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COZEN O'CONNOR

THE BASICS: *Commercial Agreements of Sale*

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TABLE OF CONTENTS

Introduction 1

The Description of the Property 2

The Purchase Price and Deposit 3

Due Diligence 4

Representations and Warranties 6

Insurance, Risk of Loss, Condemnation 7

Closing 8

Default 9

A Note on Title Insurance 10

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INTRODUCTION

Unlike their cousin, the residential agreement of sale (which is usually a pre-printed form provided by a realtor), agreements for the sale of commercial real estate tend to be highly customized legal documents tailored to the specifics of the transaction at hand. While these agreements will vary based on, among other things, the kind of property involved (industrial, retail, office, multi-family, etc.), all agreements of sale for commercial transactions should address certain fundamental principles which, depending on the drafting of the provisions in question, may benefit the buyer, the seller, or both parties. Buyers and sellers, especially those with relatively little experience in buying and selling commercial property, ignore these provisions at their peril. This guide provides a basic introduction to some of these key principles. It is by no means exhaustive, but is intended simply to highlight some of the many issues that the parties to a commercial real estate transaction need to consider and address.

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THE DESCRIPTION OF THE PROPERTY

All agreements of sale contain a clause in which the seller agrees to sell, and the buyer agrees to purchase, the “property”, subject to the other terms and conditions of the agreement. Perhaps the most fundamental question the parties need to consider is what exactly it is that the buyer is purchasing. This question may be more complex than it first appears. A simple street address is often not sufficient to indentify with specificity all of the property being sold. It is therefore common in commercial transactions to identify the property in an exhibit to the agreement that contains a metes and bounds legal description of the land. While such a description is more accurate, it still may be impossible to tell exactly what is being described without commissioning a survey of the property. Similarly, if the buyer is purchasing a condominium unit, the unit will need to be described in accordance with the applicable provisions of the condominium statute in the state where the property is located.

In a typical transaction, a buyer purchasing the land expects to obtain all of the ownership rights and appurtenances that go with it (a concept know in legal parlance as “fee simple absolute” or “fee simple”).[1] If the land contains one or more buildings or other improvements, the buyer likely expects to obtain ownership of those as well. But what about property that is not, strictly speaking, part of the real estate being purchased – things like furniture, equipment and contractual rights that benefit the property? Under the law of most states, this so-call “personal property” will not be part of the sale transaction unless it is called out specifically in the agreement and may require a separate instrument, such as an assignment agreement or a bill of sale, to convey title. For example, if the property in question is industrial in nature, and the buyer expects to own the manufacturing equipment located in the building after closing, the agreement needs to specify this. Similarly, if the property has a prestigious name (e.g., the Empire State Building, Hearst Castle, etc.) and the buyer expects to continue to use that name after closing, the agreement should make that clear.

[1] It is possible to purchase less than all of the rights in a piece of property, as where, for example, the buyer is purchasing an easement, a percentage interest as a tenant in common, or an air rights estate.

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THE PURCHASE PRICE AND DEPOSIT

Of course, the agreement will need to specify the purchase price for the property. The determination of the purchase price is likely to be the central business issue negotiated between the parties.

As with residential agreements of sale, the purchase price in commercial transactions is often delivered in several parts. The buyer will usually post a deposit (sometimes called the “earnest money”) when the agreement is signed. The deposit may also be payable in multiple parts, with a portion of the deposit payable when the buyer signs the agreement of sale, and the remainder of the deposit payable when the buyer has completed its due diligence investigations of the property. The amount of the deposit is negotiable, with the seller wanting it as high as possible and the buyer wanting it as low as possible. The final determination of an appropriate deposit amount will depend on a variety of factors, including the relative leverage of the parties, the length of the due diligence period and the kind of property involved (e.g., raw land vs. a completed building).

The deposit is typically held in escrow by the buyer’s title insurance company pending closing.[2] There will need to be an escrow agreement among the buyer, seller and the title company to govern when, and to whom, the deposit is to be delivered. This may be accomplished under a separate agreement among the parties, or by adding a few appropriate provisions to the agreement of sale and having the title company countersign the agreement solely for the purpose of being bound by those provisions. The deposit is typically returned to the buyer if the buyer properly terminates the agreement of sale pursuant to its terms (as, for example, where the buyer terminates during its due diligence period). If the buyer wrongfully terminates the agreement or fails to complete closing, the deposit is delivered to the seller. If all goes well, the deposit is applied on account of the purchase price at closing.

[2] This is different than in a residential transaction where the deposit is often held by the seller’s realtor.

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DUE DILIGENCE

Commercial agreements of sale usually provide a period of time during which the buyer is permitted to undertake various inspections and investigations of the property. This is referred to as the “due diligence period” or the “inspection period”. The duration of the inspection period is negotiable, but the buyer will typically have the right to terminate the agreement during this period and receive a the return of its deposit. If the buyer does not terminate during this period, the deposit “goes hard” and will be paid to the seller if the buyer defaults and does not close.

The kinds of due diligence investigations that a buyer undertakes will vary with the kind of property involved, the buyer’s familiarity with it, and the buyer’s budget. Due diligence investigations may also be dictated by the requirements of the buyer’s lender if the purchase is being financed. The agreement of sale should require the buyer to obtain liability insurance before it is permitted to enter the property to conduct its due diligence.

The following is a list of some of the kinds of investigations that a buyer may consider. This list is not exhaustive, but these are some of the more common due diligence investigations the parties may encounter.

- **Title Review**: The buyer should order a title commitment from a reputable title insurance company to confirm that the seller holds good title to the property and to determine if there are any existing liens or other encumbrances.
- **Building Inspection**: The buyer should engage a qualified engineer or property inspector to thoroughly inspect any buildings or other improvements on the property, including the building’s structure, mechanical systems and roof.
- **Geotechnical Survey**: If the buyer plans to build on the property, the buyer may want to commission a geotechnical survey of the land to determine whether the proposed construction is physically feasible given the geology of the land.
- **Phase One Environmental Survey**: Environmental contractors will undertake a preliminary evaluation the property to determine whether there is a risk that the property contains environmental contamination and whether a more in-depth investigation (called a “Phase Two Environmental Survey”) is warranted.

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- **ALTA Survey**: A survey of the property undertaken by a licensed land surveyor in accordance with specifications published by the American Land Title Association.
- **Lease Review**: If the property has tenants that will remain after closing, the buyer will want to review the leases and become familiar with their terms. Attorneys are often engaged to undertake this function and produce summaries of the leases for the buyer's reference.
- **Financial Review**: If the property is generating income (from leases or otherwise), the buyer will want to review the seller's books and records to confirm that the buyer's financial projections and estimate are accurate.
- **Review of Service Contracts**: If the property is subject to existing contracts for services (such as landscaping, property management, elevator maintenance, etc.), the buyer will want to review these contracts and determine whether the buyer wants to assume them as part of the transaction or if they should be terminated prior to closing.

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REPRESENTATIONS AND WARRANTIES

Agreements of sale will sometimes contain a series of statements called representations and warranties. A representation is a statement of fact. A warranty is an assurance that the statement of fact is true and that the other party may rely on it. Representations and warranties are usually made by the seller for the benefit of the buyer, and may address anything from the physical condition of the property to the corporate authority of the seller to undertake the transaction. Buyers typically prefer to have as many representations and warranties from the seller as possible, particularly for things that the buyer can not determine on its own. Because a misstatement can give rise to liability, Sellers prefer to limit the kind and number of representations and warranties they are required to make and, wherever possible, force the buyer to use its own due diligence investigations to ascertain the condition of the property for itself.

As with most things in a commercial agreement of sale, the kind, formulation and number of representations and warranties, and the remedies available if one or more representations or warranties turns out to be false, are negotiable. Agreements sometimes make a distinction as to the available remedies based on whether the discovery of the falsehood occurs before or after closing, whether the party knew about the issue and made an intentional misrepresentation, and whether the condition giving rise to the misstatement was within the maker’s control. In some jurisdictions, if the representations and warranties are not expressly stated to survive the closing, they may be deemed to be of no further force or effect once the deed is delivered to the buyer. Therefore, agreements frequently will provide that the representations and warranties “survive” the closing for some period of time after which, if the buyer does not take some action, the buyer’s contractual remedies are further limited or extinguished altogether. If the representations and warranties survive closing for some period of time, sellers will often try to include a cap on money damages that a buyer can recover for discovering a misstatement after closing has been completed.

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INSURANCE, RISK OF LOSS, CONDEMNATION

Most modern agreements of sale require the seller to maintain property insurance against fire or other casualties that may occur at the property prior to closing. However, once the agreement of sale is fully executed, the buyer is deemed to be the "equitable owner" of the property, and it is therefore possible for the buyer to obtain its own property insurance on the building. Having the buyer insure the building was once common practice, but today it has largely been abandoned in favor of the seller maintaining the insurance.

What happens if there is a fire at the property before closing is completed? The answer to this, as with most things in commercial transactions, is negotiable. However, there is often a dollar threshold that governs the buyer's rights in the event of a casualty. If the cost to repair the building is below this threshold, the buyer does not have the right to terminate the agreement. In such a case either the closing is delayed while the seller undertakes repairs, or the closing goes forward and either the purchase price is reduced by the amount of the damage or the buyer takes an assignment of the seller's right to receive the proceeds of insurance (in which case the buyer undertakes the repairs after closing). If the cost to repair the damage exceeds the threshold, the buyer has the option to either terminate the agreement and recover the deposit, or go forward with closing under the procedure described above.

A similar parsing of rights may be employed where all or part of the property is taken by condemnation prior to closing. If the condemnation reduces the value of the property by less than a certain threshold, and the property remains usable for its intended purpose, the buyer may be required to go forward with closing and either receive a corresponding reduction in the purchase price or take an assignment of the seller's right to receive condemnation proceeds from the condemning authority. A buyer will typically have the right to terminate the agreement if the property is totally taken, or if the property is no longer suited for its intended purpose, or if the value of the property is reduced by more than the threshold amount.

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CLOSING

Closing is the consummation of the transactions contemplated under the agreement of sale. Closing procedures vary somewhat from state to state and jurisdiction to jurisdiction, but closing will typically involve four parties; the buyer, the seller, the title insurance company, and the buyer's lender. The seller delivers the deed and other documents necessary to convey title to the buyer. The buyer pays the purchase price to the seller, executes the note, mortgage and other documentation needed for its financing, and delivers any other documentation required by the agreement. The lender funds the loan. The title company issues a policy of title insurance to the buyer and lender insuring their interests in the property. In many jurisdictions, the title company will also record the deed, mortgage and any other recordable documents in the applicable land records to put the public on notice of the transaction and perfect the lender's lien on the property.

It was once common practice for the parties to gather in person around the closing table to consummate the transaction. Today, with the advent of email and overnight deliver services, its is more and more common to undertake the closing by mail (particularly if the buyer and seller are in different geographic locations). When closing by mail, the parties execute counterparts of the relevant documents and send them, in escrow, to a single party (usually either the title company or the seller's attorney) to be assembled. When the party assembling the documents confirms that everything needed for closing has been received and is in order, the parties direct that documents be released from escrow, the buyer's funds are delivered to the seller (usually by wire transfer) and the necessary documents are recorded in the land records.

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DEFAULT

What happens if either the buyer or seller refuses to close in default of the agreement? Under general principles of contract law, the non-defaulting party has the right to seek damages for any loss they have experienced by reason of the default. In some cases, the non-defaulting party may also seek an injunction to have the defaulting party compelled to perform the contract in an action for specific performance.

Each party has an interest in trying to limit its exposure in the event it is unable or unwilling to complete closing. Because it could be devastating for a buyer to be compelled to close if it is economically unable to do so, the buyer's liability for failure to close often is limited to its loss of the deposit. These "liquidated damages" compensate the seller for taking the property off the market during the period that the agreement was in effect, and for other direct damages that the seller may have incurred. Because the seller still owns the property, the theory goes, it is still able to strike a new deal with a new buyer and be made whole. Of course, this may not always be the case where, for example, due to economic circumstances beyond the seller's control, the value of the property drops significantly (a condition all to familiar in the face of the recent recession). Thus, the negotiation of the amount of the deposit is likely to be a critical issue that the parties must address.

On the other hand, since property is a unique asset, it could be impossible for the buyer truly to be made whole with money damages alone. Therefore, it is common that the buyer's remedy in the face of a seller default be limited to seeking specific performance of the contract (that is, compelling the seller to honor the contract and convey the property for the agreed upon purchase price), together with recovering the costs of bringing the suit. The buyer, therefore, receives the benefit of the bargain it struck, and the seller's liability is limited to selling the property for the price it had agreed to.

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A NOTE ON TITLE INSURANCE

An essential element of modern real estate transactions is title insurance. In connection with the buyer's due diligence investigations, the title commitment issued by the title company allows the buyer to investigate the status of title to the property and determine whether there are any fatal defects. The actual title insurance policy is issued at closing and insures the buyer that, on the closing date, the buyer owns good and marketable title to the property subject only to certain exceptions which are spelled out with specificity in the policy. A separate policy also insures the buyer's lender that its mortgage creates a valid lien against the property and insures the priority of that lien.

Unlike other forms of insurance, title insurance insures the circumstances as they exist on a particular date (usually the date of closing). If there are defects in title that existed prior to that date and to which the policy does not take specific exception, the insured is covered. If a defect in title arises after that date (as where, for example, a party puts a lien against the property after the date of closing) the insured is not covered. The policy will contain a schedule of exceptions to coverage. This schedule will list every lien, encumbrance and other defect to title known to the title company. The seller, and possibly the buyer, will also be required to sign an affidavit to the title company stating, among other things, that they have no knowledge of any other defects to title beyond those shown on the policy.

The cost of title insurance will depend on the value of the property being insured. Some states, such as Pennsylvania, are "filed rate" states, meaning that insurance premiums are determined by the state's insurance commissioner up to a threshold amount.[3] So, below that threshold amount, the premiums for title insurance should be the same regardless of which title insurance company the buyer uses. In other states, the premiums are negotiable. Various kinds of additional coverage can be added by means of endorsements to the policy. The cost of some of these endorsements is nominal, while the cost of others may be significant.

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[3] In Pennsylvania, the premium for title insurance coverage up to $30,000,000 is fixed. The cost of insurance above the $30,000,000 threshold is negotiable.

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