

DUE DILIGENCE FOR COMMERCIAL AND RESIDENTIAL REAL ESTATE PURCHASES

Elizabeth A. Tellessen, Principal, Winston & Cashatt, Lawyers
May 20, 2021

1.0 Introduction

Purchasers of real estate in Washington are expected to conduct all investigations of the property necessary to confirm that the property is suitable for the intended use. This investigation is often referred to as due diligence, or feasibility. In light of the purchaser's duty to conduct due diligence, Washington courts have continued to follow the doctrine of caveat emptor, except as might be applied to the purchase of new residential dwellings. House v. Thornton, 76 Wn.2d 428, 457 P.2d 199 (1969).

Although the legislature has mandated that sellers disclose certain property conditions to the purchaser, these disclosures can be, and often are waived. Even if the seller provides the statutory disclosures, the purchaser still must conduct the investigations it deems necessary to ensure the property is suitable for her/his/its intended purpose. RCW 64.06.013, .015, .020. In addition, once a purchaser is put on notice of a defect, or the potential for a defect, she/he/it becomes obligated to conduct further investigation. Douglas v. Visser, 173 Wn. App. 823, 295 P.3d 800 (2013).

In order to avoid your client being caught by surprise or sustaining losses for an unexpected property condition, comprehensive due diligence is a must. These materials provide a general outline of investigations to be conducted prior to closing a real estate transaction.

2.0 Allocation of Responsibility

Most sophisticated real estate purchasers will assemble a team of due diligence experts and professionals, which commonly include a real estate broker, attorney, title and closing agents, accountant, engineer, surveyor, geologist, environmental specialist, or hydrologist. On the other end of the spectrum is the first-time-home-buyer, who might pay for a cursory home inspection, but otherwise will proceed blindly to closing.

Most residential purchasers rely exclusively on the real estate broker to guide them through the transaction. This, as most real estate practitioners know, is folly. A real estate broker in Washington typically does not have any duty to inspect the property or verify any information provided by the seller. RCW 18.86.030(2). To that end, the standard real estate forms

specifically direct purchasers to obtain the professionals and conduct the inspections they deem appropriate. But, rarely does a residential purchaser heed this advice. When given the opportunity, a real estate lawyer should take care to educate his/her client about encumbrances to title, the importance of a thorough independent home or property inspection, as well as an inspection of any on-site systems or conditions (buildings, well, septic, boundaries, slopes, etc.).

Regardless of the type of transaction or client, the real estate lawyer should be prepared to advise her/his client regarding the real estate and loan contracts, title encumbrances, land use, zoning, and building restrictions. The lawyer's advice and review will often be supplemented with the reports prepared by a building inspector, surveyor, engineer (i.e. structural, environmental), or other specialized consultants.

The uniqueness of each property will dictate the scope of the experts and investigation needed. The assignment of the inspections should be clearly spelled out even before the purchase contract is mutually accepted. Having a checklist with the responsible party and inspection deadline is one way to avoid the "I thought you were taking care of that" situation.

3.0 Verify Seller's Disclosures

In some situations the statutory disclosure sheet is the first opportunity a purchaser has to get familiar with the property. An informed purchaser should review these disclosures with her/his/its attorney. While the questions are usually pretty straight forward, the significance of the answers may be something that a purchaser might not appreciate.

In one extreme case, not only did the seller fail to disclose, but also undertook to hide the existence of extensive dry rot in a home. Douglas, 173 Wn. App. 823. The purchaser noticed that the seller had not answered many of the questions on the disclosure sheet, and marked "don't know" for a variety of others. Id. at 826. The purchaser asked the seller to complete the disclosure sheet, but only partial and evasive answers were provided. The purchaser then ordered a home inspection, which revealed the existence of some dry rot, although it did not reveal the extent of the damage. Id. The purchaser did not conduct any further inspection and proceeded to closing. Id.

After closing the purchaser discovered the dry rot was so bad that it would be less expensive to tear down the house and rebuild than repair. Douglas, at 828. After trial the court awarded the purchaser damages for the seller's concealment of the defects. Id. at 829. But, the court of appeals reversed the judgment, concluding that the purchaser was put on notice of the defect and should have conducted further inquiry and investigation. Id. at 834. While the court deemed the seller's conduct was "reprehensible" it did not relieve the purchaser of its duty to conduct a careful and reasonable inspection. Id.

The court of appeals affirmed two very important lessons in Douglas. First, an incomplete seller's disclosure statement is notice to the purchaser that thorough inspection and investigation must be conducted. Second, once a defect is discovered a complete investigation to determine the extent of the damage is essential.

4.0 Scope of Due Diligence

Even before entering into a purchase agreement, the purchaser should begin due diligence. The offer will contain the inspection contingencies and the time needed to conduct the inspections prior to closing. Some contracts are structured with a blanket inspection or feasibility period, which gives the purchaser a certain amount of time to complete all of the inspections. Others have tiered contingency periods, which sometimes trigger additional requirements. For instance, some contracts may require that the earnest money become non-refundable after the title or financing contingency expires, although the inspection contingency remains.

Regardless of the contingency structure, determining the likely scope of due diligence prior to entering the contract will help to avoid wasting time during the contingency period, and hopefully avoid the need to extend the time for closing. The following inspections and investigations should help to ensure that the purchaser knows exactly what she/he/it is buying.

4.1 Title Review

The title commitment will likely be the first document provided to the purchaser after mutual acceptance of the agreement. What the responsible real estate lawyer will immediately do is obtain copies of all of the documents listed as exceptions to title, as well as a copy of the vesting deed(s). Some things to look for:

Does the legal description match the listing, and more importantly, the purchase agreement? And, is this consistent with what the purchaser intends to purchase?

Is the seller the vested owner? Is there another party listed with a vested interest that will need to sign the deed in order to convey title? (i.e. ex-spouse, personal representative of an estate, joint owner or tenant in common, or business entity)

Easements: Are there any? Does it benefit or burden the property? Have they been properly created/conveyed under the statute of frauds? Where is it located, and could it interfere with the intended use?

Plats/Surveys: Are there surveyed encroachments? Are there plat covenants, restrictions, or dedications?

Declaration(s) of Covenants, Conditions, and Restrictions: Will those interfere with purchaser's intended use? Is there an association? Are there architectural restrictions/review? What are the assessments?

Any liens, past due taxes, local/road improvement district (LID/RID), or other financial obligations?

Other Title Notices: Natural resource notice? Notice of land use decision?

While the title commitment will show a majority of the matters affecting title to the property, the real estate lawyer should also review publicly available information. For instance, a litigation search and review of building permit or development files might bring to light significant issues that the title commitment would not disclose.

4.2 Physical Inspection

The physical inspection of the property may be as simple as a residential home inspection, or could require multiple engineers, surveyors, and other experts. While the real estate lawyer should be aware of the property's physical attributes and prepared to advise the purchaser regarding the type of inspections, most of the physical inspections will be conducted by other professionals. Depending on the type of property, a well-informed purchaser will consider inspections evaluating:

Property boundaries: At a minimum a purchaser should obtain a survey that confirms the boundary lines and identifies any encroachments. It is often a good idea to obtain a complete ALTA survey, which will include an evaluation of the title encumbrances and the location of any structures, easements, or other appurtenances affecting the property.

Soil/Geology: If development or redevelopment of the land is intended then geologist will inspect the sight for things like slope stability, erodible soils, fill, and when appropriate contamination.

Structures: A building inspector and/or structural engineer is likely to assist the purchaser in identifying deferred maintenance, construction (progress or defects), accessibility and ADA compliance, water intrusion, and necessary improvements or upgrades.

Multiple Units: All units should be inspected and the condition of each independently evaluated.

On/Off site storm water drainage: A hydrologist can help identify drainage problems, system deficiencies, or required maintenance of storm water swales, ditches, or dry wells.

Road Access: Is it public or private access? Are there express or implied easements with shared use or maintenance obligations? Are there road restrictions (truck traffic, weight limits)? If it is a public road, are there planned or anticipated improvements, which may create a payment obligation (RID/LID)? Is there public transit available to the site?

Parking and Loading Facilities: Are they shared? Sufficient for the intended use? Restricted by covenants or easements for other users? Will they be restricted by the weather, such as snow storage?

Utilities: What is already available to the site? What will need to be brought to the site or connected? What is the timing and expense of connection (i.e. connection fees)? Public or private providers or cooperatives? Limitations to service (i.e. high-speed internet, cellular coverage)? Are there energy efficiency or sustainability considerations, such as LEED?

Sewer or Septic Availability: In addition to understanding the type of system serving the property, a purchaser should know the capacity or limitations of the system. Purchasers of rural properties relying on private septic systems should have the system tested and pumped prior to purchase. Purchasers should also evaluate the capacity of the system and the ability to expand the system if additions or redevelopment is planned.

Neighbors: It is always a good idea to take a look around the neighborhood, and even stop in and visit the neighbors. Not only can these folks be a wealth of information about the purchased property, but they can give the purchaser a heads up regarding historical or upcoming issues facing the property or neighborhood.

4.3 Water Water Water

The availability of water to a site, building, or home, is something many purchasers take for granted. Even if the property is serviced by a municipality or water district there may still be investigation that needs to be done. If water is supplied through any other means, a multi-level investigation is probably in order. As water continues to become a scarcer resource and commodity, the evaluation of its quality and availability cannot be stressed enough. What follows are very general comments and cautions, and any purchaser or real estate lawyer considering water availability is advised to seek the assistance of a professional hydrologist or hydrogeologist.

Water District: Water districts are typically treated as quasi-governmental agencies in Washington. RCW Title 57. They may charge for water provided as well as connection fees, or other improvement or system development fees. A purchaser buying property in a water district should get in contact with the district to evaluate the fees, charges, and any past due amounts.

Private Wells: Private wells may be shared by a community, neighboring parcels, or independently used by a single property. If there is any aspect of the well that is shared, or if the well is not shared but resides on a neighboring property, then careful review must be made of the agreements, easements, and covenants that

control the use of the well. Failure to analyze the status of a well has led to litigation and sometimes the necessity of drilling a new well.

In most residential situations the well is a permit exempt well under RCW 90.44.050, which permits withdrawal of ground water for “stock-watering purposes, or for the watering of a lawn or of a noncommercial garden not exceeding one-half acre in area, or for single or group domestic uses in an amount not exceeding five thousand gallons a day...” There are many existing exempt wells that provide year-round water for the allowed uses. However, this assumption must be tested prior to purchase. The quality and quantity of a well should be tested. This may include an extensive investigation into the historical water availability of any area, including well draw-down tests. Information on water availability and shortages is the kind of information one might have greater success getting from a neighbor than a seller.

The use of permit exempt wells has been under attack for years. In 2016 the Supreme Court of Washington ruled that county planning under the growth management act has the obligation to determine that water for a permit exempt well is factually available before issuing a building permit. Whatcom County v. Hirst, et al., 186 Wn.2d 648 (2016). Legislation has since been enacted requiring local jurisdictions to obtain evidence that an adequate water supply is available for new residences and uses before issuing a building permit. RCW 19.27.097. This is very important for purchasers of vacant rural land, and will impact the ability to develop that land without obtaining a water right, among other land use implications.

Water Rights: Washington follows the prior appropriation doctrine when it comes to water rights. This means the first in time is the first in right to claim and use waters of the state. Generally speaking, in order to secure a water right one must obtain a permit from the Department of Ecology to divert water from a source, for application on a particular property, for a particular purpose, and also then put that permitted water to beneficial use.

The analysis of a water right is certainly part of any agricultural or rural property due diligence. In some instances a hydrologist will be necessary to measure the availability of the water under a particular right, in light of prior appropriation and the intended use. A real estate lawyer will assist in evaluating the interest as a property right and ensure that it is perfected. If the real estate lawyer is not directly familiar with water right evaluation then he/she should obtain the advice of a lawyer experienced in water right analysis.

4.4 Environmental Considerations

The scope of environmental analysis, will again, be controlled by the type and location of the property, as well as the prior, existing and intended land use. Typically, residential purchasers need only consider the existence of potentially hazardous building materials. But consideration should also be given to air and water quality. Purchasers of industrial, manufacturing, or even agricultural or natural resource properties, will need to conduct a keener evaluation of the potential environmental risks, which may include some or all of the following:

Environmental Assessment: For most commercial properties, particularly those related to industrial, manufacturing, or agricultural uses, a Phase I Environmental Study will be obtained. If the Phase I is not required by the lender, it should often be obtained by the purchaser. While the Phase I is only a cursory review of potential environmental conditions, it is an essential tool for evaluating latent environmental risks and liability. When the Phase I reveals a problem or potential problem, a purchaser will be well advised to obtain a Phase II study prior to purchasing.

One thing to keep in mind is that these studies are often conducted for a particular interest, and often disclaim any third party reliance. This means that the purchaser does not have a right to rely on the Phase I conducted for the lender. If the purchaser wants to have the benefit and protection of an environmental assessment it must either obtain its own, or have the other parties to the assessment consent to reliance in a letter. While this is not uncommon, there may be some restrictions or limitations imposed by national lenders.

Building Materials: Asbestos and lead paint are the most common building materials that present an environmental risk, although there are others. If the purchaser intends to raze or significantly remodel a structure containing these materials then an assessment should be made regarding the disposal and/or remediation expenses, as these may impact the valuation of the property or planned development.

Storage Tanks: “Buyer be-very-ware” above or underground storage tanks (AST/UST) are often cited as significant potential environmental hazards because they were largely unregulated and their historical use can be difficult to determine.

Hazardous Substances/Sites: Under both federal and state law a person that owns property that contains a hazardous substance, regardless of whether the person had any part in the hazardous substances being deposited, can be held

jointly and severally liable for the cleanup. E.g. RCW 70.105D.040(2). In light of this a purchaser must exercise extreme care and caution when evaluating a site that has or possibly could contain hazardous substance. Not only should the review include the type and scope of any contamination, but also the history of owners and tenants to evaluate the solvency of any other potentially liable parties. It is not advisable or recommended to proceed with a “don’t ask, don’t tell” mentality, liability may exist even if there is not actual knowledge of a problem.

4.5 **Land Use**

In most instances, the state, county, and local municipality will all have a say in exactly how a property may be used. Most of this oversight comes in the form of local zoning regulations. But, restrictions may also be imposed through environmental policies, building codes, or even multijurisdictional planning or development agreements. The real estate lawyer, if not directly familiar, should seek the assistance of a lawyer with land use experience in the particular jurisdiction. Local experience in these areas is invaluable. But, regardless of the jurisdiction, a typical land use evaluation should consider the following:

Comprehensive Plan Designation: All counties in Washington that are obligated to plan under the Growth Management Act (GMA), RCW Chapter 36.70A have adopted comprehensive plans. These plans provide valuable insight into the jurisdiction’s long term planning and goals. Because any categorical change in zoning will also require a change to the comprehensive plan, both the purchaser and practitioner should be aware of the practices and procedures adopted in a particular jurisdiction.

Zoning Classifications: The zoning of a particular property will control the allowed uses of the property. Zoning classifications are often broken down into subclasses that control the intensity of allowed uses--think high v. low density residential, or heavy v. light industrial. The variations in allowed uses are very important considerations, especially if the purchaser plans to change, expand, or redevelop the property. The present use, in light of the existing zoning can also be important. It is not terribly uncommon that a zone change may turn an allowed use into a disallowed use, creating a non-conforming situation.

In addition to evaluating the zoning for the prospective purchase, the surrounding zoning and uses should also be evaluated. Some residential purchasers have been surprised to learn that the open space adjacent to or near their home can and will be developed into another housing development, or maybe even a shopping center. These neighboring uses can impact property values and should be considered prior to purchase.

Critical Areas/Overlay Zones: The GMA along with the state environmental policy act (SEPA), RCW Chapter 43.21C, mandate the designation and protection of environmentally sensitive areas. These areas are identified as critical areas, and include designating for protection wetlands, fish and wildlife habitats, geo-hazard areas and critical aquifer recharge areas. These designations are made in addition to the zoning classifications, and often impose additional restrictions on development. Part of any land use analysis must include the existence of any designated critical areas on or near the property.

There may also be other overlay zones that could impact the use of the property. For instance, in Spokane there is an airfield overlay zone that restricts development near the airports and Fairchild Airforce Base, as well as the development of property in the flight paths to these sites.

Shorelines and in-water development: There are a variety of state and federal statues and regulations that control the use and development of shorelines, as well as in water uses, such as docks. Some of those include GMA, SEPA, Washington's hydraulic code, and the list goes on. Because development of shorelines are a true multijurisdictional affair, there has been adopted the Joint Aquatic Resource Permit Application (JARPA), which must be used to obtain a permit for almost every shoreline development. Consequently, if the subject property is on a shoreline, then the purchaser and his/her counsel should evaluate not only the development potential and restrictions, but also the existing uses, appurtenances, and fixtures to ensure there are not any existing violations that the purchaser could become responsible for.

Entitlements: Occasionally a purchaser will desire to purchase a property that has been only partially developed or planned for development. The approval process for many residential subdivisions or commercial developments includes multiple steps. Regardless of where the project is in the process, if a purchaser plans to buy a property that is entitled for development, in whole or in part, but that has not yet been developed, a detailed analysis of the entitlements must be conducted. For instance, many permits and approvals allow for some extension of time to complete the process to obtain final approval. However, if this time passes and a permit, application, or approval expires, then the project may have to go back to step-one. This can be an expensive and time consuming process, so comprehensive evaluation prior to purchase is essential.

Building Permits and Codes: While these codes will be important upon construction or redevelopment of any structure, they typically do not have a material impact on the purchaser’s decision to buy a particular piece of property. However, an important review prior to purchase is the building file and permits related to existing structures or improvements. This search may reveal that there are improvements that were not permitted, which can result in a building code violation that the purchaser may have to remedy. Unpermitted improvements can also impact the value of the property, and may be excluded from an appraiser’s analysis. Particularly with respect to rural residential properties it is important to review the building permit file to verify that any accessory structures or living quarters have been permitted and are legal to occupy. Even if ensuring structures are permitted is not material to your client as the buyer, it may become more important when your client becomes the seller. In this scenario I offer the advice: “don’t make someone else’s problem your problem.”

4.6 **Business and Other Considerations**

Purchasing a business is often part-and-parcel of a real estate purchase. And, while business purchases and evaluations warrant separate and complete due diligence, there are some overlapping considerations. Some of which include:

Existing Leases: If there are leases in place that the purchaser will be taking responsibility for, then the purchaser will want to review each of those leases and also obtain estoppel certificates from the tenants. The purchaser may also want to meet with tenants in person to discover any budding issues that may arise after purchase. While one may commonly think of space leases, there may also be ground leases for things like wireless communication towers or billboards.

Professional Work Product: This issue may arise in both partially-developed and fully-developed sites—that is the need to obtain the plans and specifications for the structures and systems on site. While having a set of plans may often address the need, the purchaser should also consider whether there are any warranties that might need to be transferred. Or, whether the purchaser wants the ability to rely upon and enforce a contract for professional planning services (i.e. architectural drawings for an expansion of a building). Most sellers and professionals are willing to consent to a transfer of their work, but such transfer should be documented and not just assumed.

Crime: Although the crime in a particular area is not likely something that a purchaser is able to affect, it is something that could impact the future use of the property and warrants consideration.

Transfer of Personal Property: In some instances the purchase of real property may also include personal property. While most people may think of furnishings and fixtures, it may also include a mobile home, machinery, or equipment. This is another area that requires separate documentation and due diligence. For the due diligence side of things, a UCC search should be conducted to ensure there are no security interests that encumber the personal property and, if there are, that those are cleared at closing. In addition, for those items that are separately titled, such as a mobile home or equipment, a purchaser needs to take care that these titles are also transferred at closing.

5.0 Conclusion

The scope of a purchaser's due diligence is controlled by the unique characteristics of a property and the purchaser's present and future intentions. Since no property and purchaser are exactly alike, no due diligence is exactly alike. Nevertheless, I hope that these materials are a helpful tool for identifying potential issues and risks prior to your client closing on her/his next real estate purchase.