

PRACTITIONER'S CORNER
Warren Gorham & Lamont Real Estate Outlook

BUYER BEWARE:

Clauses for protection of the Buyer
in the purchase of income-producing property.

By Marc H. Morgenstern and Mitchell C. Schneider*

The buyer of income producing property, such as apartments, shopping centers or hotels, is generally acquiring both real and personal property. The purchase price reflects a capitalized value of an anticipated cash flow. A purchase agreement that details only the classic real property concerns of title, ingress and egress, and physical condition of the property is deficient. These customary real property representations are necessary, but not sufficient. The focus of the agreement must also reflect the buyer's need to know that the total capital committed to the property (i.e., the price to the seller, soft costs of closing and financing, and capital improvements outside of normal maintenance) is not disproportionate to the anticipated cash flow. Thus, representations and agreements with respect to fiscal condition are as important as those with respect to physical condition because they equally impact on the basis for the acquisition, i.e., a fair return on invested capital. This article briefly addresses financial and other representations, the role of representations in the purchase agreement and the importance of addressing the offset, estoppel, subordination and proration issues.

The most basic element of the purchase agreement is specifying those assets which the buyer is purchasing. In addition to the transfer of the basic asset of real property, fixtures and building, a purchase agreement can include

*Mr. Morgenstern is a principal and Mr. Schneider an associate at the Cleveland, Ohio law firm of Kahn, Kleinman, Yanowitz & Arnson Co., L.P.A.

or exclude items of personal property, contractual arrangements affecting the property (including leases, service contracts, or financing arrangements), and documentation relating to the property such as architectural drawings, plans and specifications, surveys and interior design layouts.

Unless leases, contracts and personal property are specifically dealt with, it is unclear whether such assets remain the property of the seller or become the property of buyer. Absent clear contractual language, the transfer of such assets may depend upon how expansively the term the "premises" was defined in the general conveyance language. A broad definition of the term the "premises" as including all rights, privileges and appurtenances thereto may well have the effect of transferring leases and contracts. To avoid any confusion on such a critical issue, the purchase agreement should first, specifically list all of the real, personal and intangible property affecting the property and then indicate those items being transferred to the buyer.

The next most important provisions of the purchase agreement are the seller's representations. In addition to the physical and financial due diligence performed by the buyer and its agents (e.g., lawyers, engineers and environmental specialists), seller's representations provide the factual basis for buyer to evaluate the property and its condition.

Because of their paramount importance in the decision making process, the contract should specify that seller's representations constitute "a material inducement to buyer to enter into the agreement and consummate the purchase and sale of the property". The buyer is best protected if the representations and warranties survive the closing which can best be achieved by specific written agreement. Seller will generally negotiate a limitation to the survival

period. By making seller's representations a material inducement, a buyer can later demonstrate reliance upon them, thereby permitting buyer to sue seller both for fraud as well as breach of warranty if the representations are untrue.

A clause favored by sellers provides that if buyer was aware at or before the closing that a representation was untrue, whether through buyer's due diligence efforts or otherwise, then buyer cannot rely on the representation to seller's detriment. Buyers obviously, and correctly, resist this clause. The comparable buyer's clause provides that the buyer's due diligence and review of the property does not diminish the scope or enforceability of seller's warranties.

The difference in the foregoing clauses illustrates the dual role of representations. Representations constitute a source of information provided for buyer by seller to assist buyer in learning the facts about the property. Separately, they represent a contractually bargained allocation of specified risks. Where a representation is modified by the qualifier "to the best of seller's knowledge", buyer is essentially attempting to elicit information about a particular subject and prevent the seller from defrauding buyer actively or by concealment. Buyer wants to establish what seller actually knows about a particular matter. By contrast, where a representation is absolute and unqualified, seller and buyer are agreeing that in the event the representation is untrue, liability for the breach of representation will be borne by the seller and not the buyer regardless of whether seller had knowledge, or could have had knowledge, with respect to the accuracy of the representation.

The financial status and prospects of a property are reflected in its operating statements (or rent rolls), and less frequently in financial statements, relating to the property. These statements are normally attached

to the purchase agreement as an exhibit and seller represents their completeness and accuracy. The minimum acceptable representation is that such statements accurately reflect the operation of the property, have been prepared in accordance with specified accounting principles, consistently applied, and that there has been no material adverse change in the operation of the property since the date of the most current operating statement or rent roll.

The nature of the property, however, may necessitate more detailed representations. Statements can be mathematically accurate and appropriately presented and yet be misleading. The more closely real property resembles an operating company (such as a hotel) the more the representations should resemble corporate representations in a stock purchase agreement. Where inventory and receivables are significant, the buyer should conduct a physical inventory to verify the inventory and its cost basis. With respect to receivables, the buyer may either: (a) have a seller's guarantee as to collectibility and an obligation by seller to repurchase receivables uncollected after a specified time period; or (b) obtain extensive representations outlining the aging of the receivables, their validity and collectibility, the lack of claims which could degrade the receivables, and the adequacy of and basis for the receivable reserve.

In addition to the historical financial information, most current information affecting the income stream of the property stems from the leases. Accordingly, a schedule of leases should be attached to the agreement (and incorporated by reference) which correctly identifies each tenant, monthly rentals and security deposits, the amount of delinquencies, prepayments and offsets, and the commencement and termination dates and renewal options (including rent adjustments). Seller must represent that this exhibit is complete and accurate. Despite the representation, the prudent buyer will

thoroughly review the underlying leases to verify the accuracy of the summary schedule. Seller should additionally represent that each lease is in full force and effect, that neither landlord nor tenant is in default thereunder, and that the leases have not been modified, amended, or extended.

Finally, an exhibit should be attached to the agreement setting forth all contracts, agreements, licenses, permits, warranties and other intangible property associated with the operation of the property. Licenses and permits frequently can be transferred but it is certainly not uncommon for local and regional permits to require application by the buyer, the granting of which may not be automatic. The seller should represent that the contracts listed on the exhibit are the only contracts affecting the property and indicate whether the contracts or obligations are cancellable or assumable by buyer at buyer's election. Depending on the type of property, the transfer of contracts and leases can be of modest importance or tremendous significance. In general, apartment lease agreements strongly favor the landlord and are freely assignable by the landlord. Most major shopping center leases are assignable by the landlord either without the tenant's consent or with consent which cannot be unreasonably withheld. It is the exceptions to the general rule, however, which require diligence by the buyer and its attorney.

In the case of shopping centers and office buildings, the continuance and terms of tenant leases are critical, because they are the basis for the debt financing for the property. Seller must provide tenant estoppel certificates from each tenant. Like the seller's warranties and representations, the estoppel certificate serves two functions. It is an additional source of information for buyer and establishes an equitable, if not a legal, right or defense if the tenant certifications are untrue.

At a minimum, the tenant estoppel certificate should contain the following certifications: (a) that the leased premises have been satisfactorily completed, all tenant improvements paid for, and the tenant has accepted possession subject to the terms and conditions of the lease; (b) the commencement and expiration dates of the lease, including renewal periods; (c) the date when rent commenced and the monthly rent (including additional charges such as real estate taxes and common area expenses); (d) the date through which rentals have been paid; (e) the square footage of the leased premises; (f) that the lease is in full force and effect and that no default, or state of facts which with the passage of time or notice would constitute a default, exists; (g) that the lease is unmodified, unamended and unaltered except by the amendments specifically recited in the certificate; and (h) that the tenant has opened for business within the leased premises.

Similarly, seller should covenant to provide subordination and attornment agreements from major tenants in form and substance acceptable to buyer's lender since are normal conditions precedent to a mortgage loan. Tenants tend to insist upon provisions unacceptable to lender, such as that lease terms prevail over inconsistent mortgage provisions. Probably the most common problem is the tenant's requirement that the premises be rebuilt upon damage or destruction, or upon a partial taking in eminent domain, while the mortgage provides that the lender can accelerate the mortgage upon such events. The buyer can be caught in the middle between a valuable tenant and its lender. Although it may be impossible to avoid conflict altogether, the prudent buyer will attempt to shift the burden to seller in the purchase agreement or at least condition its obligation to purchase upon a satisfactory resolution of these issues.

Pervasive problems are raised by state, federal and local laws. Numerous representations regarding compliance with law are therefore significant. Because of the extensive liabilities of buyers under federal and state environmental legislation, representations regarding hazardous and toxic substances should be included. This representation should be broad and all encompassing and should provide that no chemical, material, or substance including, without limitation, asbestos in any form, ureaformaldehyde, polychlorinated biphenyls and toxic wastes which is prohibited, limited, or regulated by any governmental authority, or which poses a hazard to the health or safety of the occupants of the property or to the owners of the property adjacent to the premises, was ever applied, used, generated, stored or disposed of on, under, or about the property. The representation should additionally provide that no above-ground or underground tanks for the storage of gasoline, kerosene, oil, or other hazardous substances are or were located on, under, or about the property. Seller should also represent that the property is in conformance with all applicable zoning, building, health, safety, environmental, subdivision and other laws, ordinances and regulations whether state, federal or local.

These representations go to the heart of the dual nature of representations. Buyer and seller must squarely address the kind of the representation sought by the buyer and prepared to be given by the seller. If the goal is to avoid active fraud by seller, then buyer can settle for a representation that "to the best of seller's knowledge, after due inquiry, there are not now, nor have there ever been, hazardous wastes on the premises". That, however, leaves buyer without a remedy if the wastes had been there, if seller in fact conducted a due inquiry, and seller was truly unaware of the problem. (The issue of what constitutes "due inquiry" is an open one and

seller and buyer may choose to specify the precise due diligence contemplated.) Buyer can only be protected from the effects of all prior ownership by obtaining an absolute representation that "there are not now, nor have there ever been, hazardous wastes on the premises". The resolution of .the tension between the two approaches is generally determined on economic grounds depending on how badly seller wants to sell, buyer wants to buy and the amount of profit in the transaction. An intermediate position is for seller to give an absolute representation but limit seller's liability for breach of the representation to a specified dollar amount.

The foregoing representations give the buyer several bases for legal remedies. The practical remedy, however, is to pay a portion of the purchase price with a non-negotiable promissory note. The note should provide that buyer may offset payments under the note for breaches of representations and warranties either by automatic offset or by paying contested funds to an escrow account pending final determination of the respective rights of buyer and seller.

There are important substantive issues in addition to seller's representations. Of paramount concern is the proration of income and expenses. Standard provisions provide that current fixed rental income and current operating expenses are prorated as of the date of closing or possession, all easily determinable amounts. The proration of pass-through items such as common area maintenance charges, insurance charges, real estate taxes, and percentage rents, however, is often much more difficult. Such charges are generally billed in arrears to tenants with an adjustment at the end of a year or do not become payable by the tenant until the end of a lease year or a calendar year. Because narrative descriptions are sometimes ambiguous, it is a good idea to provide specific examples so that no confusion or disagreement

develops. For example, a purchase agreement may provide that rent shall be "allocated" as of the closing date so that rent attributable to the period prior to the closing date belongs to seller and rent attributable to the period after the closing date belongs to buyer. This language will lead to confusion if any tenant is delinquent in rent on the closing date. Therefore, a specific example should be included stating how rent paid by a delinquent tenant after the closing date will be treated. Obviously, buyer would like to include language and an example stating that rent received from any tenant who is delinquent in rent on the closing date is to be applied first against current rent and next against any delinquency. Buyer would agree to deliver delinquent rent (as defined by the example) to seller upon receipt by buyer. Similar examples can be included relating to pass-through items.

The universe of issues applicable to income producing real property is large, and this article is not exhaustive. It does, however, illustrate basic principles which apply, and demonstrates some of the fundamental language which must be included in the purchase agreement. By incorporating these items, the expectations and obligations of buyer and seller will be clarified, and each will receive *the* benefit of the negotiated bargain.