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Core Concepts 5

Economic Terms in Purchase and Sale Agreements: Show Me More Money!

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I. **Introduction**: This Seminar and the one immediately following are meant for attorneys who may be new to the industry and looking to learn a broad overview of standard purchase and sale agreements ("PSA(s)") provisions for retail-oriented transactions. The first session will cover basic economic clauses, and the second will cover more "legal" clauses. These materials are not meant to be a comprehensive guide to all components of a PSA but will discuss how the business and legal components of PSAs interact with each other and provide a helpful guide of key, highly negotiated topics.

II. **Types of PSA**: Typically, a PSA will follow a traditional format with consistent business terms and legal terms across all asset classes. However, each deal will have property and asset-class specific considerations to include. Some types of properties with accompanying deal-specific issues to consider include: **Vacant Real Property, Single Tenant Properties, Outparcel**s, **Shopping Centers / Retail Projects, Condominiums for Retail Components of Mixed Used Building, Mixed Use Buildings.**

III. **LOIs / Term Sheets – The Starting Point**: The letter of intent ("LOI") is your starting point for drafting a PSA. Outside counsel typically receives the LOI after it is fully negotiated and agreed to by the business parties, although smart clients discuss the LOI terms with their attorneys before finalizing. It contains the basic business terms and, depending on your client, is either extremely detailed or only covers the absolute basics. Some key business terms we expect to find in all LOIs include: Seller and Buyer entity information; property information; purchase price; earnest money deposit; due diligence period; closing date; transaction cost allocations; title company; and who is drafting the PSA. A more detailed LOI may include items such as tenant estoppel certificate requirements and tenant inducements as well as any exclusives being granted to the buyer and whether any Seller obligations will be performed before closing.

III. **Purchase Agreement Economics**:

A. Purchase Price.

1. How Derived: Although the specifics of how a purchase price is derived can differ from property to property, the typical analysis we expect to see is a calculation based on a cap rate and Net Operating Income ("NOI") and/or based on comparable sales. In some cases involving distressed assets (i.e., the land is encumbered by a mortgage worth more than its fair market value), the property is sold for substantially less than would otherwise be the case.

2. All Cash and/or Financing. A buyer who needs full or partial financing generally makes the transaction more complex, particularly with respect to properties with one or more tenants. This is because such financing needs often induce the need or requests for a financing and/or appraisal (i.e. an acceptable loan to value ratio) contingencies, lender deliverables, and a clean Phase I. With respect to lender deliverables and given the tough financing market, lenders are becoming more aggressive in terms of underwriting and due diligence requirements. The main deliverables that most lenders want to receive are: (1) SNDAs (subordination, non-disturbance and attornment agreements) – traditionally, lenders require SNDAs for leases that do not have automatic subordination provisions, and/or leases that have recorded memorandums of lease; and (2) Estoppels for the lender's benefit. For retail projects, Lenders often condition their loans on receipt of a clean estoppel from the "Major Tenants" (typically above 15,000 sf) or other credit tenants that the lender believes adds significant monetary value to the project plus an additional percentage of the "remainder tenants" (we are seeing this percentage between 70-80%). Tenant estoppels typically contain confirmations of substantive business information, such as current rent and additional rent payments, the lease term, lease option terms remaining, as well as factual information such as current contact information for the parties and the amount of any tenant inducements remaining; and (3) an acceptable Lender Title Policy at closing.

Seller financing is also sometimes provided in retail purchase transactions. Seller financing customarily consists of (i) a carryback promissory note covering a portion of the purchase price and (ii) a deed of trust or mortgage to secure the same against the property being sold. If well advised, the seller-lender will require its own lender's policy at closing (similar to a traditional lender). Seller financing may introduce potential usury issues into a transaction that needs to be addressed or at least analyzed for the client.

B. Deposits.

1. What is Typical? One vs. Multiple Deposits. The LOI will indicate the amount and how many deposits there are for the subject transaction. In general, there is always an initial earnest money deposit due

within a certain time period of PSA execution. Frequently, an additional deposit is due within a certain time period after expiration of the Due Diligence Period ("DDP") or Inspection Period ("IP").

2. When Refundable, Held in Escrow or Released. Earnest Money Deposits are typically fully refundable during the DDP or IP. Once that period has expired, we refer to the deal as "being hard", meaning the earnest money deposit is now "hard" or "non-refundable". However, generally, in certain instances the earnest money deposit will always be non-refundable: due to Seller Default, Seller's failure to satisfy Buyer's closing conditions, or a casualty or condemnation event that triggers a buyer's termination right. If released, the subject PSA often provides that buyer may record a memorandum of agreement or instrument to create a lien against the Property in case seller defaults at closing.

3. Interest on Deposits. Most well drafted PSAs for real property transactions include that deposit or earnest money will be deposited in a federally insured, interest bearing account acceptable to the parties, which will not be a general account of the escrow agent. Otherwise, bankruptcy of the escrow agent could result in deposit funds being tied up or even lost. Such PSAs also usually specify that any interest earned on deposit or earnest money will be deemed part of the same. A practical note is that in order to place earnest money into an interest-bearing account, buyer will need to provide escrow agent with a W-2.

4. Generally Constitute Liquidated Damages and Relationship to Caps on Seller Liability under the PSA. PSAs in general should include language stating that in the event a buyer defaults, the earnest money will be released to seller as "liquidated damages" on the premise that a buyer defaulting under the terms of a PSA results in damages incurred by Seller that are difficult to calculate, and the parties thus agree a fair remedy for Seller is being able to retain the earnest money deposit. Some aggressive sellers push for specific performance as an additional remedy, but we do not find this to be in line with the market and/or actually enforceable in many jurisdictions. Several states have specific requirements for making a liquidated damage provision enforceable in the subject jurisdiction. If the deposit is relatively low, then the buyer has the ability to walk away from the deal instead of closing for a relatively limited (and known) cost. In other instances where the deposit amount is above market, the parties may agree that only a portion of the deposit constitutes liquidated damages. The "cap" referenced in the subheading is the maximum amount of damages a seller will be liable for. A buyer will not typically start out with a "cap" because it limits a seller's post-closing liability and can leave buyer with damages that are not recoverable from seller.

C. Independent Consideration. Independent Consideration is a separate, distinct non-refundable payment "made" by buyer to seller, and helps ensure the agreement is legally binding. Clients that transact across the country typically include an independent consideration clause, as some state courts have ruled that contracts where buyer has a "free look" period in the DDP are actually option contracts, where seller could technically terminate the contract or the contract is void without any "independent consideration." Such consideration is typically a small monetary amount of $100, and is deemed not to be part of the deposit once released back to Buyer or paid to the Seller.

D. Extension Fees. PSAs sometimes include provisions allowing the Buyer (and sometimes the Seller) to extend the closing date or contingency periods. With respect to the Buyer, such extension rights may at times require the Buyer to pay a fee for the extension to be effective.

1. Applicability vs. Non-applicability and Refundable or Not. Often extension payments are non-refundable, except in limited circumstances such as seller default, but are applicable to the purchase price. Some sellers may want to assert that these extension payments are not applicable to the purchase price as they are meant to compensate seller for additional time required to hold its property off the market to see if the buyer will perform and close. In some instances, such as an extension being necessitated due to a seller-controlled process (such as the seller is responsible for a subdivision that the municipality has not approved of), a buyer extension deposit being refundable makes sense. However, buyers often want flexibility to extend for any reason (particularly if seller is not willing to give a true financing contingency). As a result, extension deposits are typically non-refundable, except in limited circumstances such as seller default.

2. Part of the Deposit or Not? Some PSAs provide that extensions are part of the Deposit and will be treated in the same manner as the rest of the Deposit while other PSAs provide that such payments are separate extension fees, not part of the Deposit and should go directly to the seller / be released immediately upon receipt by escrow agent for the granting of additional time.

E. Closing Costs, Prorations, and Reconciliation.

1. Customary Closing Cost Allocations. Typical closing costs allocation can be ascertained in referencing charts prepared by title companies. Responsibility for closing costs is usually negotiated as part of the LOI. In many commercial real estate transactions, the agreed upon allocation is to use the customary county or jurisdiction allocation of closing costs and spell out the same in the PSA. In almost all instances, each party will agree to pay its own attorneys' fees and costs, and the buyer will agree to pay for the survey and other due diligence costs (unless payment of those diligence costs was negotiated differently in the LOI). In some deals, seller will agree to pay for some aspects of a Phase II investigation if recommended by the Phase I. Even in jurisdictions where seller typically pays costs of the title policy, most costs will be limited in the PSA to costs of a base title policy (in CA, for example, a standard CLTA owner's policy) with buyer paying for the overage for an extended coverage ALTA owner's policy and any endorsements it wants (except for those being issued to cure a title objection per seller's agreement, which are typically paid for by seller).

2. Prorations. Because of the complexities of operating retail shopping centers and projects, prorations provisions in PSAs are drafted to address the same. Specifically, prorations provisions generally address proration of base or minimum rent, reimbursable tenant expenses or reconciliations (e.g., CAM charges, real property taxes and assessments, and insurance, often referred to collectively as operating expenses or reconciliations in such PSAs), any percentage rent obligations, and the parties' duties towards each other with respect to the above after closing. Proration of base or minimum rent is usually straight forward, i.e., prorated based on either a 30-day month or the actual number of days in the month in question. As a general rule, delinquent rent of any type is not prorated. Frequently, buyers also push to have the right to apply delinquent rent received to current rent owed, even if the payment specifically references such delinquent rent. Most commercial PSAs ultimately provide that seller will retain the right to collect delinquent rent from tenants after closing, but seller is not entitled to evict the tenant or otherwise interfere with its right to possession after closing. Such clauses also require buyer to cooperate at no material cost with seller's efforts to collect delinquent rent. Usually such cooperation clauses are subject to a sunset provision (e.g., it goes away after 12 months). As real property taxes are state, county, and sometimes municipality specific, it is important to confer with local counsel or the title company to ensure that the real property taxes are prorated appropriately.

3. Reconciliation. With respect to reconciliation expenses, there are two schools of thought. Some PSAs for retail projects provide that if at closing the amount collected by seller for reconciliation / operating expenses is more than what is owed for the expenses in question for the partial year in question, then seller will provide buyer with a credit for said amount and if the amount collected is less than the actual expenses, buyer shall pay such difference to seller at closing (minus any delinquent rent attributable to the shortage) in addition to the purchase price. A buyer or its attorney will often object to such language as it assumes buyer will be able to recover the difference from the tenants as part of the annual reconciliation process and essentially acts as buyer guaranteeing seller for seller's potentially poor estimates or true-up process with its tenants. A better, more market approach is to provide that buyer is obligated to bill the existing tenants for such sums (to the extent allowed under the applicable leases) and pay seller its share of said sums if and when received.

4. Leasing Costs and Security Deposits. Sellers usually agree to pay, and have reflected in the PSA that they are responsible either through a credit or other direct payment for any tenant allowances or commissions owed under the leases entered into prior to the PSA being signed. Usually, buyer will be responsible for such costs for any lease entered into or signed after the PSA. Any and all security deposits are either delivered or credited to buyer at closing.

5. Post-Closing Obligation to Cooperate. With respect to the proration of rent and handling of reconciliations under tenant leases, the PSA should also provide that seller will assist escrow agent in preparing the closing statement with buyer having the right to reasonably approve the same. It is customary for the PSA to have re-prorations similar to the following: "In the event that any prorations, apportionments or computations made under this Section require final adjustment after the Close of Escrow because of the unavailability of information on the Closing Date (or other cases when the original proration was simply incorrect), then the parties hereto shall make the appropriate adjustments promptly when accurate information becomes available and either party hereto shall be entitled to an adjustment to correct the same." It is good idea, however, to have the obligation to re-prorate expire after a set number of days after closing, usually in the range of one year to 18 months. The PSA should also impose a duty on seller to cooperate with buyer to produce the year end reconciliation statement for the year of closing and further provide that seller will cooperate with buyer for any CAM or other reconciliation audits relating

to any period prior to closing, and ultimately be responsible for any sums determined to be owed any tenants as a result of such audits for any period prior to closing.

F. Obligations to Pay-Off or Cure Monetary Liens. Generally, most PSAs provide that the seller must pay-off or otherwise release any monetary debts (such as a loan or amounts owed to a contractor) that are secured by lien against the property being sold (e.g. a deed of trust or mechanic's lien). In some cases, sellers wish to have a provision in the PSA that gives the seller the obligation to only pay-off or cure "voluntary" monetary liens (such as a deed of trust), which are also almost always defined to include delinquent taxes) as opposed to involuntary liens, such as a judgment or environmental lien.

G. Limitation on Damages re Defaults and Breaches by Parties and Other Remedies.

1. Buyer's Default. As discussed above, we typically see the earnest money deposit as the agreed upon amount of liquidated damages due and owing to a seller in the event of a buyer default under a PSA. Sometimes as noted above, if the deposit is a very large percentage, liquidated damages will be a percentage of the deposit.

2. Seller's Default.

a. Limitation on Monetary Damages for Failing to Close and Specific Performance: There are certain situations where a Seller failing to close will trigger a buyer remedy of terminating and reimbursement of its out of pocket costs, or sometimes a pre-determined "break up fee". The argument here is that a buyer moved forward to closing and expended capital and resources with the expectation of owning the property, so seller should reimburse buyer for those expenses. When representing a buyer, this should be separate and distinct from a situation where Seller sold the property out from under your client, in which case, remedies should either have a higher cap or be unlimited, and most importantly, if at all possible, a right to enforce the contract through the remedy of specific performance. If a seller agrees to grant a buyer the right to specifically enforce the PSA in the event of a seller default, the PSA customarily will provide for a limited period in which the buyer must file such action or waive the right, which filing period is normally much shorter than the applicable limitations period (typically between 30 to 90 days after the event of seller default).

b. Caps and minimum thresholds on Damages for Breach of Reps and Warranties: A post-closing Survival Period with a cap and basket concept is typical for retail PSAs. The purpose is to allocate the risk of violations of reps and warranties between seller and buyer.

1. The "basket" is the minimum amount of damages a buyer must prove before it can make a claim against seller during the survival period. There are typically two types of baskets: tipping and non-tipping.

2. The "cap" is the maximum amount of damages a seller can be liable for. Sellers will want the lowest cap possible. Buyers will push for a high cap.

3. Dollar amounts for caps and baskets are highly negotiated and vary depending on deal size.

In seller form PSAs, buyer often expressly waives any recovery for consequential or special damages (i.e. lost profit or revenue).

3. Cure Periods. Many, but not all PSAs, include a notice and cure period before either party is deemed in default under the agreement. In some instances, such cure periods are stated not to apply to requirements to timely make a deposit or wire the purchase funds into escrow.

H. Commissions. Real estate commissions paid for commercial, or retail, purchase and sale transactions tend to be heavily negotiated. In our experience, purchase prices in the $2 million or less range generally generate commissions equal to 5% to 6% of the purchase price. For transactions where property is being sold for over $2 million, but less than $10 million, we have seen commissions in the 4% to 5% range. Most commissions for a purchase price of $10 million or more will not exceed 3% to 4%. [$50m range 2% plus] For very expensive real estate, such as a property worth $100 million, a commission equal to 1% thereof would not be unusual. The commission amount also varies based on how much work the broker has to do or anticipates having to do to sell the property in question (i.e., the harder the work, the higher the commission).