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Commercial Real Estate Sellers - Ten Additions to a Buyer's Contract [Ober|Kaler]

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When a seller and a buyer agree upon the terms for the sale of a commercial property the next step is often for the buyer to prepare the first draft of a Contract, which embodies those terms, as well as other customary provisions such as representations, warranties, covenants and conditions of closing. After receiving the draft, the seller, its agent and counsel can scrutinize each provision suggested by the buyer. With the Contract laid out in front of them, the seller's team can focus on the concepts and language they would like to delete or modify. Somewhat more difficult, however, is for the seller's team to know what is missing from the buyer's draft. That is, what things does a buyer tactically omit from its Contract that the seller would want included? Below are ten provisions that a seller would want in its Contract but that a buyer may well not include in its draft.

1. Not Binding until Executed

Negotiations often begin with the execution of a letter of intent. A letter of intent typically contains an express statement that there is no binding agreement until a final Contract is negotiated and executed. The buyer's draft, however, usually will not have similar language. One might ask why such language is necessary. Either the Contract is eventually fully executed and delivered, in which case the Contract is effective, or the Contract, though negotiated, is never signed by one of the parties and, therefore, by virtue of the statute of frauds or otherwise, there is no enforceable agreement. Unfortunately, things are not always so clear cut. Buyers have been known to take the position that an unexecuted Contract, perhaps transmitted by email or facsimile together with a statement to the effect that the seller is in agreement with the terms of the Contract, constitutes the equivalent of a Contract executed and delivered. Though such a claim may not prevail on the merits, a suit to enforce the "contract", or even the threat of such a suit, may cloud title to the property and render it unmarketable. To avoid this argument, the seller should be sure the Contract contains express language stating that there will be no binding agreement unless and until both parties sign and deliver a final Contract document.

2. Limitation on Survival of Representations and Warranties

The buyer's draft will almost assuredly require the seller to make certain representations and warranties. Typically, the parties negotiate the time period for which the seller's representations and warranties survive closing. Occasionally, however, the buyer's draft may not set forth a survival period and, indeed, may be silent as to whether or not the seller's representations and warranties survive closing. Does this mean that they do not survive and that the buyer is precluded from bringing a claim after closing based upon a breach of a seller's representation or warranty? Depending upon the state's law, it may well be that many representations and warranties survive closing, notwithstanding that the Contract was silent on the issue. The "merger doctrine" (i.e., the doctrine that the terms of the Contract merge into the Deed) may not apply to matters collateral to title.

Rather than leave it to chance, the seller should add language to the Contract explicitly stating that its representation and warranties do not survive at all (which likely will not be acceptable to the buyer) or that its

representations and warranties survive for an agreed upon period but no longer. In this regard, the seller should be careful to avoid any ambiguity regarding the interpretation of the survival period. For example, what if the buyer notifies the seller of a breach within the survival period but does not file suit until after the expiration of the survival period. To avoid any such ambiguity, the seller can provide that the buyer is precluded from bringing a claim based upon an alleged breach of a representation or warranty unless an action is filed in a court of competent jurisdiction within a specified period of time after closing. Note, however, that not all States allow such a contractual statute of limitations, so the seller should inquire whether governing law prohibits the parties from agreeing to such a provision.

3. Definition of “Knowledge”

Some of the seller's representations and warranties set forth in the buyer's draft will be unqualified, but some may be made “to the best of the seller's knowledge”. The seller then needs to consider what exactly it means when it makes a representation or warranty to the best of its knowledge. Does that mean that the seller is required to undertake an investigation of some sort? Must he review many years of files related to the property and its operation; interview the management company or others that are or were involved in the operation of the property; and, will the seller be charged with constructive knowledge from public sources or knowledge imputed from its officers, employees or agents? In order to avoid these uncertainties, the seller should include a definition of knowledge which limits knowledge to the actual, subjective knowledge of a named individual and expressly excludes constructive knowledge, imputed knowledge and any duty to investigate. As a drafting matter, if the seller succeeds in obtaining a favorable definition of “actual knowledge” then the seller should be sure to use that exact term throughout the Contract. That is, the seller should not use “actual knowledge” as the defined provision, but use “to the seller's knowledge”, “to the best of the sellers knowledge” or similar but not identical language in other provisions. Doing so may give rise to the argument that the use of even slightly different language means that the parties intended that a different standard be applied where the different language is used.

4. As Is Sale/Integration Clause

As mentioned above, the buyer's draft will likely ask the seller to make various representations and warranties. Certainly, that is fair and the seller has the opportunity to adjust the buyer's language and limit the scope of those representations and warranties. In addition, however, the seller will want to be sure to include in the Contract a detailed statement to the effect that, except as expressly set forth in the Contract (or in documents executed and delivered by the seller at closing), the sale is strictly “As Is” without representation or warranty of any kind and that the buyer takes the property subject to any and all matters that affect its title or condition and also accepts the risk that information contained in due diligence materials may not be true or accurate. The “As Is” provision can be a sentence or two or run for several pages, depending upon the seller's level of concern and the buyer's willingness to accept many paragraphs of onerous language. Either way, the idea is to prevent the seller from being responsible for any statement of any party or for any inference raised from any materials, except to the extent expressly incorporated in a formal representation or warranty.

Together with the “As Is” provision, the seller should also include in the Contract an “integration clause”. The integration clause states that all of the prior negotiations and all of the parties' understandings and agreements are integrated into and made a part of the Contract and that there are no other understandings or agreements relating to the transaction. Similarly, the seller should include a provision that no modification or addition to the Contract is effective unless it is in writing and signed by the parties. These provisions help to prevent a buyer from making an end run around the As-Is concept.

5. Seller's Due Diligence Related Provisions

The buyer's draft will typically provide for a study period and the right of the buyer and its designees to enter onto the property during the study period (and perhaps at all times prior to closing) to inspect and conduct tests on the property. This is appropriate, but the buyer's draft may not include certain related provisions which are essential for the seller. The seller will want the buyer: to indemnify the seller against any injury, death or damage to property during the buyer's entries; to promptly restore the property following any tests which might disturb it (and perhaps limit the type of tests the buyer can make to those that are non-invasive); to provide evidence of liability insurance coverage in a reasonable amount with the seller named as an additional insured; and, to give to the seller, at no cost, any title, survey or other test or study results (assuming the sale does not close for reasons other than the seller's default). The foregoing provisions should expressly survive any termination of the Contract and the indemnification provision should also survive closing under the Contract. The seller may also want to limit the time of day that the buyer can enter the property, require prior notice, require that a representative of the seller accompany the buyer during all entries and make all such entries subject to the rights of tenants under existing leases.

6. Broker Indemnity

More often than not, the buyer's draft will include a provision stating either that the parties have not utilized brokers or specifying the brokers they have utilized and providing for cross-indemnities in the event a claim is made by a different broker. But if such a provision is not present, the Seller will want to add it, as under the law of most states the seller is likely to be the party responsible for paying the broker's commission, even in the absence of a written agreement between the seller and the broker. In addition, the seller should be certain that the representation, warranty and indemnification survive any termination of the Contract and closing.

7. Limitations on the Buyer's Remedies

The buyer's draft may provide that in the event of a seller default, the buyer has all remedies available at law or in equity. Alternatively, the buyer's draft may be silent on the buyer's remedies in the event of a seller's default. Under these circumstances, what is the seller's exposure if the seller, perhaps for reasons beyond its control, does default under the Contract or does breach a representation or warranty? Because the seller's exposure may be extensive and/or may not necessarily be clear, the seller will want to specify and limit the buyer's available remedies.

The extent to which the seller can limit its exposure is, of course, a matter of negotiation. Ideally, a seller would not want to allow a buyer to obtain specific performance, as a suit for specific performance would tie up title to the property and likely prevent prompt remarketing of the property. Most buyers, however, will insist upon specific performance.

Whether or not the seller will need to agree to grant specific performance, the seller would be wise to limit the buyer's other remedies in the event of a pre-closing default to termination of the Contract and reimbursement for reasonable and customary out of pocket costs and expenses paid to unrelated third parties, up to a maximum dollar amount. This would at least liquidate the seller's exposure for monetary damages in the event of a pre-closing default.

In addition, the seller will want to consider its exposure in connection with defaults that are not discovered until after closing. For example, what if the buyer discovers after closing that the seller breached a representation or warranty? The seller would not want to have unlimited liability. To deal with post closing claims, sellers often negotiate limitations on damages based on a basket and cap concept. That is, the seller may suggest a

provision that states the buyer cannot make any claim unless the buyer can show that the buyer's aggregate damages exceed a specified amount (to prevent nuisance claims) and that the buyer is limited to recovering a certain maximum amount under all claims (to provide a ceiling on the seller's liability). Also, the seller may want to include a provision stating that if the buyer knows, before closing, that a representation or warranty is breached and yet consummates closing the buyer can not recover any damages resulting from the known breach of that representation or warranty.

8. Time is of Essence

Typically, a time is of the essence provision is more of a concern for the buyer than for the seller. Therefore, this provision is often absent from the buyer's draft. Time is of the essence can be a double-edged sword, but, typically, the seller would rather have definitive drop dead dates which it can rely upon in the event that the buyer does not close and the seller wants to remarket the property. In the absence of such a provision, the buyer, even if it does not close on the specified closing date, would likely be afforded a reasonable additional period of time under the circumstances to consummate closing. If the seller wants to insist on a time is of the essence provision, but the buyer strenuously objects, a middle ground is to include the time is of the essence provision, but also add notice and cure language, specifying that before any party can pursue its remedies for default, the non-defaulting party must notify the other party of a default and the defaulting party is given a short period of time to cure.

9. Buyer's Representations

While the buyer's draft will likely require the seller to make many representations and warranties, it typically will not include any representations or warranties from the buyer. The seller would be wise to include some basic representations and warranties regarding the status and authority of the buyer, the due authorization of the Contract, the absence of conflicting agreements and the enforceability of the Contract against the buyer. Typically, a buyer will not object to reasonably drawn representations and warranties of this nature. Adding these representations and warranties should, at the very least, cause the buyer to consider and undertake whatever internal approval processes are required in order to make the Contract the enforceable act of the buyer and eliminate possible issues related to claims of parties with an ownership interest in the buyer that were not involved in the Contract discussions. The seller may also want to require representations and warranties relating to anti-money laundering and anti-terrorism laws.

10. Does the Buyer have Assets

During the preliminary phase of negotiations, the seller typically deals with one or more individuals that are affiliated with a solvent entity. By the time the buyer's draft reaches the seller, however, the actual "Buyer" may be an undercapitalized, single purpose entity set up solely to acquire the property. The seller would be wise to avoid dealing with such a buyer and would rather deal with a buyer that has substantial assets and ongoing viability.

While the buyer may counter that (as is typically the case) its exposure in the event of default is limited to forfeiture of the deposit that is not a satisfactory response. As noted above, the seller will want to obtain indemnities from the buyer, at least regarding entries onto the property and disclosure of brokers. These indemnities would be largely meaningless if the buyer has no assets beyond the deposit. Moreover, the buyer's draft may provide for legal fees to the prevailing party in the event of litigation. This is a reasonable provision and, indeed, a preferable provision in the event that the seller agrees to give the buyer the remedy of specific performance (the prospect of paying the seller's legal fees could provide at least some disincentive for the buyer to file a frivolous claim for a specific performance). Such an attorneys' fees provision, however, is really

a one way provision if the buyer does not have assets. Therefore, if at all possible, the seller should deal with a properly capitalized buyer or perhaps obtain a guarantor of the buyer's liabilities.

There are other provisions that the seller may want to insert into the buyer's draft Contract, such as permitting a like kind exchange; providing for conditions of the seller's obligation to close; and providing a requirement that the buyer's title company deliver all closing documents a certain period of time in advance of closing so that the seller's attendance at closing is unnecessary. But, in any event, it is clear that when evaluating the initial draft of a buyer's proposed Contract, the seller and its team must not only carefully review each provision that is included in the draft, but must also carefully consider what provisions do not appear in the draft but should become a part of the Contract.

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