the delivery of the deed. For further information about the history and use of the ‘recording acts’ in the USA, please see ‘Powell on Real Property’.

In most US states, deeds, mortgages, liens and other instruments that affect title to real estate are indexed by the recording clerks in the names of the parties mentioned in the instruments. For example, the names of the sellers, mortgagors and other parties who are granting an interest in the real estate are indexed in the ‘grantor index’ and the names of the buyers, mortgagees and other parties who are receiving an interest are indexed in the ‘grantee index’. In order to determine who has ‘title’ to a particular parcel of real estate, title searchers review the grantee-grantor indices for the preceding 40 years or more, depending on state law, and establish the ‘chain of title’ for the particular parcel of real estate that they are searching.

The complexity of the title record searching process in the USA led to the development of the title abstract and title insurance industries in the late 1800s. In some states, these industries also created privately-owned ‘title plants’ as a more efficient and accurate alternative to the official ‘public’ land records. For a detailed explanation about the title search requirements and real estate conveyance practices and procedures for each state, please see Boackle’s ‘Real Estate Closing Desk Book’.

In other countries, the title to real estate is often determined by some type of land ‘registration’ system or a ‘unified’ land taxation and title records system. Land registration systems are generally based on the Torrens Law that was enacted in South Australia in 1858:

‘The operative principle of the Torrens system is the *registration of the title* to land, instead of the *evidence of that title* as under the recording system. Under the Torrens registration system, only the ultimate fact that a certain named party has title to a particular parcel of land is registered, and a certificate indicating that fact is delivered to him or her. (Citations omitted.) Under the recording system, the entire evidence of title and matters affecting it (ie deeds, mortgages, liens, and so forth) are recorded’ (emphasis added).

In a nutshell, under a title ‘registration’ system, title to real estate is ascertained by means of an official certificate, whereas under a title ‘recording’ system, title is determined by a search, examination and analysis of the ‘evidence of title’ which is on file in the recorder’s office.
office. That search, examination and analysis is usually performed by a private attorney, title abstractor or title insurance company as opposed to a governmental official. Furthermore, unlike in the USA where notaries are limited to performing authentication services in connection with the execution of deeds etc, in other countries, ‘public notaries’ must be used to perform various title conveyance and registration functions instead of attorneys, title abstractors and title insurance companies. Also, in some jurisdictions, public notaries are appointed for ‘life’ or very long terms and are given ‘exclusive’ territories in which to operate. Because of all of these ‘local’ considerations, an in-house counsel in charge of a multi-national and multi-state real estate portfolio transaction often assembles a team of real estate professionals to provide the local and site-specific expertise needed to accomplish the task of making sure that all of the real estate gets transferred properly.

Depending on the legal expertise and qualifications of the in-house real estate counsel and the location of the properties, the in-house legal counsel usually retains a real estate attorney or law firm that provides jurisdiction-specific legal advice on the transaction. When the properties are located in multiple states and countries, it is not uncommon for an in-house counsel to retain a large law firm that has offices or affiliates in those states and countries, which frees up the in-house counsel from the task of trying to find a qualified attorney for each location. The in-house counsel can also ‘deputise’ or designate the ‘lead attorney’ at the law firm to coordinate the closing, prepare/review the deeds and analyse the title reports etc, so that the in-house counsel can concentrate on the ‘big picture’.

For the same reasons, the in-house counsel may often select a single title insurance company, land surveyor, building inspector and environmental engineer instead of hiring several ‘local’ firms. Having single points of contact for legal, title, survey and site-specific physical information saves time in explaining the deal repeatedly to multiple vendors and often results in a saving of fees.

To find due diligence professionals who offer single points of contact for national and/or international commercial real estate transactions, refer to the websites of the respective trade associations for these professionals. These websites often contain profiles or advertisements for members, articles on due diligence topics etc. While access to some parts of these websites is limited to members, most offer some public pages that are helpful. In all cases, however, it is advisable to obtain references for such vendors. Examples include the American Bar Association, American College of Real Estate Lawyers, American Land Title Association (ALTA), The Royal Institution of Chartered Surveyors, National Society of Professional Surveyors (NSPS), American Congress on Surveying and Mapping (ACSM) and the Institute of Professional Environmental Practice.

GETTING ORGANISED — BUILDING THE CHECKLIST AND ‘WAR ROOM’

With the due diligence team in place, it is recommended that the in-house counsel now turn to the task of developing a comprehensive, transaction-specific checklist to keep track of all of the details involved in a portfolio acquisition transaction. These checklists are usually placed on a file server or website so that various members of the due diligence team working in different locations can update the checklist as tasks are completed. This also allows the in-house counsel to easily monitor the progress of the due diligence and to add tasks as needed. These checklists are often divided into the following major categories:

- **General information:** property addresses; lot numbers; tax identification numbers; record
owners’ names; list of tenants; number, types and uses of buildings and other improvements etc.

- **Title and survey:** copies of prior and new title insurance policies; abstracts; deeds; covenants; restrictions; easements; mortgages; liens; notices of leases and surveys, maps and plats; tenant estoppel certificates and proofs of vehicular and pedestrian access to public streets etc.

- **Real property taxes and other governmental assessments:** copies of all tax bills, notices and assessments.

- **Zoning, subdivision and land use matters:** planning and zoning reports, copies of permitted use and subdivision approvals and violation notices etc.

- **Structural condition information:** copies of building plans, permits and certificates of occupancy and violations notices, equipment warranties, building condition report performed by a qualified inspector etc.

- **Tenants and subtenants:** complete copies of all tenant leases and amendments, security deposits, utility bills, floor plans and information about tenant improvements, common area maintenance (CAM) information and calculations, and service contracts.

- **Utilities:** information about the sources of all utilities, copies of bills etc.

- **Insurance:** obtain property and casualty insurance, obtain information about pending premise-related litigation and claims etc.

- **New financing or financing to be assumed by the purchaser, if any:** copies of all notes, mortgages/deeds of trust, loan documents etc.

- **Eminent domain:** notices of any condemnation or eminent domain proceedings that may affect the property.

- **Appraisals.

- **Permits and licences:** copies of all permits, licences and other governmental approvals that affect the property.

- **Property agreements:** copies of all property management and maintenance agreements.

- **Personal property:** obtain a list of all personal property (eg equipment, furnishings etc) that will remain on the property and obtain all bills of sale and other ownership documentation relating to same.

- **Historic property designations:** obtain any documentation concerning designations of historical status etc.

- **Americans with Disability Act (ADA):** copies of all documents, notices, audits and reports related to ADA matters that affect the property.

- **Adjustments:** obtain information needed to make any financial adjustments for taxes etc at closing and determine the local customs that apply to those adjustments.

- **Visual Artists Rights Act (VARA):** determine whether there are any murals or other works of art that will remain with the building.

- **Environmental matters:** obtain all of the required ownership information and conduct the relevant environmental site assessments, underground storage tank evaluations, analysis of prior and ongoing operations on the property that involve the use and storage of hazardous materials, waste management facilities, water and air discharges, and the presence of PCBs, radon, lead etc, and review all federal, state and local environmental enforcement and inspections actions that affect the property.

In addition to electronic checklists, many companies use electronic ‘war rooms’ or online transaction document depositories that are created by the company itself or by the outside law firm, the land surveying company or title insurance company. These secure websites allow the various participants to easily upload and share the land surveys, title reports, building inspections, deeds, easements, leases, mortgages etc. After the transaction is closed, the final transaction documents are often downloaded to a compact disc or other website for future reference.
For additional topics to include when building a due diligence checklist, please see Stein et al.’s ‘A Practical Guide to Commercial Real Estate Transactions’.12

COMMENCEMENT OF THE DUE DILIGENCE PROCESS — ORDERING THE SURVEYS, TITLE REPORTS, STUDIES, ETC

To keep the process moving smoothly, it is suggested that the in-house counsel hold a conference call or meeting to introduce all of the members of the due diligence team to each other and to establish the all-important distribution list for reports. For example, the title company is usually instructed to distribute the title reports, commitments and copies of instruments that appear in the chain-of-title to the surveyor and outside counsel at the same time that it sends them to the in-house counsel, and the surveyor is instructed to distribute its surveys to the title company and outside counsel at the same time that it delivers them to the in-house counsel. In cases where there is an electronic ‘war room’, the electronic system can be configured to automatically notify the appropriate parties when the reports and surveys are uploaded to the war room website. Clear communication at this step is essential. In the rush to order title searches and surveys, mistakes are often made in identifying exactly which properties are involved in the project and precisely what types of reports or surveys are needed.

For example, instead of sending the title company and surveyor copies of prior deeds or title insurance policies for the properties which contain the names of the parties and precise legal descriptions of the land, some in-house counsels just send out a spreadsheet with a list of street addresses. In many parts of the USA and in other countries, title records are not indexed by street addresses. In most jurisdictions, deeds, mortgages, liens and other legal instruments that affect title to real estate are indexed in the names of the parties recited in the deeds etc. These names are clustered into two search groups: the grantees (eg buyers, lenders and lien holders) and the grantors (eg sellers and mortgagees). Other jurisdictions index property transfers by the lot or tract numbers that are recited in the legal descriptions contained in the deeds and other instruments.

Another common mistake that is made at this point in the due diligence process is carelessness in specifying exactly what type of title report or land survey is desired. For example, the terms title report/certificate, title abstract and title insurance commitment have very different meanings:

• A title report issued by a title company usually provides the name(s) of the current owner(s); a ‘legal’ description of the property (that either references a recorded map or calls out the exact metes and bounds of the property); and a list of the mortgages/deeds of trust, liens, easements, restrictive covenants and other recorded instruments that encumber the title. When a title report is issued by an attorney-at-law, it is often referred to as an attorney’s certificate of title or title opinion. Regardless of whether the title report, certificate or opinion is issued by a title company or an attorney, the liability is limited.

• A title abstract, on the other hand, is simply a collection of either summaries/abstracts or photocopies of the recorded instruments that the title abstractor found during their search of the chain of title to the property. In many jurisdictions, the abstract is given to an attorney, title examiner or title insurance company to review the copies and abstracts and issue either a title report/certificate or commitment that specifies:
  — who owns the property;
  — the proper legal description; and
  — the list of liens and encumbrances that affect the title.
• A title insurance commitment includes all of the property-specific information contained in a title report or certificate. In addition, however, it also includes a commitment by a title insurance company to issue its policies of title insurance provided that certain requirements are met. These requirements often include specific recommendations as to how to cure various defects in the title (see below for additional information on title insurance commitments).

Likewise, there are different kinds of land surveys. For example, in commercial transactions, it is customary for the buyer or lender to request an ‘ALTA survey’ in those states where it is available. The contents of an ALTA survey are specifically set forth in the ‘Minimum Standard Detail Requirements for ALTA/ACSM Land Title Surveys’ (effective 23rd February, 2011) as issued by ALTA and ACSM. Furthermore, the ALTA survey standards include 21 ‘Optional survey responsibilities and specifications’ in Table A. For a copy of the ALTA 2011 survey standards, please click on the ‘Related documents’ button in the ‘Policy forms’ section of the ALTA website.13

Accordingly, in order to avoid delays, extra costs and future disappointments when the wrong product shows up, it is highly recommended that the title reports, title commitments and surveys be ordered carefully and with great specificity. A miscommunication at this point in the due diligence process can easily result in failure to meet the due diligence deadline set forth in the purchase and sale agreement and the forfeiture of the deposit or down payment.

THE IN-HOUSE COUNSEL’S DREAM — SEEKING STANDARDISATION IN A LAND OF DIFFERENCES

One of the biggest challenges inherent in a multi-state or multi-national real estate transaction is dealing with the absence of uniformity and standardisation in just about all aspects of the transaction. This is the case because the ownership and conveyance of real estate is controlled in large part by state and local laws, regulations and customs. For example, the parties will often find that they cannot use the same form of deed to transfer all of the properties in all of the states and countries involved in the transaction. Each state and country has its own detailed requirements as to the wording, font type, margins, paper size and deed execution requirements that must be used to transfer the title to real estate. In the heat of battle, it is not uncommon to hear the in-house counsel yell out in frustration: ‘That’s a stupid requirement! Why can’t they do it the way we do it in this state? It’s perfectly legal here. They need to change their law!’ One way to avoid this frustration is to have one of the attorneys or paralegals on the due diligence team assemble a spreadsheet that lists all of the items that vary by law and/or custom in each of the states and countries involved in the transaction and then gather that information. Here are some of the variable items:

• What are the proper forms of deed needed to transfer title?
• What are the proper deed execution and acknowledgment requirements?
• What is the usual loan encumbrance form? Mortgage or deed of trust?
• Who is the customary/required closing entity or professional? Attorney, title insurance company or public notary?
• Is there a transfer or conveyance tax due when the deed is recorded or registered? If so, is the tax collected at the state/county/municipal or all levels of government?
• Is there a ‘controlling interest’ transfer tax due in cases where only the controlling interest in the corporation or a limited liability company that has title to the property is transferred? Note: This is often very important in corporate merger transactions.
Is there a mortgage tax due upon recordation/registration of a mortgage or deed of trust? If so, is the tax collected at the state/county/municipal or all levels of government?

Is there a leasehold tax due? If so, is the tax collected at the state/county/municipal or all levels of government?

Are the title insurance premiums regulated by the state? If so, do all companies charge the same rates (ie rates are promulgated), or is each company permitted to file its own rates? If not, then the rates may be negotiable.

Do the title insurance premiums include the cost of the title search and examination?

Which party to the transaction customarily pays for the title insurance policies, title search and examination, survey, closing, recording fees etc?

In transactions involving properties in countries other than the USA, are there restrictions on foreign ownership of real estate? What constitutes a title transfer, what types of instruments must be registered and are there time limits on when the instruments must be registered?

Many of the major title insurance companies have websites and publications that provide the state, county and, in some cases, country-specific answers to these questions. One caveat to note is that, as country, state, county and municipal governments frequently change their deed/conveyance, mortgage, controlling interests and leasehold tax rates and recording fees, it is very important to verify the exact amount of the taxes and fees due within a few days of the closing.

**TITLE INSURANCE ASPECTS OF THE DUE DILIGENCE PROCESS**

In an effort to bring standardisation to the real estate transaction process in the USA, ALTA periodically publishes standard forms of title insurance policies and endorsements that are generally acceptable to buyers and lenders in all but a few states. In conjunction with ACSM and NSPS, ALTA also publishes minimum standard detail requirements for land title surveys. Further information about these forms and survey standards can be found on the ALTA website.14

Although title insurance has been available in some parts of the USA since the late 1800s, it did not become widespread until the 1970s. Many people familiar with the title insurance industry credit the creation of the secondary mortgage market by the Federal National Mortgage Association (Fannie Mae) in 1970, and other subsequently established government sponsored entities (GSEs), such as the Federal Home Loan Mortgage Corporation (Freddie Mac), as the catalyst for the spread of title insurance throughout the USA. Prior to 1970, most local banks and savings and loan associations held their mortgages in their portfolios until maturity, sale or refinance. In the eastern states, it was customary for the lender to obtain a certificate of title or title opinion from a local attorney to provide assurance to the lender that the borrower/mortgagor did, in fact, hold clear title to the real estate pledged to secure the loan and that the lender’s mortgage was not subject to any preceding mortgages, judgment, liens etc. These title certificates and opinions varied widely in form, contained disclaimers for most off-record matters such as physical encroachments, and were unenforceable against the issuing attorney after expiration of the statute of limitation for negligence and before that time if the attorney did not have any assets or malpractice insurance.

When Congress authorised Fannie Mae to create a secondary mortgage market in 1970, local banks started to assign their mortgages to Fannie Mae. It was shortly thereafter that Fannie Mae and Freddie Mac, in an effort to create standardisation and uniformity in the mortgage industry, started to ask that the title to the assigned mortgage be
insured by a standardised title insurance policy issued by a financially secure title insurance company instead of being backed by an individual attorney’s certificate of title or title opinion. Working with Fannie Mae and other industry groups, ALTA modified its existing policy forms at that time and created uniform policies and endorsements that could be more easily adopted for use in most jurisdictions.

There are two basic types of ALTA title insurance policies:

- the owner policy, which, as the name implies, insures the owner’s title to the real estate; and
- the loan policy, which insures the title to the lender’s mortgage on the owner’s real estate.

Both policies are subject to certain terms and conditions and pre-existing matters such as easements, restrictions and unless paid at closing, liens and taxes. Prior to the issuance of its policies, the title insurance company issues a title insurance commitment, which advises the proposed insured of the current record ownership of the property and the status of the title. It also includes the recorded legal description of the property and a list of requirements or corrective actions that need to be undertaken before the company will issue its policies. ALTA also has adopted several endorsements that provide additional coverage to the insured. The latest versions of these policies, commitments and endorsements were adopted in 2006 and these forms are now used in most states. For a detailed discussion of title insurance, please see Gosdin’s ‘Title Insurance: A Comprehensive Overview’.

Although ALTA has not published title insurance forms for use in countries other than the USA, most of the major title insurance companies that operate outside the USA have developed policy, commitment and endorsement forms that are based on the ALTA forms, but have been adapted to local use. Accordingly, there is some standardisation outside the USA as well. In addition, in certain countries, some title insurance companies have developed single-risk indemnities to provide coverage for title risks that cannot be either legally or economically cured and gap coverage indemnities to provide assurance to a lending bank that its mortgage will be registered in the registry and that the bank will have the first or priority position during the period between the date of its application and the mortgage registration.

The availability of standard title insurance forms makes life a lot easier for an in-house counsel charged with handling a large multi-state commercial real estate transaction. The first document that the in-house counsel receives from the title insurance company is the title insurance commitment. As explained above, this document gives the in-house counsel vital information about the status of the title to the property that their company is about to acquire. Attached to the commitment are copies of all of the recorded instruments (eg mortgages, judgments, tax liens, covenants, easements and notices of leases) that affect the title to the property.

The commitment and its attachments are quickly shared with other members of the due diligence team. For example, the outside counsel needs to review all of the restrictive covenants and notices of leases listed in the commitment in order to protect their client’s interests, and the surveyor needs to review the legal description and easements in order to verify the accuracy of the description and the location of the easements.

Unlike most kinds of insurance, which are designed to just spread risk, title insurance is often considered to be a type of risk elimination insurance. Nowhere is this concept more evident than in the requirements section of the title insurance commitment. In that section, the title company notes any defects in the title and recommends the curative actions that must be undertaken before it will insure the title. Needless to say, this type
of information is critical to an in-house counsel who is in charge of the due diligence aspects of a multi-site real estate transaction.

After the in-house counsel, the outside attorney and the surveyor have reviewed the title commitment and its attachments, they prepare the deeds and other transfer instruments, update the existing survey or create a new survey. These instruments and surveys are then sent to the title insurance company underwriting counsel for review as to insurability etc.

The in-house counsel works with the title insurance company’s underwriting counsel to draft the final versions of the owner policy. That policy will be used to insure the buyer’s title to the properties. The in-house counsel, the counsel who is representing the lender and the title insurance underwriting counsel then settle on the final version of the loan policy that will be used to insure the title to mortgages involved in the transaction. These attorneys also decide on what endorsements will be used on each policy. These negotiations are governed, in large part, by the state and/or foreign laws and regulations that affect real estate and mortgages and by the state and/or foreign laws that regulate the title insurance industry.

CONCLUSION

At the outset, the task of conducting the due diligence on the purchase of a portfolio of commercial properties located in different states and countries looks daunting. But if the in-house counsel assembles a due diligence team composed of the right real estate professionals, uses a thorough checklist and well-organised war room, and obtains appropriate title insurance policies and endorsements, they can accomplish the task quickly, accurately and safely.

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REFERENCES

(3) Powell, ref. 1, above, Vol. 15, section 83.02.
(9) See: www.nspsmo.org.
(10) See: www.acsm.net.
(13) See: http://www.alta.org/forms.