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NAVIGATING DISTRESSED REAL ESTATE: LEGAL INSIGHTS FOR FAMILY OFFICES

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While investing in distressed properties can be lucrative, it can have significant legal and financial implications. Given the current market fluctuations, distressed real estate can impact a family office in several ways, from capital allocation and operational challenges to legal entanglements and reputational risks.

How can distressed real estate affect a family office? Wiggin and Dana's Family Office Team offers key legal considerations to ensure your investment decisions are well-informed and legally sound.

What is Distressed Real Estate?

Typically, the term "distressed real estate" applies to real properties that can be purchased at below market rates due to some known (and, in some cases, unknown) issues. There are various reasons why these properties are offered at these rates and, as discussed below, it is paramount to investigate and understand the reasons why such property is being marketed at that lower price point.

Buyer Beware

Distressed real estate investments often come with increased financial exposure and substantial risks. The first issue to consider is the source of distress, which could include foreclosure, bankruptcy, environmental issues, deferred maintenance, or tenant disputes. These factors can affect the family office's financial and legal standing.

- **Capital Exposure:** Distressed properties typically require significant upfront investment for repair, legal disputes, or restructuring. As an initial step, a family office should carefully assess the expected return on investment and ensure that the family office has sufficient liquidity set aside to manage any unforeseen financial burdens (such as negotiating liens, settling disputes, and paying back taxes or overdue mortgages). Family offices should appropriately budget for the investigation, acquisition, rehabilitation, and operation of these properties, including associated legal costs. Diligence reports, such as property condition assessment reports, are key to understanding the current state of the property and can identify short-term and long-term cost centers.
- **Unforeseen Expenses:** Legal liabilities tied to distressed properties often exceed basic acquisition and financings costs. These properties might have unresolved legal issues, such as unresolved liens, unpaid property taxes, environmental concerns, or litigation from previous owners. Conducting thorough due diligence before committing significant capital is crucial.

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Legal Considerations in Acquiring Distressed Properties

When purchasing distressed properties, you are entering a complex legal environment. The acquisition of distressed real estate often involves navigating complicated legal processes, which could pose risks to the family office if not handled carefully.

- **Title Issues and Liens:** One of the first legal hurdles to consider is the condition of the property's title. Distressed properties often have unpaid debts, which could result in liens against the property. These liens may include unpaid property taxes, contractor bills, or previous mortgage balances. A thorough title search and lien investigation is critical to avoid inheriting these obligations upon acquisition. Without a clear title, the family office risks costly litigation to resolve title issues (such as ownership or boundary disputes).
- **Foreclosure Process and Rights:** If the distressed property is involved in foreclosure, it is essential to understand the legal process involved in acquiring the property. This may require dealing with court proceedings or purchasing the property through auction. Depending on the jurisdiction, you may encounter complications such as redemption rights, where the original owner can reclaim the property after foreclosure. Engaging experienced foreclosure counsel can help navigate these complex processes and avoid legal pitfalls.
- **Environmental Issues:** Distressed real estate often involves poorly maintained or neglected properties or properties that have certain environmental liabilities based on prior use. This can lead to environmental contamination or violations, resulting in legal obligations to clean up or remedy the situation. Our environmental attorneys can assess these issues' potential legal liabilities and work with environmental consultants to outline remediation costs before acquiring such properties.

Operational and Management Challenges

Once distressed properties are acquired, operational management becomes crucial. A family office may not have in-house expertise to handle distressed real estate, so hiring third-party property managers or contractors is essential. From a legal standpoint, there are several issues to consider.

- **Tenant Disputes and Evictions:** Distressed properties often have problematic tenants, including those who may have fallen behind on rent or been involved in legal disputes with the property owner. Evicting tenants or resolving these disputes can be a lengthy and legally complex process, especially in multifamily investments if the tenants have rights under local rent control or tenant protection laws.
- **Contractual Liabilities:** If the family office hires for repairs or property rehabilitation, various legal concerns must be addressed, such as negotiating and enforcing construction contracts, ensuring compliance with local building codes, and managing potential disputes over workmanship. These contracts must be carefully reviewed and structured to mitigate the risk of future litigation.

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This publication is a summary of legal principles. Nothing in this article constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney. The information published here is believed accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.

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Reputational Risks

Maintaining a positive reputation in the investment community and the broader public is paramount as a family office. Distressed real estate can introduce significant reputational risks if the properties are not managed correctly.

- **Public Perception:** If the family office struggles to rehabilitate distressed properties or fails to address tenant complaints, it can lead to negative publicity. Additionally, the family's reputation could be damaged if the family office does not fulfill its obligations to creditors, tenants, or local communities. In extreme cases, public litigation could further tarnish the family's image. It is essential to have a legal strategy in place to address any disputes quickly and discreetly before they escalate.
- **Family Legacy:** Preserving wealth and legacy across generations is a primary goal for many family offices. The mishandling of distressed real estate investments, – whether due to poor financial management, litigation, or reputational damage – could negatively impact this long-term objective. Our attorneys can help mitigate these risks and safeguard the family's legacy by creating a well-crafted legal framework for managing distressed properties.

Distressed real estate presents both risks and rewards for family offices. While there is the potential for significant returns, the legal complexities – ranging from title issues and tenant disputes to tax liabilities and environmental concerns – demand careful investigation and planning.

Wiggin and Dana is uniquely positioned to assist family offices approach these investments proactively and strategically. By conducting thorough due diligence, consulting, and ensuring proper legal compliance, our team can assist your family office in successfully mitigating the risks associated with distressed properties and enhancing long-term financial growth. Wiggin's ability to draw on various practice groups such as restructuring, real estate, tax, environmental, and litigation allows us to collaborate and provide a comprehensive plan on how to navigate these issues. For tailored legal advice and support specific to your family office's needs, please reach out to members of our **Family Office and Strategic Investments Practice Group**.