

Real Estate Bulletin

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Due Diligence in Real Estate Transactions by Glenn A. Fuller Esq.

Overview

I. Why Due Diligence?

One of the oldest common law maxims regarding real estate is that no two pieces of real estate are the same. In a highly complex and an increasingly sophisticated real estate market, this has never been more true. For instance, take two buildings of the same size, class and quality; chances are, there will be significant differences in valuation between these assets based simply on variables such as the location of the property itself, the legality and flexibility of its existing and potential uses, traffic patterns, lot configuration and a host of other factors. In addition to empirical differences, the provisions of the leases, matters on title and the location of the improvements on the property in relation to recorded restrictions can result in dramatic economic differences in the value of seemingly similar real estate assets. The only way these factors can be ascertained and incorporated into the decision making process is through thoughtful, exhaustive investigation – in other words, through due diligence.

For purposes of this article for conceptual reasons, I have divided the due diligence process between “factual” due diligence and “legal” due diligence. Sometimes, depending upon the circumstances, traditional “legal” due diligence must be supplemented by two additional areas of concern: compliance with land use and zoning regulations (“Land Use”) and if toxic or hazardous materials or other contaminants are involved, environmental legal review

(“Environmental Issues”). These two “legal” due diligence categories will not be discussed in this article since they are each broad and important enough to merit their own separate analysis. Also for the purpose of this article, I use the term “investor” to represent the party conducting the due diligence since I believe the need for thorough due diligence exists in virtually every major transaction, including the acquisition of property for investment or development, extension of a loan secured by real estate, formation of investment in a real estate syndication or entry into a long-term ground lease. While the needs of each of these “investors” in each individual transaction will vary, the core principles involved are the same, including the absolute necessity of extensive due diligence. Finally, the issues involved in conducting the due diligence will vary depending upon asset class and the status of entitlements and improvements on the asset. This article will focus primarily on the common issues an investor and its legal counsel should consider in connection with the acquisition of a fully improved office building, shopping center or industrial complex.

II. Allocation of Responsibility

The due diligence process for real estate investments involves many professional disciplines, including law, architecture, planning, engineering, appraisal, market and the financial analysis. In general, in order to conduct adequate due diligence within the time frames generally provided by the contract provisions it is necessary to assemble a qualified team to conduct

the process. The availability of resources, the number of professional consultants, and the allocation of due diligence responsibility will, of course, vary with each transaction and the needs of the individual investors. In almost every case, however, the process will involve a team approach. As such, the first task of the real estate investor and its attorney is to identify the team of consultants and their respective roles.

While the attorney’s substantive contributions will in almost all cases require expertise in traditional real estate law including landlord/tenant law, conveyance and title issues, entity formation issues, and the principles of real estate financing, depending on the project in question and the history of its use, sometimes specialized knowledge of land use and hazardous waste materials regulations, development and construction principles and other related disciplines are necessary for even fully improved projects. Increasingly real estate transactions involve tax and business law issues including issues related to 1031 tax exchanges, tax and other implications of contributions of real property to entities, being cognizant of the investor’s exit strategy to help structure and acquisition a loan to militate against adverse tax consequences in the ownership and dissolution of the asset. Finally, if the investment in question involves a syndication, the attorney involved in the transaction should be able to advise the investor regarding securities and other issues in connection with raising funds from investors. This can include advising clients on the special requirements and restrictions applicable

to investments made by pension funds, real estate investment trusts and other entities.

In general, it is the responsibility of environmental inspectors, soil engineers and other consultants to identify potential environmental problems and it will be the responsibility of architects, civil engineers, building inspectors and other consultants to insure compliance with zoning laws and building codes; provided, however, that analysis of compliance for zoning, subdivision and other land use regulations generally involves legal review as well. For example, in the case of acquiring or financing a project under construction or recently built, a thorough review by a land use attorney of the project approval proceedings and other operative documentation is needed to confirm the absence of procedural defects, expiration of applicable statutes of limitation for legal challenges, or other vesting rights in project approvals.

Whatever the allocation of responsibility, the attorney/client relationship should provide that someone, either a professional consultant or an expert within the client's organization, coordinates closely with counsel to ensure that each aspect of due diligence investigation is adhered to.

III. The Due Diligence Process

Most acquisitions and loan documentation provide for extensive pre-closing conditions that require an investor's receipt and review of various information. Although different in each instance, these almost always include the following: (i) the financial information regarding the property in question; (ii) plans and specifications for improvements and notices from governmental authorities; (iii) obtaining building inspection, soil, or environmental reports prepared by third-party consultants; (iv) an original or copy of any leases as well as management and operating contracts; (v) receipt of a preliminary title report and all supporting documents referenced in the preliminary title report; and (vi) a survey showing, among other things, the boundary of the property, location of buildings and other structures on the property and plotting all exceptions of title that are plottable on the survey.

In most cases, the attorney representing

the investor will focus initially on review of the preliminary title report and supporting documentation, leases and survey. As noted above, consultants will generally focus on the third-party reports along with the investor to determine the appropriate physical condition of the property, relevant market conditions (through appraisals, market studies and financial analysis), compliance with governmental agencies' requirements and, if necessary, compliance with environmental laws.

Because of the complexity and infinite variations in the due diligence process, it is impossible to set forth a single methodology or set of procedures that will apply to each and every transaction; however, certain important principles apply to all due diligence investigations. In general, these will involve the establishment of two extremely important issues: (i) timing; and (ii) the use of checklists.

Timing. In almost all real property transactional documents, the approval of due diligence is a condition for the investor going through with the transaction. Consequently, time periods for approval are usually hotly negotiated issues, with sellers and lenders seeking the shortest possible period for investigation and buyers and borrowers seeking the longest possible period of time to insure adequate due diligence review. It is almost always the case, however, that due diligence must be conducted in a limited time period, and this fact puts a premium on establishing a systemized process for conducting due diligence as early in the transaction as possible. In connection therewith, someone (usually the transactional attorney) must "quarterback" the process and be responsible for insuring that the structure is adhered to and deal with the contingencies as they arise. In general, there are four major issues related to limited timing:

Counsel should ensure prompt delivery of existing information without which the process cannot proceed;

The initial documentation must be reviewed and analyzed quickly enough to permit counsel and the investor to make further inquiries and arrange for additional studies to the extent the initial information is

inadequate or raises significant questions;

There needs to be sufficient time to allow the investor and its counsel the maximum opportunity to evaluate the information assembled; and

The discovery and evaluation of a problem must be identified far enough in advance of the scheduled closing date to enable the parties to (i) solve the problem before closing, (ii) postpone closing to solve or eliminate the problem or to modify the relevant agreements by price adjustment or otherwise, or (iii) negotiate and document a post-closing remedy.

Use of Checklists. A good due diligence checklist is an important analytical tool for systematically reviewing issues and recording the information discovered. A checklist may simply be a lengthy list of all items that are potentially relevant to a particular transaction with an indication of who is responsible for a given issue and a space provided for indicating whether a review or investigation is required. A more elaborate version is a matrix of items that not only identifies the issues and the party responsible for each aspect of due diligence, but also allows for an updated narrative statement about what has been done and how an issue has been resolved. This approach is almost always used in complex real estate transactions and is an effective way to immediately communicate to the due diligence team the status of various issues. Attached hereto on the Appendix is a version of a checklist the author utilized in a recent transaction.

IV. Transactional Issues

As noted earlier, this section focuses primarily on issues to consider when conducting transactional due diligence, with the focus on matters that are primarily the responsibility of the real estate attorney, excluding environmental and land use due diligence items.

1. Lease Review. It is axiomatic that in connection with the acquisition of an operating asset, lease review is one of the most important due diligence items that investors and their counsel must be concerned with. Of course, the actual

nature of the asset and tenants can have a significant impact on the necessity to review each individual lease. For instance, in connection with a multi-unit residential building or self storage center, investors may be more concerned with the simple economics of the leasing structure and will only review perhaps a form lease and not have the attorney review each individual lease and/or obtain an estoppel certificate from individual tenants. In connection with retail centers, office buildings and industrial buildings wherein the leasing issues are far more complex and leases tend to be for much longer periods of time, it is absolutely imperative that to the extent feasible the leases are reviewed not only to verify the economic terms of the leases but also to unearth key legal provisions in the leases that can affect the investor's investment decision.

In connection with the actual review of the leases, it is helpful if this process not be undertaken in a piecemeal fashion if at all possible since the way that the leases interact with each other is an extremely important element of the lease review process. For instance, for obvious reasons, a thorough lease review should confirm that no two tenants have the right to occupy the same space. This situation can arise in connection with improvidently drafted expansion rights or other rights to modify space that may overlap on another tenant's current or future rights. In addition, care should be taken to ensure that the common areas are defined consistently in all of the leases, that no tenant's use of the common area conflicts with any other tenant's rights, that common area maintenance and other charges are consistently defined in all of the leases and to ascertain whether any tenant has the right to expand into any portion of the common areas or otherwise impede the landlord's ability to utilize, modify or otherwise change common areas, parking arrangements or access rights.

Once counsel is sure that it has all of the leases, the next step should be to insure that all amendments, modifications or ancillary documentation (such as exhibits, guarantees or subordination attornment agreements) are included. These amendments and other ancillary documents often contain extremely important legal provisions that significantly

modify or in some cases completely change provisions in the main body of the lease. Although it is often a tedious task to ensure that all of these documents are obtained and reviewed, obtaining and reviewing these documents is a critical part of the due diligence process. For instance, serious consequences can arise if exhibits are inconsistent or not attached as these can come back to haunt the investor who stepped into the shoes of the previous owner of the property.

While in most transactions a rent roll will be provided to the investor as part of the due diligence process, it is extremely important for each lease to be reviewed to verify that the business terms (such as rent, expenses, security deposit, and lease terms) stated in the lease corresponds to the business terms on which the buyer based its pricing of the property. Although it is tempting to simply rely on the summary of a rent roll, in more complex real estate assets that contain specialized leases, investors and their counsel should review any provisions that are fundamental to the investor's economic assumptions and consider any lease provisions that have the potential to alter the stated numbers in the rent roll or other abstracts provided by the seller. Examples of such provisions include exemptions of tenants' obligations to pay for each tenant's share of the assets' property taxes and insurance, caps on escalator clauses requiring tenants to pay for increased operating costs, exemptions on tenants paying increased property taxes in the event of a reassessment and similar clauses.

Another extremely important issue that the attorney should verify is that there are no obstacles or unsatisfied conditions in the assignment of a previous owner's interest in the leases to the investor. In connection therewith, special concern should be given to the need by the investor since standard subordination and attornment provisions in leases can mean very different things if the investor is a purchaser or acquires interest in the real estate asset through enforcement of a lien.

Investors and their counsel should also ascertain if any of the leases contain the right of early termination or rental offset.

If any such rights exist, it may be possible to obtain a waiver or to verify, through the estoppel certificates or otherwise, that events or conditions that can trigger any of these rights have not occurred. In addition, the leases should be closely scrutinized to confirm that there are no expired purchase options or rights of first refusal. If such rights exist, the investor and transactional lawyer should ascertain if the property has been offered to the tenant/optionee in accordance with the contract provisions or that such rights have been otherwise waived or terminated and obtained written confirmation of the same.

Finally, the transactional attorney should review each lease with an eye to unusual provisions that may create an undue burden on the investor. These are often pre-negotiated rights to assign or sub-lease space, damage or destruction clauses that are inconsistent with loan terms secured by the property, limitations on a tenant's obligation to pay common area maintenance or other operating expenses, exclusive use clauses, limitation on the ability of the landlord to relocate the tenant, and other similar issues.

2. Tenant Estoppel. Many investors unduly rely on receipt of written statements from tenants (commonly known as "estoppel certificates") that their lease is in full force and effect, that there are no rights of offsetting against rent, and other assurances regarding status of the lease.

Most estoppels will attempt to confirm key information such as:

- (a) Absence of knowing defaults by the landlord;
- (b) Absence of rental offset rights;
- (c) Set forth options to extend the term or extend the premises;
- (d) Confirm the lease commencement date;
- (e) Confirm the lease term; and
- (f) Confirm all amendments, modifications or revisions to the lease.

Estoppel certificates are essential in serving an important function, but they do not replace thorough and careful lease review. For example, tenant estoppels do not, absent a clear and stated intent to the contrary, alter amended leases that are inconsistent with the tenant certificate. Nor do they prevent a tenant from raising problems or issues discovered following execution, even if they existed when the tenant delivered an unqualified estoppel certificate. In addition, in the common estoppel certificate, many, if not most, representations regarding the landlord's conduct are limited to the tenant's knowledge. Accordingly, counsel should use the standard estoppel certificate primarily for investigation purposes to smoke out potential problems and not as a substitute for further review of the leases themselves.

While it is tempting to incorporate as much detail as possible in an estoppel certificate, such attempts may not be practical both because there is not sufficient time to custom draft each estoppel certificate and because many tenants will refuse to execute an estoppel certificate that contains too much detail. In addition, there is a significant danger that if an investor actually attempts to incorporate all business terms into an estoppel certificate and misses certain key issues, these issues will be deemed waived by omission. The better practice is usually to attach a copy of the lease and all amendments to the estoppel itself and have the tenant simply certify that the attachment is correct and a complete copy of the lease and all amendments thereto.

Even given the inherent limitations of estoppel certificates, proceeding without key estoppel certificates can be extremely risky in certain transactions. For instance, in connection with a large or long-term tenant for which a decision to obtain investment property is a critical element, estoppel certificates provide certain protection that there is not trouble in connection with the lease and may provide a defense against certain contrary factual assertions or legal contentions by the tenant at a later date.

Finally, in some transactions, it may be impractical to obtain estoppel certificates for each tenant. In such circumstances, a "seller's estoppel" may be obtained. In

reality, this is an additional representation and warranty from the seller that leases are in full force and effect. These generally have absolutely no protection in connection with protecting the investor against claims of the individual tenants; however, seller's estoppels can be useful in connection with certain assets such as multiple residential properties and self storage units wherein obtaining a single estoppel from each tenant is impractical.

Title and Survey Review. This article considers title and survey review together because they are inter-dependent. In general, it is difficult to adequately investigate title without reviewing the location of each "plottable" title exception. In like fashion, any attempt to have a survey review without making sure that each title exception is shown on the survey, has limited utility and, even if the exceptions are all plotted on the survey, the transaction lawyer must be able to reference the underlying documentation reflected on the plotted exceptions in order to ascertain third-party rights in connection therewith and potential limitations on the utilization of the real estate asset or improvident placement of improvements thereon.

As in lease review, a review of title and survey must be done comprehensively with an eye towards considering how all of the relevant documents relate to each other.

Without exception, one of the first things that an attorney should ensure when undertaking due diligence of real estate assets is to obtain the preliminary title report and thoroughly review each and every document supporting the exceptions set forth on the preliminary title report to ensure that they are complete and legible.

Use Rights/Financial Items. One of the most significant encumbrances that must be ascertained at the beginning of the due diligence process is whether any third-party rights to own or use the property exist (purchase options, rights of first refusal and/or reversionary interest) and if any monetary obligations are recorded against title that will not be removed at closing. For instance, unless the investor is assuming the existing financing, most well-drafted transactional documents provide that notwithstanding any other objections raised by the investor

to title, third-party monetary encumbrances are removed as of closing. This, however, is often not the case in connection with liens assessed but not yet due in connection with taxes, bonds and other governmental requirements. As such, it is absolutely imperative that title and all supporting documents be reviewed in order determine if the property in question lies within a special assessment district, whether the owner of the property has any maintenance or repair responsibilities for its own property or surrounding property or for any other unusual assessments affecting the property. If such obligations are recorded against the property, any owner of the property will be deemed to assume these obligations and such encumbrances should be taken into account by the investor in order to ensure that they do not adversely affect the investor's valuation of the property.

Covenants, Conditions and Restrictions. Covenants, conditions and restrictions, reciprocal easement agreements and other similar recorded documents (collectively, "CC&Rs") are often lengthy, cumbersome and convoluted. Nonetheless, they comprise one of the most important documents that absolutely must be reviewed and understood by the transactional attorney in providing due diligence assistance. For example, CC&Rs may prohibit a property's use as a supermarket. The attorney reviewing title must make sure not only that no supermarket presently exists on the property but also that the client does not intend to construct a supermarket on the property or convert an existing building to that use. Again, the valuation of the property may have been based as much or more on the expectation that it can be redeveloped in a way that proves to be prohibited as on the existing use.

Finally, one should attempt to obtain estoppel certificates assuring that there is no present violation of the CC&Rs with respect to existing structures or uses. Such estoppels may come from the "Declarant" under CC&Rs established as part of a recorded subdivision or from neighboring property owners who may have enforcement rights under less elaborate restrictive covenants. Although CC&R estoppels are subject to the same limitations as tenant estoppels, they also have the same strengths. They are a

potential source of important information, and they may effectively estop the estoppel-giver from subsequently asserting a contrary position.

Utility and Other Easements. Easements in favor of utility companies are common on commercial properties. Ideally, the recorded instrument granting the easement includes an indemnification of the property owner for any loss or claim resulting from the utility company's use of the easement area; provides for reasonable relocation rights to accommodate future development; and provides for restoration of the property after installation, repair, or removal of conduits or other facilities. It is also desirable for the easement to clearly define the uses permitted by both the grantor and the grantee on the easement area.

Unfortunately, such provisions are often lacking in standard utility easement instruments. Most, especially those entered into many years ago, contain hardly any terms. Utility easements without protective or explanatory language, although troubling, will rarely scuttle a transaction. When confronted with such an instrument, there is little to be done except to verify that there are no existing or proposed improvements located in the easement area. Parking areas, small shacks, temporary or easily movable enclosures, and shrubbery-type landscaping are usually acceptable encroachments. Minor building encroachments on utility easements are also ordinarily not a problem, especially in California, where title companies frequently issue California Land Title Association (CLTA) Form 103.3 endorsements (no forced removal) to buyers and lenders.

Major building encroachments are not so easily resolved. If a large building is located above an underground utility line, it is unlikely that the structure will need to be razed or moved, although that possibility cannot be dismissed. It is more likely that future maintenance and repair work by the utility company will require removal of the floor in the building for some period, which would obviously disrupt existing operations and might even permit affected tenants to terminate their leases. Potential disruption or interference with crucial parking areas or access ways should also be considered

when reviewing the location of underground utility lines. If these concerns cannot be addressed by amendment of the recorded easements, or an appropriate title insurance endorsement, the existence of the easement becomes part of the investor's business risk analysis.

Issues regarding potential encroachments over utility lines can be evaluated only by obtaining "as built" plans for improvements and having improvements and existing easements plotted on the engineering survey. There is another reason to have the location of underground utility lines and driveways and other access routes added to the survey. It is important to ensure that all utility lines and rights of way to and from the property connect directly to public conduits and thoroughfares, respectively, without crossing over privately owned property. Otherwise, the affected property owner can act or threaten to cut off access or utility service to extort some economic concession from the buyer. If access or utility line encroachments of this nature are discussed and a proper easement cannot be obtained before closing, an indemnity from the seller may be the only viable solution.

Boundary Encroachments. When reviewing the survey, the attorney should specifically locate the boundaries of the property, all structures located on the property, and all easements to confirm that there are no boundary encroachments. Counsel may accomplish this in consultation with, or by delegation to, the surveyor or project architect.

Boundary encroachments by neighboring structures are rarely a problem, especially if the historic use has had no detrimental impact. An on-site structure or easement encroaching onto neighboring property is potentially a far more significant issue. Although the long-term, uncontested existence of such a structure or easement provides some comfort, the encroachment is technically a legal trespass. Relocation of an easement is frequently a simple matter; however, the impossibility or difficulty of relocating a large, encroaching structure may lead to legal action against the owner and costly structural modifications or monetary damages. The only acceptable approach is to identify the problem and

negotiate a solution before closing.

Survey Requirements. All necessary information must be contained on the engineering survey, and the client must understand each reference and symbol on the survey. It may be necessary to request second (and sometimes third) drafts of surveys after determining that necessary information is missing or that the survey contains unlabeled or ambiguous markings. The survey should provide sufficient information to determine zoning compliance, which is frequently missing in the first version of an engineering survey. Preparing a detailed list of survey requirements and a comprehensive form of surveyor's certificates (stating that certain enumerated items have been shown on the survey), and forwarding them to the surveyor before commencement of the job, may dramatically reduce the changes necessary in subsequent iterations.

V. Building Permit and Certificate of Occupancy Review

In performing transaction due diligence, counsel should review copies of certificates of occupancy and major building permits. Some jurisdictions instead evidence authorization of occupancy by final building permit sign-offs. The lawyer must discuss the applicable procedure with the local building inspection authority to determine the form of approval available for the property and the significance of any missing documentation.

Ultimately it is not the lawyer's job to determine current compliance with building and safety codes. This evaluation should be completed by a qualified engineering or architectural consultant. Indeed, even if there is a certificate of occupancy for every existing tenant and a final building permit for every building or street address at the property, a tenant or previous owner could have performed unpermitted work at the site after the issuance of the certificates of occupancy or building permit. Thus the review of the building department files is simply part of a more comprehensive

inquiry and is intended as only one source of information.

VI. Other Due Diligence Responsibilities

1. Party Formation and Authority Documents. The lawyer must review the formation documents of the seller, particularly when partnerships are involved, to ensure that (i) all necessary approvals for the transaction have been obtained before closing; and (ii) the seller, and the individuals who execute documents on its behalf, have the authority to enter into and consummate the transaction. The seller ordinarily represents in the purchase agreement that it has the requisite authority to enter into, and perform its obligations under, the purchase agreement. The “bootstrap” nature of such assurances should be obvious; if the signatory cannot bind the seller, its representation is unenforceable. The buyer’s lawyer must independently confirm that these representations are true.

2. Confirmation of Seller’s Continued Existence. Lawyers often spend a great deal of time negotiating representations, warranties and indemnities in a purchase agreement, without any serious consideration of the status or creditworthiness of the party giving such assurances. In many real estate transactions, real estate assets are held by single purpose entities whose only asset is the property to be conveyed. As such, in certain circumstances, the investor may insist on either holding a certain amount of the sale proceeds in escrow for a specified period or obtaining a guaranty from the entity affiliated with seller to cover the seller’s contingent liabilities. In addition, certain insurance products are available to provide coverage for representations and warranties.

3. Assumption of Underlying Debt. If a buyer intends to assume any existing financing encumbering the investment property, it is imperative that the attorney review all applicable loan documents to confirm the business terms stated in the loan documents are acceptable to the investor, verify that the loan documents may be assigned and assumed, and, if necessary, obtain the lender’s consent, and identify any hidden costs associated with the

assumption.

4. Taxes, Assessments and Fees. An important part of the due diligence process is identification of the taxes, assessments and fees associated with the transaction and the subsequent ownership of the property. Documentary transfer taxes, bulk sales taxes on personal property, and other transactional taxes should be identified and quantified.

5. Tax Withholding. Under certain federal and state tax laws, a “reporting person” (usually a title company or other escrow holder, but, if no escrow is involved, the buyer) must withhold a specified percentage of the sale proceeds if the seller does not certify its nonforeign status. (IRC §§ 1445, 6045(e); Rev & T C § 18662.) Failure to (i) withhold or (ii) obtain the requisite certificate or other appropriate evidence that withholding requirements do not apply, could result in the imposition of some or all of the seller’s tax liability on the buyer. Accordingly, the lawyer must review, and ensure compliance with, the applicable tax withholding requirements before closing the purchase transaction.

6. Uniform Commercial Code Searches. If the buyer is acquiring any significant interest in personal property, the lawyer should obtain a UCC search to ascertain the existence and priority of any third party security interest affecting such property.

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