

**Auctions as Marketing Devices
For All Categories of Non-Distressed
Real Estate – A Future Trend:
Representing Clients to Maximize Their Success**

Irwin I. Gzesh
Neal, Gerber & Eisenberg LLP
Two North LaSalle Street
Suite 2200
Chicago, Illinois 60602
igzesh@ngelaw.com

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I. Introduction.

We all know that non-performing and underperforming real properties constitute significant ongoing cash drains and poor uses of capital that would be better deployed elsewhere. These types of properties accordingly are often disposed through an accelerated auction process. While the historical use of auctions to quickly dispose of these types of properties, often in connection with debtor/creditor default scenarios, may have fostered the perception that auctions are only used to sell distressed properties, this is clearly not accurate. Non-distressed sale properties likewise have attendant carrying and opportunity costs which can be successfully mitigated through the use of an expedited auction sale process. Moreover, the problem with simply listing any real property for sale through traditional means and then waiting for the right buyer to come along is that in addition to the axiom that “time is money” for our clients, traditional sale techniques may also inadvertently create a ceiling on price thereby leaving significant value behind. For these and other reasons explored in this article, the real estate auction industry is booming. This growing trend is evidence of the recognition by the marketplace that the use of properly conducted auctions affords many significant advantages over traditional sales techniques. However, attorneys for the parties must fully understand and appreciate the motivations, benefits and methodologies of the auction process in order to properly advise and effectively represent their clients as buyers and sellers in the rapidly expanding auction arena.

II. Specific Reasons for Participating in Auctions.

Auctions present all sellers with an effective alternative marketing strategy which, if properly executed, will enable the seller to (i) take control of the disposition timeline (and in so doing limit carrying and opportunity costs), (ii) more accurately gauge and better position itself to realize optimum market value and (iii) dictate the terms of sale. Auctions also present savvy buyers with strategic buying opportunities.

- A. Timing and Enhanced Value.** Typically, an auction program, from listing to closing of sale, can be accomplished in as little as 8 to 10 weeks. Intense marketing campaigns for commercial auctions and the auction mystique draw tremendous attention when compared with conventional promotional efforts on listed properties. An auction set for a specific date in the very near future broadcasts urgency to potential buyers. This often forces strategic buyers off the sidelines. By accelerating the sale and thereby reducing carrying costs for debt service, taxes, insurance and maintenance expenses, a property owner realizes substantial savings. Moreover, triple net leased properties intended to be marketed to passive investors (including as like-kind exchange replacement properties) will lose value as the remaining terms of the existing leases wind

down in a soft leasing market. Similarly, a tenant auctioning its leasehold or a sublease can cut-off or ameliorate its rent and CAM obligations that much sooner. Finally, as always, the time value of money tied up in untapped real estate equity and missed opportunity costs are significant considerations as well.

- B. Obtaining True Fair Market Value While Protecting Fiduciaries and Other Decision Makers.** Auctions can gauge true fair market value more accurately than appraisal methods. There are good reasons why properties which sell quickly at the asking price tend to leave sellers wondering whether they should have asked for more and why buyers' initial offers that are accepted without negotiation leave them wondering whether they paid too much and give rise to "buyer's remorse." Sealed bid and open outcry auctions that are properly conducted will defuse that concern for sellers. Open outcry auctions similarly resolve such self-doubt for buyers. Conventional brokers, investment bankers and real estate appraisers called upon to help a prospective seller set an "asking" price for a traditional listing will determine fair market value using one or more methodologies (i.e., capitalization of income streams, comparable reported sales and/or replacement costs). However, the appraisal process clearly is an art as well as a science. Applying the wrong cap rate or improperly identifying and adjusting between comparable properties can cause the estimate of fair market value to miss the mark by quite a wide margin. Moreover, one simply cannot gauge the value of the property to an unidentifiable buyer who for unknown strategic reasons may be willing to pay a premium for a specific property. Additionally, some properties are inherently unique and therefore difficult to value. A properly executed auction, whether through sealed bid or open outcry, provides the best evidence of what a willing buyer will pay a willing seller for the property in a competitive market setting. By so doing, the auction process prevents the establishment of an artificial ceiling on price (i.e., the traditional notion of an "asking price") and should provide a safe harbor, if properly conducted, to partners, trustees and other fiduciaries as well as corporate officers and directors who may be later called upon to defend an approved sale price.
- C. Controlling the Documentation.** The auction process allows sellers and their legal counsel to dictate the structure and control the documentation for the sale transaction. The only element a winning bidder can control at an open out-cry auction is setting the final price. Bidders are required to bid with the understanding that, if successful, the sale will proceed pursuant to the prescribed form of Seller's contract included in the "Bidder's Information Package" which has been provided to all prospective bidders well in advance of the auction. This avoids the risk of protracted negotiations between the buyer and seller (or more often their respective attorneys) typical of traditional sales. In most auctions, each bidder is required to provide a registration deposit via certified or cashier's check as a condition to participating in the process. At an open outcry auction, the winning bidder must sign the contract as soon as the gavel falls or forfeit its registration deposit. In sealed bids auctions, bidders are required to sign and submit the prescribed form of contract as a part of their sealed bid. Moreover, there are usually no contingencies provided in the form contract. Accordingly,

the success rate for closing the sale of auctioned properties is extraordinarily high. To the extent a seller is willing to offer purchase money financing, those documents (i.e., the forms of Promissory Note, Mortgage or Deed of Trust, Assignment of Leases and Rents, etc.) are also prescribed by the Seller and included in the Bidders Information Package. Hence, the need to engage in lengthy negotiations of these financing documents is similarly avoided. Lastly, in sealed bid sales, where contingencies are sometimes tacked by bidders onto their bids (even when not invited or permitted by the auction materials), the Seller is afforded the unique opportunity to collect all bids contemporaneously and then intelligently weigh and compare the relative benefits and burdens attendant to the pricing and related contingencies of all of the various bids that it has in hand when making its choice of which to accept.

- D. **Strategic Advantages.** From a buyer's perspective, savvy purchasers of commercial and other properties can quickly realize upon strategic opportunities by monitoring and bidding upon auction offerings. Examples of strategic motives include purchases in order to pick up new retail locations, enhance portfolios, create opportunities for physical expansion of existing facilities and sometimes to gain the ability to influence, modify or nullify existing operating covenants and easements that might be impediments to the bidder's existing property interests. Other buyers may purchase simply in order to control a property or leasehold as a means to stymie competitors such as competing retailers in the shopping center arena. However, in order to realize these benefits, buyers (as well as sellers) must fully understand the auction process.

III. **Types of Auctions.**

There are two basic auction formats. "Open outcry auctions" are just that. An auctioneer calls the auction in public having all bidders present (or connected by phone) with price being the only variable. In "sealed bid auctions" all interested bidders submit confidential written offers by a specified date sometimes also allowing for differing proposed terms of sale as well as the price variable. Within each of these two formats, there are three basic variations typically utilized:

- **Without reserve**, which means to the highest bidder regardless of price.
- **Without reserve but subject to a minimum bid**, which means to the highest bidder, but only at or over a minimum required bid.
- **With reserve**, which means that the seller has the right in its sole discretion to reject any and all bids including the highest bid.

In auctions without reserve, the guarantee of a sale regardless of price tends to generate tremendous buyer excitement because of the possibility that the property will be sold at a bargain price. As a result, enhanced buyer participation is likely which often leads to higher bid prices. The downside for the seller is that there is no minimum bid and no ability to reject the highest offer; it generally being held that the proffer of a property at auction "without reserve"

constitutes an offer by the Seller to sell which is accepted by the high bidder's submission of its bid, thereby creating a legally enforceable contract. Minimum bid auctions do provide a safety net for sellers but tend to blunt the excitement surrounding the potential for a bargain selling price that would be presented at an auction without reserve and therefore may negatively impact the bidding enthusiasm. Lastly, auctions "with reservation" really are not absolute auctions at all but instead are merely invitations for bids which need not be accepted by the Seller. The obvious drawback to this strategy is that prospective buyers simply may not invest the time and expense of investigating a property or attending the auction if they have no certainty that the highest bid will in fact be accepted.

It should be noted that auction company commissions are usually competitive with traditional brokerage commissions. In some cases, auctioneers may even accept lower than conventional brokerage commission arrangements. However, the auctioneer typically does require the owner to fund a marketing budget necessary to properly promote both the property and the auction itself. Additionally, the owner may be required to pay a stipulated fee to the auctioneer if it elects to reject the high bid in an auction with reserve. The auctioneer's fees may also differ depending on: (i) whether the property sells prior to auction, (ii) whether the owner removes the property from the process prior to auction (assuming it had reserved the right to do so), (iii) whether a property that goes to auction fails to generate a minimum required bid, and (iv) whether co-operating brokers are involved.

IV. The Lawyer's Role.

- A. The Seller's Lawyer.** By fully understanding the motivations, benefits and methodologies attendant to the auction process, an experienced lawyer will help the seller decide if an auction is appropriate for its property and help select the right auctioneer. The lawyer also confers with the auctioneer and client on the recommended auction format and negotiates the auction listing agreement. These auction listing agreements are somewhat more complex than a conventional listing agreement. Aside from setting forth the auctioneer's rights to its commission, the auction listing agreement should specify the type of auction to be held, spell out the specific obligations of the auctioneer, specify the marketing plan and corresponding budget and delineate the seller's specific obligations to co-operate with the auction process.

The seller's lawyer also helps to compile the Bidder's Information Package and prepares the sale agreement and any purchase money financing documents. It is essential that a seller's lawyer understand that the sale agreement should not be unfairly favorable to the seller but instead must provide a buyer with a reasonable transaction format which includes adequate assurances as to the buyer's ability to obtain clear title (and title insurance), customary prorations, a fair allocation of closing costs between the parties, appropriate remedies to both parties upon one another's default, and an appropriate allocation of the risk of loss in the event of casualty or condemnation. Similarly, any financing documents should be commercially reasonable and must comport with the nuances of local law. Offering short-term seller financing often enhances the likelihood of a successful auction. Many bidders in purchase scenarios need such short-term purchase

money financing in order to be in a position to participate in a prospective auction with the understanding, however, that once the property is acquired they will be required to find long term financing promptly.

Without the normal give and take between the parties' lawyers, a seller's lawyer may be tempted to withhold disclosures of adverse information (e.g., problematic environmental or structural conditions) or heavily slant the form of purchase and sale contract in favor of the seller. These temptations must be avoided at all costs! Lack of disclosure and unfairly slanted contracts will doom the auction process to failure.

- B. The Buyer's Lawyer.** Conversely, a bidder's lawyer should review the terms of sale and the Bidder's Information Package with his or her client in order to be certain that the client understands the auction process and the property. Since the success of the auction is primarily dependent upon the bidder's ability to obtain a reasonable comfort level, the Bidder's Information Package must include sufficient information. At a minimum, it should contain the terms of the auction offering, a current title report with copies of all documents of record, a current survey, zoning information, copies of all service contracts and leases, copies of tax and utility bills, financial statements, existing inspection reports, environmental phase 1 reports (and, where appropriate, phase 2 reports) as well as the sale agreement and any purchase money financing documents. Additionally, information regarding the availability of utility hook-ups, buildable floor area ratios and reports from soil compaction, wetlands and archeological studies may be appropriate for raw lands slated for sale as development properties. Potential buyers must also be afforded sufficient opportunities to make on-site physical inspections of the property along with their architects, engineers and other consultants prior to auction.

V. Is an Auction Appropriate for your Client?

In deciding whether to utilize the auction process to sell a property, you and your client should carefully consider the nature of the property, the budget that will be necessary to properly market the property and promote the sale at auction and any timing concerns or other business considerations presented by virtue of extrinsic factors such as your client's role as a fiduciary, rights of first refusal or first offer that may exist in favor of third parties and other special concerns. The Seller's lawyer should play an integral role in that legal and factual analysis. To obtain maximum success, the auctioneer itself must have the expertise to conduct the auction and the seller's lawyer must fully understand and help facilitate that process.

With the help of their attorneys, prospective bidders also must feel comfortable with the rules of the auction and with both the property and the legal documentation provided for the sale. Unless prospective bidders and their lawyers have been provided the opportunity to review all relevant information, inspect the property and conclude that they are sanguine with both the integrity of the process and the fairness of the sale agreement, the auction will inevitably fail.

VI. Conclusion.

When properly conceived and executed, auctions have the potential to pay huge dividends to sellers and to present bargain purchase and other strategic opportunities for savvy buyers as well. Hence, auctions are appropriate for all categories of non-distressed real estate as well as in conjunction with the sale of underperforming and non-performing properties. Accordingly, it is reasonable to expect that the ongoing rapid growth of the real estate auction industry will continue to accelerate. Transactional attorneys need to fully familiarize themselves with the motivations, benefits and methodologies of the auction process in order to properly advise and effectively represent their clients in this auction arena. Hopefully, reading this article will be a first step for many in that process.

Irwin I. Gzesh (igzesh@ngelaw.com) is a partner practicing in both the Real Estate and Corporate groups at Neal, Gerber & Eisenberg LLP, a Chicago-based law firm of nearly 200 attorneys. He routinely represents clients in the development, acquisition, management, financing, leasing and disposition of all types of commercial, industrial and residential properties. Irwin also counsels clients in corporate transactions, finance and business planning. His corporate experience includes mergers and acquisitions, joint venture formation, partnership dissolutions and secured lending. Throughout his career, he has successfully represented financial institutions, REITs, health care providers, developers, investors, trusts and estates in the sale and purchase of real properties and loan portfolios, often by means of the auction process.