

Apartment MANAGEMENT

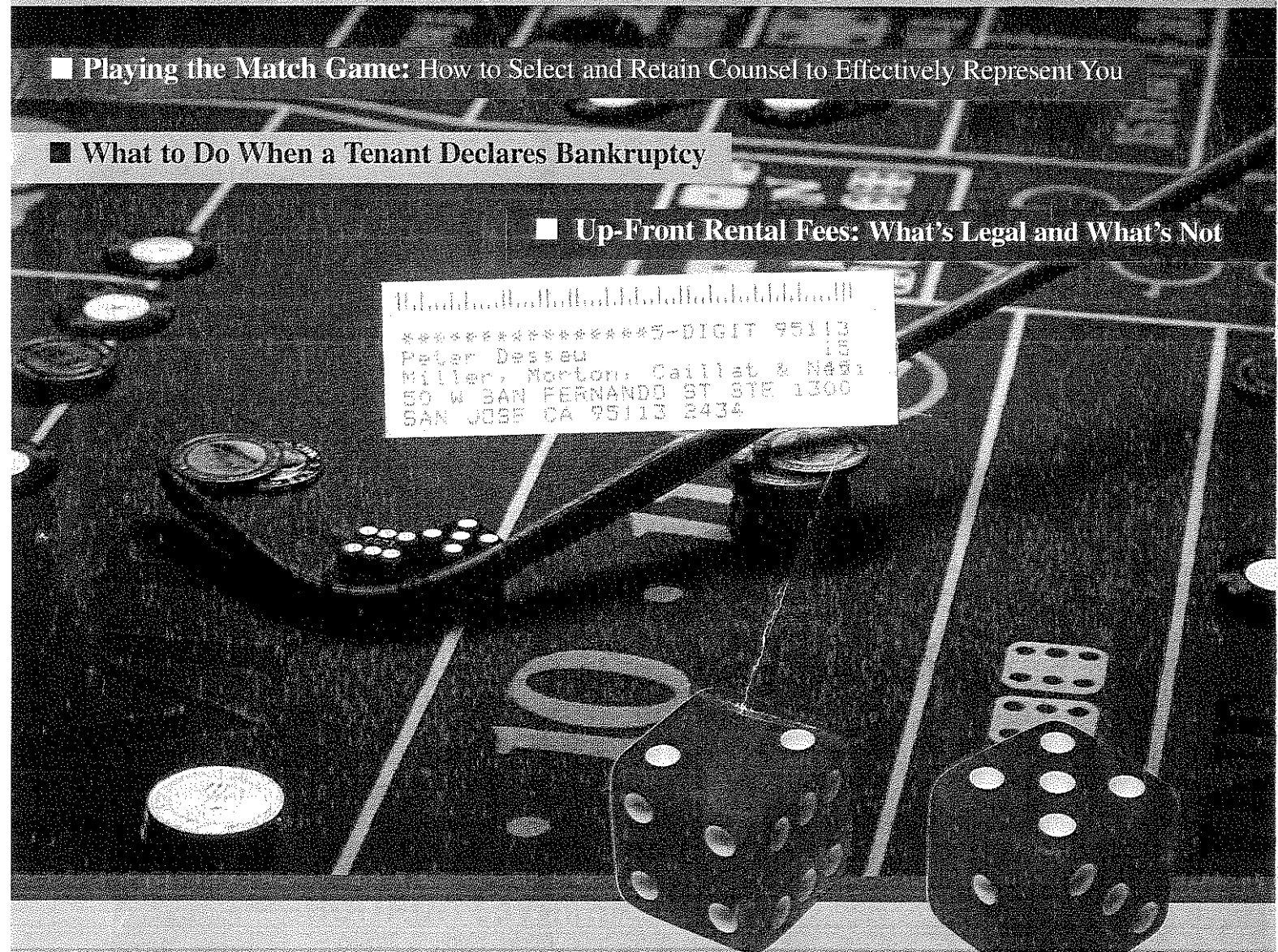
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Information for the rental housing industry in San Mateo, Santa Clara & Santa Cruz Counties

■ **Playing the Match Game: How to Select and Retain Counsel to Effectively Represent You**

■ **What to Do When a Tenant Declares Bankruptcy**

■ **Up-Front Rental Fees: What's Legal and What's Not**



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**Winning the legal game:
Not just pure luck!**

DUE DILIGENCE

A Construction Attorney's Perspective

PETER DESSAU,
MILLER MORTON CAILLAT & NEVIS, LLP

Apartments can be a fantastic long term investment. However, amateurs and professionals alike have purchased properties that were economic disasters because they were fraught with construction defects that were undetected during the "due diligence" period prior to the close of escrow.

In most cases, these defects should have been detected during "due diligence," but were not. Why? In many cases, "due diligence" efforts are inadequate. Typically, documents are made available to the buyer, but the documents are not thoroughly reviewed. The property is made available for inspection, but the inspection is inadequate. If it is adequate, the report is misinterpreted by the buyer. Too often, the end result is a project that incurs extraordinary repair and maintenance costs and a disappointing rate of appreciation.

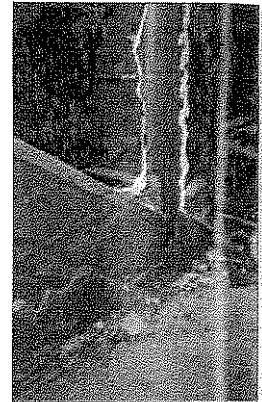
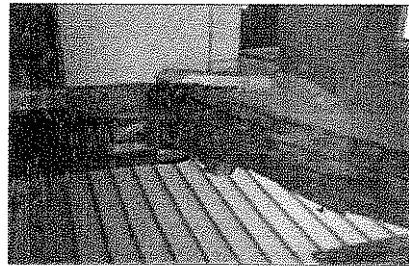
Several basic issues should be explored during the "due diligence" period that may smoke out latent defects, such as one at a particular wood-framed apartment project, and increase the probability that the investment will be successful.

PROFESSIONAL INVESTIGATIONS:

Is Your Investigator the Right Expert?

A reputable investigative firm described a particular apartment complex as "in very good condition." Among other repairs that the firm estimated at approximately \$450,000, the firm recommended that "exterior wood balcony handrails" be

replaced. In fact, the handrails suffered from extensive dry rot. (See photos.) The handrails channeled water into decks, stairwells and walls, causing millions of dollars of damage. The actual cost to repair the project exceeded \$5 million, nearly ten times the estimate of the inspection firm. In this case, the buyer thought everything was done to effectively investigate the property. The buyer was wrong.



If one is a first time buyer and has never worked with a firm that specializes in investigating properties, one's real estate broker is a good starting

point for locating a real estate consultant. Despite the reputation of the firm, it is important that the actual investigator have expertise that is relevant to the property in question. Often, firms will send an engineer to "walk" the property. Such an individual may provide an excellent analysis of the mechanical and plumbing systems, if he or



she is a mechanical engineer, but it is doubtful that the engineer will discern hidden points of water intrusion in a property. It is important that the investigator be sophisticated in how and where water penetrates buildings.

Forensic investigators who provide support to attorneys in construction defect cases often provide repair services to the attorneys' clients. These firms are an excellent resource for buyers during "due diligence." For example, one firm in Palo Alto serves property owners, design professionals and attorneys. The firm can review architectural plans for common architectural details that can allow water intrusion. After the firm's specialists review the plans, they can walk a project in Northern California and very commonly identify locations that are leaking at a project, without incurring the cost of destructive testing. If destructive testing is necessary, they can perform testing and provide estimates against which the buyer can solicit bids for the work. This information can then be used to evaluate the economics of the sale and may be useful if the buyer elects to renegotiate the sale price of the property.

WHO BUILT YOUR PROJECT?

Buyers usually demand that all the documents relevant to a property be provided. Commonly, the documents are made available, but no one knows what to do with them. There are many questions that can be answered by reviewing these documents.

Question #1: Who Built the Project?

At many projects, the original construction "job files" are available for review. The job files will contain original plans, "as-built" plans, subcontracts and prime contract documents. It is axiomatic that "good builders" build "good projects" and "bad builders" build "bad projects." Reviewing the original construction documents can assist a buyer in determining whether a "good" or "bad" builder built the project.

How does one make this determination? First, ask if the builder constructed the property for his or her own profit. Some extremely reputable developers function as their own general contractors. This is a "red flag" that should trigger caution. The economics of development can be in conflict with the time and cost requirements of contractors.

When developers act as their own general contractors, there is a probability that quality control will suffer for the sake of maintaining the development pro forma and schedule. This is particularly true if a developer did not "hold" the asset for a significant amount of time after it was constructed.

Second, ask about the design professionals who worked on the job. Different firms have different reputations. Some architectural firms are better at generating plans that are more subcontractor user-friendly than other firms. If the plans are too complicated, it is common for subcontractors to ignore them. John Griffiths, an attorney who specializes in mediating construction defect disputes, has a photograph in his conference room. It is a picture of several sticks that were assembled at a location where several walls were to tie together. It is obvious the framer had no clue how to assemble the relevant detail, because written on the sticks are the words "I tried."

Third, ask about the subcontractors who were retained to actually perform the construction work. Among the major trades, such as framing, roofing, lightweight con-

crete and HVAC, how many of those subcontractors are still in business? What was their reputation when they worked on the project? There are subcontractors whose principals are on a "first name basis" with their lawyers. There is a reason for this and it is one that should give pause to those who may buy their handiwork.

Question #2

Was the Project Administered Professionally?

Many prime contractors don't build anything themselves. Instead, they are "paper contractors" who coordinate the work of others. Commission your investigator to take six hours to review the project records that are available. To the trained eye, much can be discerned about how well a project was administered from these documents. For example, the architect may have generated excellent water-proofing details at decks and walk-ways, but the owner may have later permitted the subcontractor to delete these excellent details from its scope of work, thereby allowing the subcontractor to install less expensive, "conventional" installations.

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Did You Review the Maintenance Records and Interview the Maintenance Staff?

Purchase and sale agreements commonly have limited representations and warranties. Representations included in the agreement can be narrowed by requiring a specific person to disclose only the information the person has "actual knowledge of." Very often, this person will have little practical knowledge about the project. This will encourage the buyer to gain as much "actual knowledge" about the project as possible.

Whether maintenance records are consolidated in a computer program or spread out through years of old-fashioned "maintenance logs," they should be reviewed. This is often the most important information available to buyers and is information that is commonly ignored. Look for patterns and maintenance trends in various building systems. For example, is there a building or unit type that has inordinate plumbing or mechanical problems? If the problems occur at a particular set of locations at the project, the problem may not be the tenants, but instead may be the system

itself. Are there reports of "mold" at illogical locations in units? If the mold is at a location other than window sills in small rooms or on bathroom walls and ceilings, particular attention is warranted as it may evidence window, deck or roof leaks.

Talk to maintenance personnel. Is there a regular cycle of maintenance that the personnel follow? What do they believe works well and not so well at the project? On one occasion, a client was horrified to learn that a team of painters did nothing but caulk and paint siding, because the siding was installed improperly. The buyer never bothered interviewing any members of the maintenance team who freely volunteered the information to lawyers in the subsequent litigation.

Review Prior Sales Transactions

There are two important reasons to review prior sales materials. One is legal in nature, the other is practical.

Legally speaking, a buyer wants to own the property along with all the rights attendant to the property. These rights may include the right to sue a builder for negligent construction. It is common for a buyer

not to own these rights if he or she is the second, third or fourth buyer. The buyer can lose these rights in two ways.

The first is if the seller discovers a defect and fails to transfer the cause of action relating to the defect to the buyer. The law requires that the actual *chose in action*¹ be transferred to the buyer; it does not "run with the land" and automatically transfer during the conveyance of the property. The second is if a patent defect is discovered by a prior owner, e.g., the seller, the owner does nothing about it, and then transfers the chose in action to the buyer. Under this scenario, the statute of limitations to seek redress for the defect may have expired.

Practically speaking, by reviewing prior sales documents, the buyer can discover if the seller, or some prior owner, discovered any defects during their own due diligence investigation or use of the property. Moreover, the buyer can then discern whether any rights exist relative to the conditions and determine if the seller's repair, if any, was adequate. These conclusions can be gleaned from the representations and warranties, as well as from actual investigatory reports. Trends may be discovered in maintenance logs sufficient to put a prior owner on notice that a defective condition exists, but the chose in action may have never been transferred to the current seller and thus the buyer will be unable to seek redress for the defect.

"Due diligence" requires patience, hard work and professionals who possess the expertise to properly advise their clients. A proper investigation includes a thorough understanding of the project's construction, maintenance and transfers. ♣

¹*chose in action*: A right to something (as payment of a debt or damages for injury) that can be recovered in a lawsuit.

Peter Dessau is a partner at the San Jose law offices of Miller, Morton, Caillat & Nevis, LLP. Mr. Dessau is a construction law attorney, representing apartment owners, developers and general contractors since the late 1980's.



If you have questions or would like further information, you can reach Mr. Dessau at (408) 292-1765.

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