Friday, October 25, 2024
9:30 AM – 10:30 AM

General Session 7

Current State of Purchase and Sale Agreement Negotiations: Negotiate Like It's 2024!

Presented to

2024 ICSC+U.S. LAW
JW Marriott Orlando Grande Lakes, Orlando, Florida
October 23-25, 2024

by:

Betsy Allen
Friedman Real Estate
34975 W. Twelve Mile Road
Farmington Hills, MI 48331
248-848-4099
Betsy.Allen@freg.com

Emily Ayers
Jae Law Group, PLLC
1717 West 6th Street
Suite 262
Austin, TX 78703
737-249-0805
emily.ayers@jaelawgroup.com

Kelly Dees Noll
Benesch, Friedlander, Coplan
& Aronoff LLP
127 Public Square
Suite 4900
Cleveland, OH 44114
216-363-4506
knoll@beneschlaw.com

Financing Complications

Today's challenging financing market is having a large impact on the negotiation of purchase and sale agreements.

Financing Contingency

When financing was easier to come by, many purchasers were comfortable using their property due diligence period plus the closing period to get their financing in-line because the risk of not obtaining financing was minimal. Relatedly, many sellers refused to agree to financing contingencies.

Now, purchasers are more likely to insist on a financing contingency that allows its earnest money deposit to remain refundable until financing is achieved.

Sellers with better leverage may try to push back or limit the exposure by: (a) requiring that the purchaser diligently pursue financing (including that they may require the purchaser to use a broker or other service, or prove that they have completed at least X applications), (b) baking in a separate "financing contingency period", which permits a termination of the purchase and sale agreement after expiration of the due diligence period, but prior to the closing date, or (c) requiring that a portion of purchaser's earnest money deposit become non-refundable after the standard property due diligence period. Further, it is helpful, when representing a seller, to include certain typical loan provisions and parameters surrounding what would be a permissible termination of the purchase and sale agreement by the purchaser relative to the financing contingency so the purchaser does not have a "carte blanche" termination right, such as (i) loan amount and interest rate requirements, (ii) repayment terms, (iii) guaranty obligations, or (iv) cashflow requirements.

Lender Deliverables

Given the tough financing market, lenders are becoming sticklers for the types of due diligence that lenders care about, in particular, SNDAs (subordination, non-disturbance and attornment agreements) and tenant estoppels. Purchasers seeking purchase money financing are seeing very high delivery thresholds for SNDAs and estoppels in their loan commitments and as such, are insisting on very high delivery thresholds for SNDAs and estoppels in their purchase and sale agreements.

Moreover, the purchase and sale agreement is often negotiated prior to the purchaser obtaining its purchase-money loan commitment. As such, during the negotiation of the purchase and sale agreement, the purchaser is claiming it needs estoppels and SNDAs from all (or nearly all) tenants because of its financing needs, while the seller is loath to commit to a higher threshold based on a "phantom" loan requirement.

Given the purchase and sale agreement is normally negotiated prior to the purchaser's loan commitment, sellers and purchasers alike may gain some ground with lenders by negotiating a lower threshold for estoppels and SNDAs into the purchase and sale agreement (e.g., certain key tenants, plus a percentage of the remaining tenants), as well as including pre-negotiated estoppel and SNDAs forms as exhibits attached to the purchase and sale agreement. When negotiating the loan commitment, the purchaser/borrower then has the defense against the potential lender that it can try to get the higher yield that the lender is seeking, but it does not have the right under the purchase and sale agreement. If the lender will not yield (and purchaser still has a contingency), it can always go back to the seller to renegotiate the issue.

A seller that is resistant to agreeing to a higher threshold and a purchaser that is hesitant to agree to a lower threshold might also reach common ground by agreeing that if purchaser's loan commitment requires a higher delivery threshold for SNDAs and estoppels than what is otherwise agreed to in the purchase and sale agreement, the seller can terminate the agreement (with a return of the purchaser's earnest money deposit) or agree to the higher threshold (subject to the financing contingency),

Costs of Obtaining Financing

Although traditionally, purchasers are responsible for their own costs of obtaining financing (loan commitment fees, legal fees, et cetera), given the challenging loan market, some sellers are agreeing to reimburse purchaser (in particular, purchasers that are normally in the corporate space) for some financing costs if a deal falls through due to a financing contingency issue (e.g., if the appraisal is short or if there is a delivery yield issue for SNDAs or estoppels). Sellers that agree to this type of reimbursement are capping their exposure.

Ticking Pay-Off Time Bombs

Although practitioners often think about financing issues as being a purchaser issue, in this market, many sellers are forced to be sellers because they are having their own financing issues – their loans are coming due and they cannot refinance. Sellers are negotiating outside closing dates in purchase and sale agreements in order to ensure that they are able to avoid late fees on their own financing. Sellers may also be negotiating on the backend with their own lenders for short-term loan extensions.

Representations and Warranties

AS-IS, WHERE-IS, Do Your Diligence

Although in a seller's perfect purchase and sale agreement, it would give no representations or warranties as to the property or anything related to the sale, most sellers will agree to give representations and warranties related to items that would be challenging or nearly impossible for purchasers to ascertain on their own, but insist that purchasers rely on their own diligence for items that purchasers could sort out on their own with a bit of elbow grease. As examples:

> The seller will represent and warrant that the person signing on its behalf has authority to bind the seller – the purchaser does not have access to the seller's organizational documents to confirm authority. Additionally, the seller will agree to provide authority documents to the title company so that the title company can confirm.
>
> The seller will not represent and warrant that it has clean and marketable title – the purchaser has the ability to order a title commitment and can determine if the title is acceptable to it.
>
> The seller will not represent and warrant as to zoning compliance – the purchaser can order a zoning report and determine if there are zoning violations. As a caveat, however, the seller will represent and warrant that it does not have active notice of any current zoning compliance issues.
>
> The seller will typically agree to represent and warrant about the current operation of the property, including representations about the leases, permits and licenses affecting the property, however, typically, sellers will not represent and warrant that the applicable documentation related to such property operation is "true and correct in all respects", but instead, most sellers are willing to agree to represent and warrant that the applicable documentation provided to purchaser is "used in connection with the daily operation of the property".
>
> The seller will represent and warrant that it has not received written notice (as a more limited representation that "there are none") of pending or threatened litigation, a violation of applicable laws, or pending or threatened condemnation proceedings.

Overall, it is typical that sellers will try to qualify as many representations as possible "to seller's knowledge" and define such "knowledge" as the actual (not implied or constructive) knowledge of a specific, qualified individual, without duty of inquiry or personal liability to such individual.

Note that the scope of representations and warranties for purchasers in purchase and sale agreements are generally limited to authority, purchaser's monetary ability to acquire the property (including insolvency representations), and typical statutory representations (such as anti-terrorism, OFAC, and government lists representations), and as such, are much more lightly negotiated.

So the Seller was Wrong – Now What?

Once the seller and purchaser have worked out the scope of the representations and warranties for the purchase and sale agreement, their negotiation is not over, as they have important concerns to negotiate, namely: how long will the representations and warranties last (claims period), how much damage has to be done before the purchaser can make a claim (the basket), how much is the seller's maximum liability (the cap and any carve-outs from it) and what assurance (if any) does the purchaser have that the seller will be collectible. Note that these items are highly negotiable based on the leverage of the parties.

> Claims Period

Especially in four-seasons states, the purchaser will frequently argue that the claims period should last at least twelve months, in order to see the property in an annual weather cycle. (However, if the seller is making no representations and warranties about property condition, this argument falls flat).

In a property with tenants paying CAM and taxes reconciliations, and where the seller has provided some level of representations and warranties regarding leases, it may be fair for the claims period to last through the upcoming CAM and taxes reconciliation period.

The claim period provision will often provide that the purchaser only needs to provide the seller with *notice* of the claim prior to expiration of the claim period, and has additional time to file a lawsuit. The parties will typically agree on a survival period of between three to twelve months post-closing.

For the presenters, the actual claim period agreed to in a recent purchase and sale agreement that we each negotiated was, or a typical trend we are seeing in negotiations, is as follows:

> Betsy: most recent deal granted the purchaser nine months to make claim and the purchaser must file litigation within forty-five days after the expiration of the nine-month claim period.
>
> Emily: We typically push for a more limited period of three to six months as the seller, but we are seeing more deals end up at twelve months in this market, with the requirement that the purchaser make a claim within such period for it to be valid.
>
> Kelly: I typically see deals shake out at the nine-month mark, with buyer having nine months to assert a valid claim, with parameters surrounding what a "valid claim" entails (detailed claim and specific nature of the claim(s), description of the amount of damages, etc.).

<u>Baskets and Caps</u>

Representation and warranty provisions in purchase and sale agreements are often set up with a "basket" and a "cap" that allocate risk of violations of representations and warranties between purchasers and sellers.

The "basket" is the minimum amount of damages that a purchaser must prove before it can make a claim against the seller. Sellers advocate for a basket because (a) it prevents purchasers from "nickeling and diming" sellers for every issue and (b) it encourages purchasers to undertake good due diligence because purchasers will be liable for a portion of damages before it can make a claim against the seller.

> There are generally two types of baskets—a "tipping basket" and a "non-tipping basket".
>
> A "tipping basket" means that if the basket amount is exceeded (e.g., there is a $25,000.00 basket, and there are $30,000.00 in valid claims), then the seller is responsible for the entirety of such claims (e.g., $30,000.00), from the first dollar up to any cap.
>
> A "non-tipping basket" means that if the basket amount is exceeded (e.g., there is a $25,000.00 basket, and there are $30,000.00 in valid claims), then the seller is responsible for the claims in excess of the basket amount (e.g., $5,000.00), up to any cap. A non-tipping basket effectively works like a deductible.

The "cap" is the maximum amount of damages that a seller will be liable for. Sellers advocate for a cap because (a) it limits sellers' post-closing liability and sellers can reserve for any potential post-closing costs, and (b) like the basket, it encourages purchasers to undertake good due diligence because purchasers will be liable for damages in excess of the cap.

The dollar amounts for baskets and caps are highly negotiated and will vary depending on the size of the transaction, but it is not unusual to see a basket of $25,000.00 or $50,000.00 and a maximum liability cap of two to five percent of the purchase price. In this market, the maximum liability cap may even reach ten percent.

For the presenters, the actual basket and cap agreed to in a recent purchase and sale agreement that we each negotiated was (based on percentage of purchase price if stated as percentage):

> Betsy: Basket: .18% (tipping); Cap: 5.45%

Emily: Basket: $25,000.00 (tipping); Cap: 8%

Kelly: Basket: .37% (tipping); Cap: 1.5%

Absolute Carve-Outs from Baskets and Caps

Baskets and caps generally apply only to violations of representations and warranties in purchase and sales agreements and not to violations of covenants in same or to fraud by the seller. Additionally, parties may negotiate "fundamental" representations and warranties that are not subject to the cap. Typical "fundamental" representations and warranties may include (a) the seller's authority (e.g., legal existence, correct signatory, ownership of property) and (b) tax liabilities.

For the presenters, any "fundamental" representations and warranties carved out from the cap in a recent purchase and sale agreement that we each negotiated was, or a typical trend we are seeing in negotiations, is as follows:

Betsy: None

Emily: We typically try to exclude any indemnities (broker reps, or specific items like bulk sales tax in Illinois for example) in addition to fraud and intentional misrepresentation.

Kelly: We typically see carveouts for broker fees, as well as language that if any alleged breach of any warranty of title in the deed, that the purchaser agreements to pursue the title company under its title policy in good faith prior to bringing an action against the seller.

Collectability

Most commercial real estate assets are held in single purpose entities (SPEs). That means that the seller under a purchase and sale agreement, and the party that is granting the representations and warranties, has no assets other than the real estate asset it is selling to the purchaser. It then briefly has the purchase money (although, depending on closing costs and financing payoffs, the amount of purchase money the seller has may be negligible, particularly in today's financing market), before distributing the purchase money to its owners and investors. By the time the purchaser knows it needs to make a representation and warranty claim, the seller may very well be an entity with no assets, and obtaining payment from that entity, while not impossible, may be very challenging.

Purchasers with leverage may negotiate for a variety of protections to ensure that they have a collectable source standing behind the seller representations and warranties. Different protections that purchasers may negotiate for include:

Personal Guaranty. A collectible person or entity enters into a personal guaranty for the representations and warranties.

Net Worth and Liquidity Covenants. The seller agrees to maintain a certain net worth and liquidity through the representation and warranty period. The seller may have to send periodic affidavits or reports proving it is maintaining its net worth.

Escrowed Funds. The seller agrees to escrow funds from the sales proceeds through the representation and warranty period.

For the presenters, any collectability guarantee in a recent purchase and sale agreement that we each negotiated was:

Betsy: None

Emily: Parent company guaranty of the purchase and sale agreement

Kelly: Escrowed funds for the duration of the survival period.

Can We Make that Someone Else's Problem?

Any practitioner that deals in mergers/acquisitions/private equity transactions (for purposes of this provision, we will call those transactions "corporate transactions") knows that representations and warranties by sellers in corporate transactions are frequently far more extensive than the representations and warranties by sellers in real estate transactions, largely because of the difference in assets. A real estate asset purchase, in many ways, is more "knowable" than a corporate asset/company. For example, the real estate purchaser can undertake physical inspections, request tenant and REA estoppels, and obtain title insurance, zoning reports, surveys and physical condition reports, all of which are sources of significant valuable information, and do not necessarily have counterparts in a typical corporate transaction. As a result, corporate transaction purchasers often need to rely on their sellers in a manner that real estate purchasers do not, which results in more significant seller representations and warranties in corporate purchase and sale agreements than in their real estate counterparts.

Both the seller and purchaser in a corporate transaction, however, take on risk because of the breadth of the seller's representations and warranties. The seller has exposure and may end up owing the purchaser damages after the sale. But the purchaser also takes on a significant risk that the seller might not be collectible. Because of these risks, a market has risen for corporate transaction representation and warranty insurance.

There are typically two types of policies, seller-side and purchaser-side. The seller-side insurance pays out a claim/reimburses seller if the seller becomes liable to the purchaser. Purchaser-side insurance provides a first-party claim payment directly to purchaser if there is a claim. Purchaser-side insurance may include waiver of subrogation rights in favor of the seller (with a carve-out for seller fraud), or may allow the insurer to proceed against the seller, depending on the product. Purchaser-side products are typically more common because they include coverage for the sellers' fraud while seller-side products generally carve out sellers' fraud. Note that these insurance products are frequently paired in connection with a cap-and-basket seller indemnity, so that each of seller, purchaser and the insurance company is taking on some level of risk.

Costs of insurance differ, but parties frequently pay an underwriting fee ($30,000.00-$50,000.00), plus a percentage of the total liability (3-5%) for placement of insurance (with a minimum premium of $100,000.00+). There is a deductible (1-3% of total coverage) and coverage is normally capped around 10% of the transaction value.

Certain real estate transactions may also be good contenders for representation and warranty insurance. For example, a large portfolio deal where due diligence is challenging, or a deal structured such that the purchaser is buying an entity instead of the real estate directly, may both benefit from representation and warranty insurance. We have seen representation and warranty insurance coverage provided as an option when the purchaser has significant leverage and is unwilling to agree to a liquid net worth covenant by the seller for the duration of the survival period, but the cap on claims is significant dollars and the seller is unwilling to hold back such amount for the duration of the survival period.