

# DISTRESSED PROPERTY

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As the real estate market slowly emerges from the current recession, many see opportunities to acquire distressed commercial properties through purchase, foreclosure or short sale. Whether you are newly dipping into the real estate investment waters or returning after a hiatus, the issue of title insurance, and the status of existing title will inevitably arise during the due diligence process. Having an understanding of some of the basic title insurance terms and title due diligence issues will assist the investor in working with his or her attorney during the transaction.

**Preliminary Report:** A preliminary report is issued by a title company in connection with a request to issue a title insurance policy. The preliminary report lists existing liens, defects, easements, restrictions or other encumbrances or questions that will appear as exceptions to coverage in the eventual title insurance policy. The report is not to be construed as a representation of the actual condition of title to the property; rather, it is a “statement of the terms and conditions upon which the title insurance issuer is willing to issue its title policy ...” California Insurance Code Section 12340.11 Thus, the preliminary report serves as the initial reference point for negotiations between the title insurer and the eventual insured over the contents of the final title insurance policy.

**Commitment:** A commitment is similar to a preliminary report and in some states is used in lieu thereof. Like a preliminary report, a commitment is not to be construed as a representation as to the actual condition of title. Instead, the commitment is a statement of the terms and conditions upon which the title insurance issuer will issue a title policy if the commitment is accepted. A commitment “commits” the title insurance issuer to issue a particular title policy at the time the transaction closes to the

designated insured provided certain specified conditions are met. It is useful because it indicates what conditions need to be satisfied so that the desired insurance policy can be obtained.

**Proforma Policy / Proforma Preliminary Report:** If the buyer wants to preview what the final title policy will look like when all the title company’s requirements have been met, a proforma title policy, also known as a proforma preliminary report, can be requested. The proforma is not an agreement or commitment to insure or a representation of insurance to be received and it is not binding on the title company. It is simply an example showing as close as possible the form and content of the insurance policy that will be issued at the closing assuming all closing conditions are met.



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In all instances, the insured can only get the benefit of title insurance if it actually purchases a title insurance policy. However, the foregoing title products (along with the underlying documents referenced in the preliminary report or commitment) are necessary tools when conducting title due diligence.

**Title Encumbrances of Concern:** Reviewing the status of title is a necessary step in the due diligence process. With distressed commercial properties, certain title issues and encumbrances may appear that have particular economic significance. Examples of these issues and encumbrances are:

**Name of Owner on Title:** As an initial matter, the potential buyer should always confirm that the name of the person holding title as listed in the preliminary report/commitment matches the purported seller of the property.

**Deed of Trust:** The potential buyer will need to determine what deeds of trust currently encumber the property and arrange to have them reconveyed at closing. If the property is “underwater” (i.e., the loan amount is more than the property’s current value), then the buyer will want to ensure that contact has been made with the lender to ascertain if it will agree to a “short sale”, accepting less than it is owed in exchange for a release/reconveyance of the deed of trust.

**Notice of Default / Notice of Sale:** If either a notice of default (the first step in the non-judicial foreclosure process) or a notice of sale has been recorded, a direct sale with the owner may no longer be possible as the property is in the process of foreclosure and contact must be made with the lender regarding the status.

**Lis Pendens:** A lis pendens is a notice of the pendency of a lawsuit that may affect the property (which may include a judicial foreclosure action). In the event the potential buyer discovers a lis pendens, the potential buyer should review the nature of the underlying action to ascertain if the sale can reasonably proceed to closing (with the lis pendens released) while the action is pending.

**Judgment liens and tax liens:** If title review reveals judgment liens (created by recording a judgment ordering a payment of money) or tax liens (filed by a taxing authority against the property of a person who owes taxes), the potential buyer will need to determine the amounts necessary to satisfy these liens at closing and factor the information into the proposed purchase price.

**Mechanics’ liens:** If mechanics’ liens (statutory liens in favor of persons contributing labor, materials or supplies to improvements on the property) are on title, the resulting liens must be released prior to closing. Negotiation to reduce the release amount is possible depending on the circumstances, but can complicate the closing process.

**Environmental liens and restrictions:** Environmental liens are encumbrances on the property’s title to secure the payment of costs arising from the cleanup or other remediation of hazardous substances on the property and environmental restrictions can restrict certain uses on the property due to environmental conditions remaining on the property. The amount required to satisfy these liens or the extent of the restrictions must be factored into the property’s purchase price.