

The Steel City: How Pittsburgh's Industrial Background Still Affects Real Estate Transactions

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In real estate finance, one of the most important due diligence items of each transaction is the title insurance policy the lender receives. This policy protects the lender's lien position and its overall security interest in the collateral property. Despite its importance, I cannot tell you how many times issues have arisen in a closing due to a party's failure to pay close enough attention to the property's title.

Every commercial finance attorney can relate: by the time the term sheet or loan approval has hit your desk, the lender and the borrower have been working together for weeks (if not months), and now they want to hit the gas and close the deal as soon as possible—forgetting the amount of legal work required to get there. As a result, the lawyers are placed under the tightest of deadlines to turn around document drafts, review due diligence materials, and negotiate with all parties to keep the transaction moving at the pace the client wants to get the deal closed. In the stacks of due diligence items we receive, a title insurance commitment is usually sent to us by a third party, unrelated title insurance company that the borrower chose. It is our job and responsibility to review the commitment and voluminous title exception documents as quickly as possible to: (1) ascertain any issues with the property's title, and (2) most importantly, to get a pro forma title policy in place for closing.

While that may sound simple enough

for a routine property acquisition, what happens if there is construction involved? Real estate construction loans bring a variety of challenges themselves, and a complicated title chain is always guaranteed in southwestern Pennsylvania. Mining and oil and gas drilling have been occurring in Pennsylvania since the late 1700s, and as such, many property rights related to those minerals have been sold, conveyed, leased, or reserved in some manner throughout history. Southwestern Pennsylvania was also (and still is) an industrial hub for various areas of manufacturing and industrial production—Pittsburgh is the "Steel City," after all. So, we are not surprised when a decades old environmental covenant shows up on a title report for property in our region. These covenants, however, can play a tricky role in property development.

At the beginning of last year, a client of mine, a large regional lender in Pittsburgh, brought me a real estate construction loan for a proposed charter school. This project had been in the works for months by the time I got involved (including the commencement of construction before the loan was approved and before any collateral security documents were prepared—a story for another day). This project was a three-party arrangement wherein a local developer agreed to donate a five-acre parcel of vacant land to a nonprofit organization and construct a school building on that land. The nonprofit organization in turn was to lease the

school building to a public charter school through a long-term lease agreement. Most of the fundamental terms of this multi-tiered transaction had already been agreed upon by the time my team got involved. My instructions were simple: draft loan documents, ensure construction would be completed, and get the deal closed so the school could open in the fall! At first, I thought we had all the time in the world—little did I know what lie ahead.

Despite ongoing negotiations and having already started construction, the borrower did not order a title until mid-March. Title searches, especially in some of the more rural counties in southwestern Pennsylvania, can be voluminous—but we were not expecting to learn that this five-acre parcel had 55 title exceptions included within the 60 year title search. The property that was to be conveyed for the school was once part of a much larger piece of land and had since been subdivided off, which seemed to account for much of the various rights-of-way and easements affecting the title. However, what really caused heartburn was the fact that the original parcel had previously been used as an integrated steel manufacturing plant, and the property once housed a steel testing lab. Throughout the property's history, it was owned and operated by various steel manufacturers, and it wasn't until 2010 that its former owner decided to remediate the property for re-use. As I'm sure you can guess, the amount of

impact to the soil and ground water from the prolonged industrial use was substantial.

But, in Pittsburgh, this is not abnormal to find. The critical issue, however, arose from a two-sentence prohibition, buried deep within an environmental covenant recorded on the chain of title. A prohibition that was overlooked by many people in the transaction—especially because the parties had already begun constructing the school building. That prohibition specifically stated:

*The Property shall be used solely for non-residential purposes in accordance with the Act 2 and Department regulations. Nonresidential use **excludes schools, nursing homes or other residential-style facilities or recreational areas.***

This caused a full-stop on construction and the parties were left wondering what the options were given the amount of money already invested into the project that was now seemingly dead.

Around the same time the title search was delivered, the Phase I Environmental Study was also completed, so we had a better picture of the condition of the property which allowed us to strategize with the bank and formulate a plan to move forward and hopefully, complete the transaction. The developer contacted the Pennsylvania Department of Environmental Protection (PADEP) to work on a solution. We quickly became experts in environmental remediation. After spending several weeks game planning, we were informed by the PADEP that remediation would not be finished until after construction was complete, and it was only then that the PADEP would record a new covenant removing the restriction against use as a school.

Not only was the timing of the transaction caused by the delay threatening the opening of the school on time, but the lender refused to lend the construction funds until the new covenant was recorded. So where did that leave us? The borrower needed the loan to pay for the construction but couldn't get the loan until the construction was completed. This seemed like a hurdle we could not overcome.

Several more weeks passed and countless hours were spent on the phone with the parties attempting to re-structure a deal that would move the transaction forward. After each party made some concessions, including the lender obtaining internal approvals necessary to proceed with closing prior to the new covenant being issued and recorded, we found a path forward. It wasn't going to be easy, but a new subdivision plan would need to be created to carve out some of the remediated property—the school wouldn't receive half as much land as it wanted, the sales price went down, and the construction price went up due to additional remediation costs. Despite all that, we had found a way forward.

It was now my job to document all of that, while making sure I included necessary covenants and protections within the loan documents to not only require the borrower to complete the remediation and receive final approval from the PADEP post-closing, but to protect the lender from any issues in the event that they failed to do so. No sweat! While it is typical for transactions to have post-closing conditions included, this one posed a significant risk to the lender. After a few more weeks of discussions with the lender and its internal departments, we created adequate post-closing provisions, which were able to minimize as much risk as possible, and the loan closed

in early June. As we sit here today, the building has since been fully constructed, the covenant terminated, and the school opened for enrollment in time.

This transaction was a great example of the importance of a close review of the title documents for each real estate loan transaction. The parties were all in agreement that there were no title issues since the former owner remediated the property. They assured us that their teams reviewed everything and that all was in order. However, buried in a stack of hundreds of documents, this two-line prohibition was nearly a transaction-killing issue. Thankfully, my team was able to not only discover the issue, but also work to resolve it to help the parties renegotiate their deal in order to open the school while protecting the lender's interests.