# The Due Diligence Process

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# I. INTRODUCTION

Substantial due diligence is necessary in any real estate transaction to ensure that the property is what is bargained for.

# II. TITLE ISSUES

## A. TITLE EXAMINATION

The purpose of title examination is to establish who owns what interests in the property, what encumbrances or other restrictions may affect the property, and whether the title is marketable. A marketable title is one free from reasonable doubt that a prudent person would be willing to accept. While title examination is an important part of establishing the marketability of title, a thorough physical examination of the property is still necessary to reveal a number of other issues that may not be discovered in the title examination process.

Basic due diligence in the title examination process generally begins after a purchaser executes a purchase agreement to buy real property. The buyer should confirm that the seller actually owns the real estate being sold, and that the real estate is not subject to any encumbrances the buyer is not willing to accept. The best way to accomplish this is through title insurance.

## B. TITLE INSURANCE

### 1. Introduction

Title insurance is an essential component of any real estate transaction. Every purchaser should review the status of title and a proper survey of the property to be purchased before making the decision to purchase.

## 2. What is Title Insurance?

Title insurance is an indemnity contract providing insurance to the insured to pay the costs of a resulting loss if any interest adverse to the interest of the record owner is not reflected in the policy. The title insurance company promises to defend the title against adverse claims, subject to the provisions of the title insurance policy. **NOTE:** title insurance is not an absolute guarantee as to the status of title; rather, title insurance provides that in the event of loss of possession or other loss, the insured will receive money damages measured by the amount of actual loss or damage sustained, and limited to the face amount of the policy. The title insurance company will also pay the costs, including attorneys' fees, incurred in defending title to the extent provided in the Conditions and Stipulations in the policy.

## 3. History of Title Insurance in the United States

Title insurance did not exist in the United States prior to 1874. The only assurance a purchaser of real property could obtain regarding the status of title was the opinion of an attorney given based on an abstract of title. If the opinion or abstract was in error the purchaser could maintain an action against the attorney or the abstracter for damages, only if the attorney was negligent in the discharge of his duties. Following an 1868 decision of the Pennsylvania Supreme Court, *Watson v. Muirhead*, the Pennsylvania legislature enacted the first title insurance statute in the United States, and in Philadelphia in 1876, the first title insurance policy was issued.

## 4. The American Land Title Association

The American Land Title Association ("ALTA"), founded in 1907, is the national trade association and voice of the abstract and title insurance industry.

ALTA is responsible for the forms upon which nearly all title insurance is written in the United States. These forms provide a great deal of uniformity and they require minimal alteration. By having a standard form for each transaction necessary to a title insurance policy, the system of land exchange remains remarkably smooth throughout the country. There are six basic ALTA policies of title insurance: Lenders, Lenders Leasehold, Owners, Owners Leasehold, Residential (plain language), and Construction Loan policies. Additionally, a special policy has been designed for use by the United States Government in its purchases and condemnations.

Major revisions of the ALTA policy forms are made every few years, usually as a result of either a lender's request, a perceived ambiguity in existing language, or as an answer to a court whose decision interpreted a policy in a different manner than deemed proper within the title industry.

### 5. The Title Insurance Commitment

The title commitment is the initial document issued by the title company that sets out the company's conclusions as to the status of the title. The commitment also states the terms on which the insurer will issue the final policy. The seller usually provides a title commitment to the purchaser within ten days of the execution of the purchase agreement. The title commitment will reveal to the purchaser if there are title issues that need to be corrected before purchase and if there are title issues that the purchaser may want to get additional title insurance to cover.

The commitment consists of (1) a pre-printed cover, (2) Conditions and Stipulations of the contract between the underwriter and the customer, (3) Schedules A and B exceptions, and (4) all relevant attachments, such as easement maps or surveys. The Schedule B exceptions will generally be the purchaser's focus.

#### a. Schedule A

Schedule A of the commitment sets forth basic information such as:

- The effective date of the commitment
- The estate or interest covered by the commitment
- The name of the vestee of the estate or interest
- A description of the land referred to in the commitment
- The name of the proposed insured
- The type and amount of each policy to be insured
- The title company's file number

**b. Schedule B**

Perhaps the most important component of the title commitment, Schedule B lists all exceptions to coverage under the policy. Exceptions are of two (2) types: general and special.

General exceptions usually appear on all commitments. There five standard general exceptions:

- rights or claims of parties in possession not shown by the public records
- encroachments, overlaps, boundary line disputes, and any other matters which would be disclosed by an accurate survey or inspection of the premises
- Easements, or claim of easements, not shown by the public records
- Any liens, or right to a lien, for services, labor, or material not shown by the public records
- Matters first occurring after the effective date of the policy and prior to the creation of the interest to be insured

Special Exceptions typically include items which must be addressed and corrected by the buyer before issuance of the policy, or else the policy will exclude coverage of the items. Special exceptions often include:

- unpaid taxes or assessments

- existing mortgages
- adverse claims
- defects in description or vesting of title
- defective access or lack of access to property
- any other judgments, liens, easements, restrictions, covenants, conditions, or other encumbrances unique to the property

### 6. The Title Insurance Policy

The title insurance policy insures estates of ownership and possession against loss or damage due to:

- Title to the estate or interest described in Schedule A being vested other than as stated therein
- Any defect in or lien or encumbrance on the title
- Unmarketability of the title
- Lack of a right of access to and from the land

A title insurance policy will cover matters that occurred before the effective date of the policy, insuring the lender against damages that may result from unknown defects that stained the title prior to the policy's start date. For example, the title insurance policy could cover losses due to another unknown creditor's priority.

With insurance of title, the insurance policy fixes a maximum amount of coverage for liability on a flawed title. Title policies will automatically insure the lender against later damages that arise due to *unknown* title defects. Unknown defects may include liens or encumbrances recorded during the gap in time between when a document is recorded and when title records get certified. Other examples of unknown defects are forged mortgage satisfaction documents or deeds in the chain of title. In addition to such unknown risks, title insurance

companies are often also willing to accept *known* risks. For example, a title insurance company is often willing to provide coverage on a title with a known defect such as a small judgment. The insurance company knows that it will only have to sustain insurable loss in the event of a foreclosure, which is relatively uncommon. An uninsured lender, however, would not be likely to assume the known business risk so freely.

Liability under an owner's policy continues as long as the insured either has an insurable interest or has liability under any conveyance given. Protection under the owner's policy is subject to certain "Exclusions from Coverage" which are pre-printed on the inside front cover of the policy, including:

- Laws or ordinances restricting the use of the land
- Governmental rights of the police power or of eminent domain
- Defects created by the insured or known to the insured and not the insurer
- Defects attaching subsequent to the date of the policy, or loss which would not have been suffered if the insured had paid value for the property
- Certain claims arising out of the operation of certain creditors' rights laws

The final title insurance policy is typically issued in one of the uniform policy forms adopted by ALTA. These forms are:

- ALTA commitment
- Standard owner's policy
- Standard loan policy
- Extended loan policy
- Owner's policy

### 7. Endorsements

Endorsements are added to title insurance policies for a variety of reasons. They may be added for routine corrections, such as to change spelling or correct typos in the policy. Endorsements may also be pre-printed forms, called standard endorsements, which address specific issues or provide certain coverages. Endorsements are typically requested by insureds to provide them with additional title protection.

There are twelve standard endorsements – referred to by their ALTA number (1-12) – consisting of:

1. Street Assessments -- provides specific coverage against liens for street improvements completed or under construction as of the date of the policy and not excepted in Schedule B

2. Truth in Lending – provides coverage to mortgage lenders who are concerned by the right of rescission given to a borrower under TILA; does not guarantee that lender did not violate the law but insures against termination of the insured mortgage lien or loss of title to the security resulting from the right of the borrower to rescind

3. Zoning – 3 is for land with construction taking place; 3.1 is for land with buildings; insures against forced removal of buildings in order to comply with zoning ordinances

4. Condominium – for lenders on condominium projects

5. PUD

6. Variable Rate Mortgage Endorsements – insures lenders with variable rate mortgages who are concerned about challenges to the priority of their mortgage liens

7. Manufactured Housing Unit Endorsement

8. Environmental Protection Lien Endorsement

9. Restrictions, Encroachments, Minerals Endorsement

10. Assignments

11. Modification of Mortgage

12. Aggregation or “Tie-In” Endorsement

There are also many non-standard endorsements, depending on the characteristics of the individual property and the how much title insurance coverage the purchaser desires. With the increasing complexity of both the conveyancing and the financing of real estate transactions, there are more and more situations that require specific endorsements. ALTA has created various endorsements or groups of endorsements that include, but are not limited to, coverage for zoning, condominiums and planned unit developments, variable rate mortgages, residential environment liens, and special restriction, easement and mineral problems.

Examples of non-standard endorsements include:

- Access Endorsement – access to a specifically identified physically open street
- Survey Endorsement – land insured under policy is same as land shown on a specific survey
- Usury Endorsement – may be issued where the transaction falls within an exemption of Minnesota’s usury law
- Increased Coverage – guarantees that upon completion of improvements, coverage amount increases to value of property with improvements
- First Loss – allows the insured to recover up to the amount of its insured loss without pursuing other remedies against other collateral prior to tendering a claim (such as marshalling assets)
- Last Dollar Endorsement – requested when the amount insured under the policy is less than the amount stated to be secured by the mortgage (used when the lender holds other collateral as security for the loan)

## III. Environmental Assessments

Like a certificate of title, an environmental site assessment looks to past events to convey information regarding the present condition of the real estate. To this end, an environmental consulting firm should be hired to look for any past commercial or industrial activities or events that may have contaminated or otherwise affected the site. These searches are conducted

through a "Phase I" environmental site assessment and a "Phase II" environmental site assessment.[1]

### A. "Phase I" Environmental Assessment

The "Phase I" investigation is designed to reveal any potential for contamination on the site. In a "Phase I" investigation, an environmental consulting firm can provide an assessment of the activities of the property's prior owners. The assessment can also include a look at the activities of current and prior owners of neighboring cites. Typically, the Phase I assessment also involves a visual observation of the property, in an effort to observe any features that may point to the presence of potentially hazardous materials such as storage tanks or disposal zones. *See* 25 Minn. Prac. § 9.20(a).

The requirements of the assessment are flexible, and will vary with the circumstances. Real Estate with a long history of industrial use will require a thorough and rigorous assessment; a previously undeveloped site will require very little assessment. The purpose of the "Phase I" assessment is to determine whether the real estate is subject to recognized environmental conditions, i.e. the presence or likely presence of any hazardous substances or petroleum products on a property under conditions that indicate an existing release, a past release, or a material threat of a release of any hazardous substances or petroleum products into structures on the property or into the ground, ground water, or surface water of the property. As such, the process consists of the following:

- Property Records Review
- Visual Inspection
- Interviews with Current and Past Owners

[1] *See generally* ASTM E1527-05 "Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process;" ATSM E1903-97 (2002) "Standard Guide for Environmental Site Assessments: Phase II

- Interviews With Local Government Officials

If the Phase I assessment demonstrates any signs of contamination, the lender should engage the environmental consulting firm in a "Phase II" assessment.

### B. "Phase II" Environmental Assessment

The primary objectives of conducting a Phase II assessment are to evaluate the recognized environmental conditions identified in the Phase I assessment for the purpose of providing sufficient information regarding the nature and extent of contamination to assist in making informed business decisions about the property; and where applicable, providing the level of knowledge necessary to satisfy the innocent purchaser defense under CERCLA. In Phase II, the assessment actually includes a physical inspection of the site, such as soil boring or groundwater sampling, in an attempt to ascertain with more certainty whether contamination has occurred. *See* 25 Minn. Prac. § 9.20(a).

Again, the standards for a Phase II assessment are flexible, and depend upon the scope of the users objectives. The mere confirmation of contamination or the preliminary indication of the extent and magnitude of contamination may be sufficient for the purposes of many users. If a user desires a more complete characterization of the environmental condition of the property, further assessment may be undertaken. Accordingly, the assessment may require multiple iterations, or may be subject to termination at the point where sufficient data have been generated. At the completion of a Phase II assessment, the environmental professional should be able to conclude, at a minimum, that either:

> *(a)* the assessment has provided sufficient information to render a professional opinion that there is no reasonable basis to suspect the presence of hazardous substances or petroleum products at the property associated with the recognized environmental conditions under assessment; or

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Environmental Site Assessment Process." Available at www.astm.org.

> *(b)* the assessment has confirmed the presence of hazardous substances or petroleum products at the property under conditions that indicate disposal or release.

If the data generated is insufficient to support either of the above propositions, additional iterations of the assessment may be required.

The assessment is intended to identify recognized environmental conditions and develop technically sound data. It is not intended to satisfy the level of inquiry that may be necessary to support remedial solutions for a site.

## IV. Survey and Boundary Issues

A mortgage and a security agreement must contain a legal description of the real estate that secures the commercial loan. Where title insurance provides a legal description of the land, a survey is a different kind of insurance. A survey can be used to confirm that the legal description of the real estate accurately depicts the real estate contemplated in the transaction. A survey can also provide a detailed account of existing conditions on the real estate.

The American Land Title Association ("ALTA") has set standards for surveys, as well as titles, and a surveyor's work generally conforms to these standards. The surveyor will address the most basic of issues, such as a boundary lines. The boundary line survey assures the lender that the structures securing their transactions are actually on the borrower's property. The surveyor will also address complicated issues, such as the conditions that exist on the property. With larger structures and properties, the lender will benefit from the survey's visual depiction of how municipal codes or ordinances have placed conditions on the real estate. For example, the survey may be able to reveal conditions on setbacks, parking spaces, or utilities more accurately and clearly than a legal, textual description. Other conditions that are important to be aware of

are the existence and location of any easements or riparian interests on the property. The surveyor should draw attention to all such conditions.

Once the survey is complete, the attorneys should compare the survey with the legal descriptions of the real estate. Specifically, the attorneys should look for any ambiguous or erroneous legal descriptions. The attorney will also want to assess whether there are any conditions that may prevent the buyer from conducting their intended business. The diligent lawyer should also become aware of any prior surveys on the real estate, and check to see whether prior surveys conflict with the present survey.

In attending to the red tape, the survey certification form should be checked to ensure that it is addressed to all required parties, that it is signed, current, and in the required form. Finally, the survey certification form should be attached to the current title commitment.

While a survey may be relied upon even if it contains errors, there is a two-year statute of limitations on survey errors, except for where fraud is involved. Minn. Stat. § 541.052. Attorneys will also want to maintain the survey certification by keeping it up to date and accurate, and call the insurance company and/or surveyor to update or recertify the survey as needed.

## V. Wetlands Issues

The Wetland Conservation Act ("WCA") regulates the draining and filling of wetlands.[2] The Minnesota Board of Water and Soil Resources ("BWSR") has promulgated regulations to implement the WCA. Minn. R. 8420. Wetlands are defined by the presence of hydric soils,

[2] *See, e.g.,* Minn. Stat. § 103G.221 (stating the general prohibition against draining public wetlands); Minn. Stat. § 103G.222 (setting forth wetland replacement requirements).

surface or subsurface hydrogeology, and hydrophilic vegetation.[3] Generally, wetlands must not be drained or filled unless (1) a drain or fill activity is exempt under the rules, or (2) the wetlands are replaced by restoring or creating wetland areas of at least equal public value. Minn. R. 8420.0105. "Public waters wetlands," which are regulated by the Minnesota Department of Natural Resources ("DNR"), generally may not be drained or filled unless replaced by wetlands of greater or equal value.[4] Local governmental units ("LGUs") regulate other types of wetlands with oversight by BWSR. Generally, the LGU is the city or county, but may be another entity such as a watershed district or a soil and water conservation district.[5]

The WCA specifies ten categories of exempt drain and fill activities for which no permit or approval is required. Minn. Stat. § 103G.2241; Minn. R. 8420.0122. Express exemptions include those for certain agricultural activities, maintenance of existing public drainage systems, and previously approved developments. Minn. R. 8420.0122. The rules also provide a *de minimis* exemption for activities that drain or fill less than 400 square feet. Minn. R. 8420.0122(9)(A)(4)-(5). Other *de minimis* exemptions can range from 2,000 to 10,000 square feet, depending on the type, location, and ownership of the wetland. Minn. R. 8420.0122(9)(A)(1)-(3).

If an activity is not exempt, affected wetlands must be replaced under a replacement plan approved by the LGU. Minn. Stat. § 103G.2242; Minn. R. 8420.0230. If a wetland replacement

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[3] *See* Minn. R. 8420.0110(52)(D) (defining wetlands and explaining that a wetland boundary is determined according to the United States Army Corps of Engineers Wetland Delineation Manual (January 1987) and that wetland type is determined according to United States Fish and Wildlife Service Circular No. 39 (1971 edition)). *But see Rapanos v. US*, 126 S.Ct. 2208 (2006) (only those wetlands with a continuous surface connection to bodies that are waters of the United States in their own right are adjacent to such waters and covered by the Clean Water Act).

[4] Minn. Stat. § 103G.222(1); *see also* Minn. Stat. 103G.005(15)(a) (defining public waters wetlands to mean all types 3, 4, and 5 wetlands as defined in United States Fish and Wildlife Service Circular No. 39 (1971 edition)).

plan is not approved, the person seeking plan approval may drain or fill the wetland or obtain partial compensation for the loss of use of the land. Minn. Stat. § 103G.237(2). The replacement plan must demonstrate that (1) wetland impacts are avoided if possible, (2) to the extent they cannot be avoided, wetland impacts are minimized, and (3) unavoidably affected wetlands are replaced as required by the rules. Minn. R. 8420.0520.

Those rules include specific requirements regarding location, size, and type of replacement wetlands. Minn. R. 8420.0546, 8420.0550. The minimum replacement ratio is generally two acres of replaced wetland for each acre of wetland drained or filled. Minn. Stat. § 103G.222(1)(e). For wetlands on agricultural land, or in counties in which 80 percent or more of the pre-settlement wetlands still exist, minimum replacement constitutes one acre of replaced wetland for each acre of drained or filled wetland. Minn. Stat. § 103G.222(1)(f). The WCA allows wetlands previously restored or created and deposited into the state wetland bank to replace wetlands lost to drain and fill activities. Minn. Stat. § 103G.2242; Minn. R. 8420.0700-8420.0760. Banked wetlands may be used only if there is no net loss in the quality, quantity, and biological diversity of the state's existing wetlands. Minn. R. 8420.0720(1). LGU determinations regarding exemptions or replacement plans may be appealed to the BWSR. Minn. R. 8420.0250.

[5] *See* Minn. R. 8420.0110(30) (defining local government unit); Minn. Stat. §§ 103D.201 (describing the purposes of a watershed district); Minn. Stat. 103C.201 (describing the procedures for forming soil and water conservation districts).