

## **Land Acquisition and Development Finance Part III**

In last month's "Learn" article, we discussed finding the land and the preliminary investigation and financial analysis. This article will discuss tying up the land and a more in depth due diligence building on the preliminary investigation previously completed.

### **TYING UP LAND**

Once you've identified a parcel of land and completed the preliminary investigation, you'll need to tie up the land until you are ready to acquire it—assuming the conclusions of the investigation are positive. Tying up the land allows you to gain control of the property with minimal risk while you complete a formal due diligence. The method of tying up land prior to the actual purchase depends on the seller's requirements coupled with the developer's ability to pay. Often the seller wants cash. In other situations, the seller may prefer payments over time for tax planning purposes or to allow participation in the future profits of the developer.

Given these scenarios or any number of variations, there are many options that you can use to tie up land. Some can get quite complex depending on the unique circumstances surrounding a seller and buyer. The three most common methods are:

- Letters of intent
- Option agreements
- Purchase contracts

### **Letters of Intent**

A letter of intent is a document used to describe your interest in a parcel of property and the terms and conditions under which he or she will purchase it from a seller. While typically not a binding contract, it can be used as an outline or framework from which a more binding contract could be drafted. At a minimum it usually contains a clause allowing price to be determined by mutual agreement in the future, a timeline for you to perform due diligence on the property, and acknowledgment that it is the seller's intent to sell the property to you, and the seller's agreement not to market the property in the interim. The biggest advantage of using a letter of intent is speed. You should be able to deliver a letter of intent within one day of deciding to make an offer.

**Option Agreements** An option agreement is a contract between you and the seller that allows you to have the right to purchase the property once certain contingencies have been met. It can be very similar to the letter of intent or a contract containing contingencies. As a buyer, an option contract gives you a secure agreement, subject to events or timing that neither seller nor you can control or predict. This is why it is imperative that the agreement specifies the conditions of the sale very clearly. In general, you purchase the option rights at a price, much like making a nonrefundable down payment on the property that may be deducted from the purchase price if you opt to complete the purchase.

Some examples of options that are widely used include the straight option, letter of credit option, interest option, and rolling option.

**The Straight Option.** Using a straight option, you have the opportunity within a specified period of time to purchase a given piece of land for a certain price. For the privilege, you pay the seller a certain amount of money. If you ultimately proceed with the purchase, this money can be deducted from the purchase price at settlement. If instead you do not close on the property, then the seller keeps the option amount. Essentially the simplest form of option agreements, the straight option is the most common form used by sellers and purchasers of property.

**The Letter of Credit Option.** Using this type of agreement, a letter of credit is issued from your bank to the seller in the amount of the option price. There is a charge for the letter of credit and the bank typically requires some type of security. If the option is exercised, in other words, if the purchase has proceeded to closing, the letter of credit is voided. If the option is not exercised, in other words the contemplated purchase does not close, then the seller collects the value of the letter of credit from your bank. This form of option eliminates money up front, however the additional required paperwork involving your lender makes it more complex.

**The Interest Option.** In this form of option agreement, you agree to pay the seller the amount of interest that he or she would have earned on the purchase price or appraised value of the parcel during the period of due diligence. If you do not exercise the option to purchase the property, in other words if closing never occurs, then at least the seller has received compensation while the property was unavailable for sale. This form of option is more commonly used when the seller is only willing to tie up their property if the buyer is willing to pay the true "loss of use" cost between the time of sale and time of closing.

**The Rolling Option.** The rolling option is used when you and the seller divide a larger parcel into smaller parcels and the selling price for each is predetermined from the onset of the option agreement. When you take the option on the entire parcel, you both agree to treat each smaller parcel as an individual contract within a larger contract. A predetermined event typically triggers closing on each smaller parcel. For example, a triggering event could be plat approval by the governing jurisdictional agency and/or the expiration of all appeals by any objectors to approval. The closing then allows you to "roll" the first option to the next parcel under similar terms. You continue this rolling option process until all of the parcels are purchased. If you decide not to purchase all of the parcels, the option amount is applied to the last small parcel to be purchased and you relinquish all future options on the land. Developers use this option to gain control of a large piece of property as it is needed for development. This is ideal for the small developer who discovers the "perfect" parcel for a project, but it is too large for the immediate development plans.

### The Purchase and Sale Contract

A purchase and sale contract is a document that outlines the terms and condition under which you will purchase and a landowner will sell their property. It becomes the roadmap to the planned closing on a parcel of property. If drafted properly, it will also allow you

some “outs” should the property fail to meet all of the requirements during the due diligence process. Only experienced developers should consider drafting the purchase and sale contract language. Competent legal advice prior to executing this contract is also advisable. Besides the obvious items of purchase price and closing date, several important issues should be addressed in any purchase contract. These include contingencies, notice of default, and right to cure, timeframes, and assignments.

Contingencies. The contract should specify any terms and conditions, called contingencies, set forth by you and/or seller that must be met prior to purchase. In a contract with contingencies, parties are not bound to the purchase until the specified terms and conditions set forth by you and/or the seller are met. Establish reasonable contingencies to protect you in the event that the property is unable to support planned development activities. Contingencies help you avoid entering into a purchase and sale contract to then learn that the property is unsuitable for your intended use. In short, without contingencies, you could get stuck with a useless piece of property for development. For example, they become very useful if you are unable to secure financing to close on the property, soil or environmental conditions test as unsatisfactory, or rezoning requests are not approved. The following terms are often contingencies within most purchase and sale contracts:

- A brief explanation of your development plan to include a condition that the purchase is only possible if the site is economically feasible
- An adequate timeframe set by you to obtain the necessary approvals, to determine the project's feasibility, and to complete the appeals period or any subsequent litigation
- A statement that you will be the sole determiner of the feasibility of the development project on the property specified for purchase

Timeframes. It is imperative that a purchase and sale contract provide ample time for you to perform reasonable due diligence on the property and to seek necessary approvals in order to develop the property. This timeframe varies by region and municipality. It may be necessary to include reasonable extension times in the contract to anticipate unforeseen delays during the due diligence period.

Right to Cure. The contract should include an automatic extension, or right to cure, on the feasibility period of approvals that are pending when the agreement expires. For example, the contract could stipulate that, although the timeframe established to close on the purchase of the property had expired, as long as you are awaiting approval by a third party or governmental agency and making good faith efforts to obtain approvals, you have the right to extend the closing deadline. Similar to timeframe extensions pertaining to the activities during the due diligence period, this right ensures that you will not have to close or lose out on the property if your contingencies have been satisfied due to lagging third party activities for which you have little or no control. Some developers attempt to negotiate extensions for the "free-look" period by offering to hand over all due diligence materials if the deal does not go through.

Assignment. A statement should be included in the contract which allows you to assign the ability to close on the purchase of the property to another individual or entity without amending the original terms and conditions of the contract. As an example, you may enter into a contract to purchase as one entity and for tax planning or other reasons want to close on the property as another entity.

## DUE DILIGENCE

In the formal due diligence phase, you complete a more thorough investigation of the parcel. It builds on information gained during your preliminary investigation to clarify and address any issues or concerns that should be clarified and addressed. Your objective is to clearly define any land development issues and determine whether to proceed with the purchase of the land and construction of the development. If you have tied up the land in a formal agreement, it would likely have a provision for a period of formal due diligence in which you are allowed to perform these investigative activities. If the parcel gains a positive evaluation, then you would complete the land purchase transaction. However, if the due diligence raises costly land development issues, then the contract should allow you to walk away from the deal with no fines or penalties.

Formal due diligence often requires a financial investment to hire professionals and specialists who perform land evaluation services that provide the definitive information you need about land usability for the planned development. Civil engineers or land planners are essential in this process and can aid in determining a budget for the tests and studies that may need to be performed. In addition, they can provide an estimate or a contract for the services they may be required to perform. If they are not able to answer your questions, they can identify other experts who have expertise in specialized fields of study to add to the development team.

As in the preliminary investigation, formal due diligence requires exploration of the same land characteristics, except with more depth of consideration. You take additional steps and involve expert resources to arrive at a final conclusion or decision. These can include a wetlands study, a tree survey and appraisal, flood plain analysis, soil testing, septic improvement permit applications, topographic mapping, utility assessments endangered species study, archeological or historical study, environmental analysis. political analysis, community relations activity, project planning, and financial analysis.

Wetlands Study Developing land that contains wetlands is highly regulated at federal, state, and local levels and many municipalities have different rules that may apply to development within flood plain areas. Wetlands are "those areas that are inundated or saturated by surface or ground water at a frequency and duration sufficient to support, and that under normal circumstances do support, a prevalence of vegetation typically adapted for life in saturated soil conditions. Wetlands generally include swamps, marshes, bogs, and similar areas." (EPA Guidelines, Section 404)

### Tree Survey and Appraisal

Trees are valuable resources on parcels. Tree surveys locate and identify the number and type—good information to use in the concept creation.

### Flood Plain Analysis

If the property has any areas along creeks or drainage ways, your civil engineer should survey the property to verify if it lies within the flood plain. The survey helps you avoid creating any lots within a flood plain. You'll also need this verification to assure most jurisdictions, insurance companies, and title companies that your development does not lie within a flood plain—areas that have a high probability of flooding within a 100-year time period and thus are susceptible to property and home devastation. These entities will not always rely exclusively on the maps created by Federal Emergency Management Agency (FEMA) because they don't always accurately depict elevation.

### Soil Testing

Your civil engineer can survey to determine if soil testing is necessary and direct you to a firm that performs the tests. In general, if anticipated road cuts in grading or trenches for utility lines are to be less than five feet in depth, then soil testing may not be necessary. The primary concern of testing lies with two soil types: rock formations and unstable or expansive soils. Either can be dealt with using cost effective alternatives but only if they are identified in advance.

### Topography Mapping

For areas where improvements are to be made for roadways and other improvements, such as detention areas and underground utilities have your civil engineer create more accurate on-site topography maps. The USGS maps you referenced during the preliminary investigation only provide a general sense of the topography. New global positioning technologies (GPS) make this task less costly than it has been in the past.

### Utility Assessment

Confirm any preliminary findings with regard to utilities. In addition, if using public utilities for water and wastewater, confirm any tap fees associated with the development. Using a conceptual drawing of the development, you can obtain accurate estimates for the installation of water and sewer lines. For all utilities, verify the cost of extending service and determine whether any easements are going to be required from adjoining properties.

### Endangered Species Study

The types of creatures on the endangered species list are diverse, from warm or cold-blooded to furry or feathered. It may also include plant life. Many activist groups are trying to stop development at all costs to protect them. Your task is to identify if any of them exist on your parcel. If the possibility exists for a habitat of an endangered species on the property, it is better to discover this prior to completing the land purchase instead of

spending 10 years in court to fight activists opposed to your development. You could be out of business by that point!

### Archeological or Historical Study

Finding archeological ruins or burial grounds while constructing a road are two common reasons for identifying the historical significance of the land under consideration. Many times, family burial grounds have little to no markings or the archeological or historical significance of a structure is not self-apparent.

### Environmental Analysis

Preliminary investigations sometimes uncover potential environmental concerns. In these situations, most lenders require further investigation during the due diligence period. Certified engineers conduct a formal environmental analysis, called a Phase I audit. The audit provides definitive answers regarding those concerns—good information for both you and the lender. (Recall that Superfund laws allow for the collection of fines, as well as require the remediation and clean-up of hazardous sites to be paid by the current owner.) The formal environmental analysis may involve as many as three phases.

- The Phase I environmental audit usually addresses the most concerns with the exception of hazardous materials. Engineers certified to do the audit perform it. Depending on the availability of those certified in your area, it might take three to four weeks to have this completed.
- The Phase II environmental audit is completed if Phase I produces negative results. The Phase II goes further with actual tests performed in the area where any environmental hazards are suspected. It includes recommendations for clean up.
- The Phase III environmental audit focuses on the actual clean-up and legal disposal of contaminated material.

Costs for the audits increase with each phase. Typical costs for a Phase I for a 20 acre site might range between \$1,500 to \$3,000 with Phase II and III costs varying with the nature of the issues involved.

### Political Analysis

During due diligence, formalize your involvement in the government approval process. This means gaining a very complete understanding of the process, achieving a common understanding with municipal staff, and establishing a timeline. If you have not already done so, obtain a checklist from the governing municipality.

### Community Relations.

- At this point, coordinate meetings with the concerned citizen groups identified in your preliminary investigation, as well as any regulatory groups affected by the development. This can include school, fire, and special utility districts. The purpose

of the meetings is to give information, allow time for feedback, and ultimately secure support for your project.

### Financial Analysis

In the preliminary investigation, you prepared a thumbnail estimate to make an initial determination of financial feasibility. Once due diligence is completed, you can update your lot analysis based on the additional and more thorough information you have gained. Add in the option cost, if applicable, and the costs for completing the due diligence. These costs can range from \$25,000 to \$70,000 and you should count on spending it. Most important, regardless of this investment in the property, you have to be able to walk away from the deal if your due diligence determines development is not feasible for any reason. Other important financial factors should be considered at this point, including slow profits, the timing of tax liability, and the impact of velocity on financial feasibility.