CHAPTER 2

The Purchase and Sale Agreement

§ 2.01 The Need for a Purchase and Sale Agreement

The operative document for transferring real estate is a deed, not a contract. Deeds are usually short—generally just a few pages—and simple, with language mandated by state law or established by local custom. Any property owner can convey real estate in the time it takes to sign a deed before a notary public, but most purchasers of real estate, and commercial investors in particular, are not impulse buyers. These investors need time to confirm that the seller really owns the property, to locate financing on favorable terms, to investigate the physical condition of the property, to verify that the tenants have signed leases at certain rental rates, and to perform an array of other investigations. Buyers do not wish to spend time and money on these tasks only to have the owner sell the property to someone else. They need to ensure that, for a period of time, they can perform all of this due diligence work with certainty that the property is theirs if the property is as desirable as the seller claims it is. Similarly, the owner does not want to commit the property to the buyer only to have the buyer back out months later because it gets cold feet or finds a better deal elsewhere.

In short, each party wants the other party to be committed to proceed as long as things turn out consistent with their respective expectations. The parties typically accomplish this result through the use of

an executory contract, in which each party promises to perform in the future if certain conditions precedent are met. The buyer promises to pay an agreed price for the land as long as it receives certain information about the property and finds the property and the information to be acceptable. The seller promises to deliver title to the buyer in return for payment of the purchase price. Each party desires as much flexibility as possible for itself, particularly when addressing unforeseen circumstances, while simultaneously wanting the other party to be as irrevocably committed as possible.

Comment: On occasion, this book will use terms such as "demand," "insist," "require," and "should" when describing the positions a party might take on various issues. The practitioner should understand these terms in the context of each transaction, tempering her positions with a practical view as to what is important to the client; how to reduce risk without losing the transaction for the client; and—most significantly of all—what the relative negotiating leverage of the parties is. Generally speaking, the party who wants or needs the transaction the most has the least negotiating leverage. Only a party with the strongest negotiating leverage can "demand," "insist," or "require." All others can only "propose" or "request."

Comment: Certain "hot-button" issues are deal breakers for buyers or sellers. The lawyer should learn from the client early in the transaction what these issues are. This knowledge may save the client time and money it otherwise might spend on futile negotiations.

In a typical commercial transaction, the parties will sign a purchase and sale agreement several weeks or months before the seller is scheduled to deliver title to the buyer. In some cases, this executory period may even last for years if the buyer needs to obtain a permit to develop the property or needs a rezoning. The purchase agreement will disclose certain information to the parties and allow them the opportunity to gather other information on their own. It will list exactly what conditions each party must meet before the other party is obligated to perform. It will allocate a variety of risks between the parties. It will serve as a road map for the time until the closing by spelling out the obligations of each party. Finally, it will provide remedies that each party may exercise if the other breaches.

Comment: On occasion, the parties may decide to enter into an option agreement instead of a purchase and sale agreement. Under an option agreement, the buyer may choose whether to perform, and the seller is bound if the buyer so elects. For obvious reasons, some sellers may be reluctant to enter into option agreements. While there are important legal differences between an option and a purchase agreement, there may end up being little practical distinction between the two if the purchase agreement contains numerous broad closing conditions that the seller must meet or provides that forfeiture of the earnest money deposit is the seller's sole remedy if the buyer defaults.

§ 2.02 Buyer's Perspective

The purchase agreement is not always as reciprocal and evenly balanced as the preceding section may have made it sound. In most cases, the seller knows a great deal more about the condition of the property than the buyer does. For this reason, the buyer will use the purchase agreement as a way of unearthing as much information about the property as it can. In particular, the buyer will seek to persuade the seller to represent certain facts about the property in the agreement. The buyer will also use other tools in the purchase agreement, such as seller covenants and closing conditions, to shift to the seller risks that relate to the property.

The traditional rule of *caveat emptor* (buyer beware) survives about as strongly in the law of commercial real estate as it does anywhere in the law. Sellers of commercial property usually have few disclosure obligations.[1] This rule does not, however, allow the seller to misrepresent the condition of the property. The more disclosure the buyer seeks during the negotiation of the purchase agreement, the more it will learn about the property. If the seller is unwilling to represent certain facts about the property in writing, then the buyer will wonder why and will undertake its own investigation or will refuse to sign the purchase agreement. If the seller makes a representation that turns out to be untrue, then the buyer will be able to enforce its rights under the agreement, which may include the right not to close and the right to seek contractual damages. Thus, the buyer, who typically knows far less about the property than the seller, uses the purchase agreement and the negotiation process leading up to it as investigative tools.

The buyer will also use the purchase agreement as a means of obtaining information on its own. For example, the buyer must

determine whether it can borrow enough money on acceptable terms to be able to purchase the property. The buyer needs to obtain this loan commitment before it can close, and it may not be able to obtain a loan commitment before entering into a purchase agreement in which the seller promises to convey certain property at a certain time for a certain price. The buyer ordinarily will not receive financing from the seller (although it occasionally will), but it can use its agreement with the seller as a way to learn whether it will be able to obtain a satisfactory loan commitment from a third-party lender.

The buyer will also employ the purchase agreement as a way of allocating risks to others and away from itself. Suppose the buyer is acquiring an entity that owns a shopping center, and a patron slipped and fell in the shopping center two months ago but has not yet commenced a claim. The buyer surely will not know about this potential liability, and the seller may not know either. But until the statute of limitations expires, a stranger may show up unexpectedly with a viable claim against the entity for damages. The buyer will want the seller to remain responsible for all tort liability and other liability that accrued prior to the closing date.[2]

Thus, from the perspective of the buyer, the purchase agreement serves several investigative functions. The seller may disclose information about the property to the buyer in the agreement. The buyer may enjoy the right to investigate the property and confirm this information and obtain additional information on its own. And the purchase agreement may shift some risks to the seller. A good purchase agreement from the buyer's perspective will accomplish all of these goals.

§ 2.03 Seller's Perspective

The seller's perspective is quite different. Its goal is to convey the property, receive its money, and retain as little liability as possible. Therefore, a simple purchase agreement with few disclosures ordinarily will be in its interest. At the same time, the seller must acknowledge that the buyer needs certain basic protections before it can close, which, after all, is the seller's goal as well. The seller recognizes that the buyer has good reasons for wanting to learn about the property and that some of this information is available only from the seller. Therefore, the seller should realize that it may have to disclose certain facts about the property and about itself. Its goal is to keep these statements to a minimum.

If the seller is uncertain about a factual matter, it may limit its representations to its own knowledge rather than make absolute representations. Instead of representing that there are no occupants at the property, for example, the seller might state that it has no knowledge of any occupants at the property or that there are no persons occupying the property with the seller's consent. Similarly, the seller hopes to shift as many risks as possible to the buyer. The seller's goals are to avoid making any contractual representations that may later lead to liability for misrepresentation and to retain as little risk as possible after the closing. Sellers, then, tend to prefer short purchase agreements with few disclosures, just as buyers prefer lengthier documents in which the seller provides more information.

Comment: It is common for experienced sellers of real estate to seek to include a provision expressly disclaiming any representations and warranties not specifically set forth in the purchase agreement. Under this provision, the buyer agrees that it is accepting the property in "as is" condition.

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§ 2.04 Relative Bargaining Strength

The two previous sections, discussing the perspectives of the two parties to the purchase agreement, are obviously in tension with each other. The buyer is trying to get the seller to make disclosures that the seller would prefer not to make, and each party is seeking to shift as many risks as possible to the other. The ability of one party or the other to accomplish its goals depends to a large degree on that party's bargaining strength. If the market is hot and multiple parties are interested in acquiring the property, each prospective buyer is in a fairly weak position, knowing that if it makes too many demands, the seller may choose to sell to one of the other less demanding suitors. Conversely, if the seller is desperate to sell and potential buyers are not plentiful, it may prefer to yield on some of these points rather than lose the sale altogether.

Lawyers early in their careers may believe that their success in obtaining much of what their client wants in a purchase agreement is a testament to their own legal skills. Similarly, they may fear that an agreement that is not terribly favorable to their client is the result of some failing on their own part. While legal experience and skills certainly are assets that may lead to purchase agreements that are more favorable to a lawyer's client, much of the final result reflects nothing more than the relative bargaining strengths of the buyer and the seller.

These bargaining strengths, in turn, are reflections of many factors other than the skills of the parties' respective lawyers. Rather, the final agreement may simply be a manifestation of how active the market is, how desirable the property is, where interest rates are and where the parties expect them to be heading, and other similar business factors. The lawyer thus should seek to learn from her client exactly how much the client wants the property and precisely how accommodating or unyielding it wants the lawyer to be during the negotiation of the purchase agreement.

§ 2.05 Statute of Frauds

The statute of frauds applies to contracts for the sale of real estate. Although the contours of the statute of frauds vary somewhat from state to state, the statute generally requires that certain essential terms of the purchase agreement be committed to a writing that is signed by both parties. Most purchase agreements contain far more than this central core of relevant information, but it is important to ensure that this core appears in the agreement.

At minimum, the agreement should identify the parties, identify the property, state that the buyer is agreeing to buy this property and that the seller is agreeing to sell it, state the price or the manner in which the price will be calculated, and contain the signatures of the buyer and the seller. The purchase agreement also should contain an outside closing date, to forestall any argument that it violates the rule against perpetuities. Each of these terms will be examined in more detail below; the point here is to remember to include all of them.

Caution: Frequently, before the parties begin to prepare or negotiate a purchase agreement, they will enter into a letter of intent that contains the essential business terms of the transaction. A letter of intent often is designed to be nonbinding. However, unless it is very carefully drafted, the letter of intent may be binding on its own or may impose on the parties an obligation to negotiate the agreement in good faith. If the parties choose to enter into a letter of intent, the document should clarify whether or not the parties intend to be bound. Buyers and sellers often want their lawyers to draft letters of intent that bind the other party but not themselves. Ambiguous documents seeking to achieve this result have been the subject of much litigation.[3]

At the same time, if the parties enter into a purchase agreement with a lengthy list of conditions precedent, a court may view the document as nothing more than an option. If the parties truly intend to be bound, the conditions must be drawn narrowly enough that the buyer cannot easily walk away.

§ 2.06—Form: Letter of Intent

See Appendix A for a Form of Letter of Intent.

§ 2.07 Parties

The names of the parties should appear at the beginning of the purchase agreement. If a party is a business entity, its name should be followed by a statement of the type of entity and the state under whose law it is formed. Finally, the parties should be identified as the "Seller" and the "Buyer," or by similar capitalized names, for ease of reference throughout the document. For example, the purchase agreement might identify the seller as "XYZ, Inc., a Delaware corporation (the 'Seller')." By defining the term "Seller" at the outset, the agreement incorporates all of this information by reference each time this capitalized term subsequently appears.

Comment: Once the drafter defines a party by name in the document, he should be careful to use this name, and all relevant pronouns, in a way that minimizes confusion to the reader.

In the case of the seller, the name of the party that appears in the purchase agreement nearly always will be the same as the name of the current title holder. A lawyer who is representing the buyer and who knows that the party identified as the seller is not the current title holder needs to determine why. In some cases, the party identified as the seller in the agreement may itself have a separate contract to acquire the property from the current owner and may be purchasing the property and then immediately reselling it to the buyer. If the person who signs this purchase agreement as the seller does not own the property and cannot obtain title before it has agreed to deliver title to the buyer, then it will be in breach of this agreement at the closing, if not sooner. While this breach will allow the buyer to exercise its contractual remedies, it is always better to

avoid a lawsuit than to win one. Of course, until the buyer's counsel reviews the state of the seller's title, she may not yet know the identity of the current title holder, and in many cases she will not investigate the state of title until after the agreement is executed.

The buyer also must recognize that more than one party may hold an interest in the property to be sold. If the buyer is seeking to acquire a fee simple, then all parties with interests in the property will have to convey their interests to the buyer. In some cases, there may be concurrent owners of the property. The parcel may be held by tenants in common, for example, who purchased the property jointly as an investment or who took title under someone's will. One party may hold a life estate while others hold remainder interests. The property may be held in trust, and the trustee may need or want approval from one or more holders of a beneficial interest in the property. In these cases, the "seller" may prove to be more than one unique person or business entity.

In the case of the buyer, several twists may arise. Sometimes the intended buyer will be a business entity that has not yet been formally created. A principal of the buyer, such as a manager of a to-be-formed limited liability company, may serve as nominee and then will assign its rights under the purchase agreement to the limited liability company once it is formed. Buyers that are attempting to assemble a larger parcel from several contiguous smaller parcels often will use different nominees for each component as a way of maintaining secrecy during the assembly process and keeping the price down. Or the principals of the buyer may not want to go to the trouble and expense of forming a new entity until they are confident that the negotiations will succeed.

In addition, the buyer may choose to "flip" a real estate purchase agreement. It can accomplish this goal by locking up the rights to the property at a favorable price and then assigning its contract rights to a third party without ever taking title to the property. In essence, this party is selling the property at a profit without ever acquiring title to it. When this happens, the party listed as "buyer" under the purchase agreement will differ from the party that actually acquires title at the closing.

If the buyer under the purchase agreement plans to proceed in any of these ways, it needs to ensure that the agreement is fully assignable without the seller's consent.[4] Purchase agreements typically are assignable unless a provision in the agreement says otherwise, but the buyer under the purchase agreement should keep

this point in mind when reviewing the agreement. The party that executes the purchase agreement as buyer also would prefer to be released by the seller from all contractual liability once it assigns the agreement. In this way, it assigns to the third-party buyer not just its rights under the agreement but also its obligations. In the majority of cases, however, the party that signs the purchase agreement as the buyer is the party that plans to acquire the property itself.

Comment: A seller who is negotiating with a buyer entity must be cautious if it wishes to restrict the buyer's right to assign the purchase agreement. A holder of a beneficial interest in the buyer entity, such as a general partner of a partnership or a corporate shareholder, can assign its partnership interest or shares without technically violating a restriction on transfers by the buyer. Following such an action, the same entity would still be the buyer, even after the beneficial owner has succeeded in transferring its interest to another party. Thus, a seller who wishes to limit transfers of this type needs to be sure to include change of control provisions within the restriction on assignments, just as it would when limiting assignments of a lease or subleases.

Caution: If a principal of a buyer entity that has not yet been formed executes the purchase agreement as "buyer," that party becomes personally liable under the agreement unless the parties have agreed otherwise. Thus, anyone undertaking this role must be aware of the potential personal liability and should attempt to include provisions in the agreement limiting this personal liability. Better yet, the principal can be sure to form the entity before the purchase agreement is executed and have the new entity sign the agreement.

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§ 2.08—Form: Purchase and Sale Agreement

See Appendix B for a Form of Purchase and Sale Agreement.

§ 2.09 Recitals

Many purchase agreements contain lengthy recitals immediately below the paragraph that identifies the parties to the agreement. In their most archaic form, these recitals will be prefaced by the underlined term "Witnesseth," although many drafters simply

call them "Recitals" or "Background and Purposes" or do not label them at all. The recitals set forth a general statement of the purpose of the purchase agreement and often summarize the agreement in a few sentences. In more complex transactions, they also may provide useful background information, such as how the parties came to this agreement, why they are entering into the agreement, and how the agreement relates to other agreements between the parties.

Recitals can cause problems, however. Sometimes they address matters that appear nowhere else in the agreement, and courts are not always certain whether to treat the recitals as legally binding contract terms or merely as useful but nonbinding descriptive material. Worse still, the recitals sometimes contradict language that appears later in the purchase agreement. It is easy to see how this can happen, with the lawyers revising draft after draft and forgetting to conform the recitals to the evolving agreement. It is a good idea either to keep the recitals short and to be sure that substantive matters are handled in the body of the agreement rather than in the recitals or to avoid recitals altogether.

§ 2.10 Definitions

The decision whether to include a definitions section is a matter of personal preference, although in longer agreements it probably is a good idea. Even if the drafter uses clear, precise language, some terms will have special meaning within the document. For example, suppose the parties have agreed that the seller will deliver title to the property subject to three encumbrances: a prior mortgage, a right-of-way, and a disputed mechanics' lien. Rather than listing these three matters every time there is a reference to the acceptable quality of title and taking the chance of listing them in different ways in different parts of the document, the drafter might choose instead to define these three encumbrances as the "Permitted Exceptions." This shorter term is easier to use, and to use consistently. The fact that it is capitalized will remind any reader that it is a defined term that is being used in a specialized way. Some drafters even choose to underline defined terms or to use bold or italic type. The clear trend in commercial real estate transactions is to use definitions extensively.

Comment: Whenever possible, a definition should correspond as closely as possible to a word's ordinary meaning. Defining a term in a way that does not correspond to its ordinary meaning can lead to confusion. In other words, define a dog as a "Dog" and not as a "Cat."

A document should make it easy for the reader to find all definitions. Remember that these documents may be reviewed months or years later by people who did not participate in the drafting process. For this reason, it may be useful to place all of the defined terms and their definitions at the beginning of the document or to include an index of defined terms at the end. As the document grows more complex and the list of defined terms expands, the drafters can simply expand the definitions section or the index.[5]

§ 2.11 Identity of Property

While it seems evident that the purchase agreement must identify the property, it may not be quite so evident how to accomplish this goal. The most obvious answer—use of the street address—usually is not the best approach. While the address can help identify the property, it does not describe the boundaries of the land. References to tax lot numbers can also be misleading.

The parties typically will prefer to use the legal description of the property.[6] This description often will take the form of a metes and bounds boundary description and may be quite lengthy; for this reason, it may be attached at the end of the purchase agreement as an exhibit rather than included in the body of the agreement itself. The lawyer who chooses to attach the legal description as an exhibit should remember to incorporate that exhibit into the agreement by reference. Remember to include the less obvious elements of the property that may not be encompassed by the legal description of the boundary, such as beds of adjoining public roads, rights-of-way, subsurface rights (including mineral rights), air rights, and development rights. And be sure to include the improvements located on the land you have just described.

In some locations, a street address or block and lot number will suffice. When the property consists of one or more subdivided lots, the parties may use references to numbered lots that are shown on recorded subdivision plats. These devices are particularly useful

in newer developments that have been platted, such as residential subdivisions or industrial parks; in heavily urbanized areas, where addresses or block and lot numbers may have been issued in a predictable way and where lots may be of a uniform size and shape; and in condominium properties, where the units typically will be described in a publicly available condominium plan. The use of U.S. Government Survey information is standard in many western and some midwestern and southeastern states, particularly when referring to agricultural property. In all of these examples, the drafter's use of the "shorthand" information serves to refer the reader to a more precise method of determining the boundaries of the property.

Comment: Occasionally properties are identified either by imprecisely drawn plats or by tax plats that are prepared by the local jurisdiction. Tax plats tend to be extremely inaccurate and should not be relied on as the basis for a property description. Properties more frequently are described either by reference to numbered lots depicted on recorded subdivision plats or by metes and bounds descriptions prepared by a professional surveyor. This information is more reliable and should be easy to ascertain.

The seller must be careful that the description of the property it provides is accurate. If the seller inadvertently contracts to deliver more property than it owns, it has to acquire and deliver the additional property or it will breach the purchase agreement. Similarly, the buyer must be sure that the legal description in the purchase agreement covers all that the buyer believes it is getting. If the buyer is acquiring an entire business but the legal description does not include the parking lot or the loading dock, then the buyer may have to close even though it is receiving less than it expected and needs. Some of this information will not be available, though, until the buyer reviews a survey of the property.

The lawyer can find the legal description most readily in the deed that the seller received when it acquired the property, which should be in the seller's possession and also is available from the county recording office. Other documents, such as the seller's mortgage and title insurance policy, also will include the legal description. Even these documents will not be sufficient if the property that the seller is selling differs from the property it originally acquired. For example, if the seller originally acquired a large lot and is now selling only a part of it, the boundary description contained in the deed

by which the seller acquired title will describe too much land, and the parties probably will need to retain a surveyor to describe the smaller piece that the seller plans to sell to the buyer.

If the parties are in a hurry at the time they prepare the purchase agreement and cannot ascertain the precise legal description of the property, they may have to use the street address or some other general description of the property out of necessity. In these cases, the purchase agreement should include a clear process for establishing the more precise legal description that will be used in the deed. Given how easy it is to locate electronic versions of prior deeds in most jurisdictions, this problem should not arise often.

Comment: It is essential that the legal description include all easements and appurtenances to the described property, as discussed further below.

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§ 2.12 Agreement to Buy and Sell the Property

The central clause of the purchase agreement is the sentence that states, "Seller shall sell to Buyer, and Buyer shall purchase from Seller, the Property." The reason this executory contract exists is to bind each party to perform in the future, and this clause states directly what that performance entails. This required performance is subject to numerous qualifications and conditions precedent that are detailed in the sections of the agreement that follow, but the drafters should be sure to include this fundamental provision. Without this language, the parties may sign a lengthy document that does not actually obligate them to do anything.

§ 2.13 Purchase Price

The purchase agreement must state the sale price for the property. In most cases this price is expressed in dollars and cents.[7] Occasionally, the parties may agree on a method for fixing the price at some time in the future, perhaps by relying on a specified appraisal method, adjusting based on actual acreage, or establishing the price based on zoning or other entitlements obtained before closing. Make sure that the method of calculation is sufficiently precise. If it is not, the agreement may be unenforceable under the statute of frauds if a court later finds that the parties merely agreed to agree on a price.

Comment: In some jurisdictions, the parties may not have a binding purchase agreement unless the price can be determined with a heightened degree of precision. For this reason, contractual agreement on the method of determining the price, such as by appraisal, may not be sufficient unless there are ceilings or floors stated in the agreement.

The balance of the purchase price, net of the earnest money down payment, usually will be paid at the closing. The "Purchase Price" section of the purchase agreement should state which portion of the price will be paid before the closing,[8] which portion will be paid by the buyer at the closing from its own funds, which portion will be paid by the buyer at the closing with funds borrowed from the seller,[9] and which portion will be paid at the closing by the buyer's assumption of existing debt.[10]

The "Purchase Price" section of the purchase agreement should specify acceptable methods of paying that portion of the price that will be delivered at the closing. For example, if the seller wishes to be paid only by wire transfer or certified check, the agreement should state these limitations. The typical seller will not wish to be paid in cash, by a check that is not certified, or by an endorsed check from a third party. Purchase agreements for larger commercial properties typically require that the purchase price be paid in "immediately available funds," usually by wire transfer.

The parties also need to be attentive to concerns that the buyer may be violating the USA Patriot Act or attempting to engage in money laundering—issues that have understandably received heightened attention in recent years. This evolving area of law is beyond the scope of this book, but the parties must be sure to comply with all applicable laws and should consider addressing this issue in the "Purchase Price" section of the purchase agreement or elsewhere in the document.[11]

§ 2.14—Portion to Be Paid by Assumption of Existing Debt

In some cases, the parties will agree that the buyer will assume existing financing. Perhaps the lender has imposed a substantial fee for prepaying this financing or perhaps the interest rate on the existing debt is lower than the rate that now prevails. If the parties have agreed to an assumption, they should clarify this point with care in the "Purchase Price" section of the purchase agreement.[12] Do not forget that most loans contain due-on-transfer or other similar

language that allows the lender to prevent the buyer from assuming the debt. If the buyer and seller have agreed to a loan assumption, the purchase agreement needs to provide the road map for the assumption and address the consequences if the lender refuses to consent.

When a buyer purchases property with an assumption of existing debt, it is paying part of the purchase price in cash and the rest by assuming personal responsibility for the seller's preexisting debt. If the buyer fails to meet its responsibilities to the original lender, the lender may foreclose on the property and also may seek satisfaction from the buyer personally—just as if the buyer had signed the original note—but subject to any limitations on recourse in the loan documents.

The seller also remains liable for the debt unless the lender specifically releases the seller. The seller is not released from its obligations merely by selling the property to an assuming buyer, a point that the seller's lawyer would be wise to raise with the seller. In the event of a default on the debt, the lender can recover from either the seller or the assuming buyer. If the seller is called on to pay the lender, the seller can seek reimbursement from the assuming buyer or from the property itself, either directly under the assumption agreement or by virtue of subrogation principles that provide the seller with recourse against the buyer that assumed. Given this risk, most sellers will seek to negotiate into the purchase agreement a requirement that they and their guarantors be released from any prospective liabilities upon the buyer's assumption of the loan.

Caution: Note that if the buyer is a thinly capitalized entity, the buyer's assumption may be of little practical value to the seller or the lender. For this reason, the seller or the lender may seek personal guarantees from principals of the buyer.

If the buyer and seller agree to a loan assumption, the purchase agreement will need to address numerous issues that relate to this assumption. The purchase agreement must map out the assumption process, including the obtaining of lender's consent. It will need to address the extent to which the buyer will enjoy nonrecourse protection for this assumption and the extent to which the lender may require nonrecourse guarantees from any of the buyer's principals.[13] It will raise many of the typical issues found in any acquisition loan, including title and survey matters. It will allocate the costs of the

assumption, most of which are likely to be borne by the buyer. It will describe the closing process. Most importantly, as noted above, it will state how the buyer and seller plan to proceed if the lender does not grant its consent to the assumption.

§ 2.15—Portion to Be Paid by Amount Borrowed from a Third-Party Lender

The buyer probably will borrow a portion of the funds it needs from a third-party lender. The seller typically does not care whether the buyer will be using its own money or borrowing the acquisition funds (except to the extent that the buyer's inability to obtain a loan may allow the buyer to withdraw from the transaction), and the seller will deliver the deed as long as the buyer delivers good funds at the closing. The parties may, however, want to clarify that a portion of the purchase price will be provided by someone other than the buyer.

More important from the buyer's perspective is the fact that it may not yet have secured a commitment for its financing at the time it executes the purchase agreement. It is essential to the buyer that it have the right to withdraw from the agreement without penalty if it is unable to obtain the financing it needs. While this matter is discussed in more detail below in connection with the closing conditions contained in the purchase agreement,[14] it would be wise to reference that provision here, if only to remind the seller that some of the funds must come from a third-party lender that has not yet committed to provide those funds.

§ 2.16—Portion to Be Paid by Seller Financing

In some cases, the seller will provide a portion of the buyer's funds. Unlike the third-party financing just discussed, seller financing does not actually involve an advance of funds to the buyer. Rather, the seller accepts payment of less than all of the purchase price in cash, with the buyer's note and mortgage making up the difference. Seller financing is particularly useful in cases in which the buyer does not expect to be able to qualify for a third-party loan of all the funds that it needs: the buyer obtains a loan from the seller to fill the gap left after the buyer borrows all that it can from outside sources.

If the parties have agreed to seller financing,[15] they should indicate in the "Purchase Price" section the portion of the purchase price

that the seller is to provide. This provision not only should state the amount of the loan from the seller to the buyer but also should specify the repayment terms, including the interest rate, the duration of the loan, and the default provisions. If these provisions are fairly lengthy—which they will be if the parties are prudent—then it might make more sense to include all of the terms of the seller's loan in a separate section of the purchase agreement or to attach agreed versions of the note and mortgage as exhibits to the agreement. Even if the agreement treats this matter in detail elsewhere, the "Purchase Price" section still should indicate the portion of the purchase price that the seller will accept in the form of the buyer's note and mortgage.

Comment: Seller financing transactions tend to be simpler than loans provided by third parties. After all, the lender (which is also the seller) is more familiar with the property than the buyer or a third-party lender is. Nonetheless, the seller and its lawyer need to consider the extent to which the seller, in its capacity as lender, wants to enjoy protections commonly found in loans made by third parties, including nonrecourse carveout guarantees, opinions of counsel, and title insurance on the loan.

Caution: In many cases of seller financing, the property will be encumbered by two or more mortgages after the transaction closes. If the portion of the financing that the seller is providing will be secured by a second mortgage, the parties must confirm that the first mortgage permits junior financing. This issue can arise if the buyer is borrowing funds from both the seller and a third-party lender, because the third-party lender almost certainly will insist on senior status. It also comes up if the seller plans to lend funds to the buyer while also leaving existing financing in place, because the existing financing already will be senior to the new mortgage. The buyer, seller, and lender may need to execute a subordination agreement to clarify the relative priorities of the mortgages.[16]

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§ 2.17 Earnest Money

The buyer ordinarily will pay a portion of the purchase price at the time that it executes the purchase agreement. This payment, often referred to as "earnest money," a "down payment," or a "deposit," serves several purposes. It indicates that the buyer

is serious (or "earnest") enough about the sale to put its own funds on the line. The earnest money also gives the seller some confidence that the buyer has cash available to complete the purchase. Obviously, the extent to which the earnest money serves either of these functions depends on its size and the conditions under which it will be returned to the buyer, both of which are highly negotiable.

Comment: In many cases involving land that is to be developed for commercial use, the initial earnest money payment will be inconsequential. A further payment may be required when the review period ends or when certain contingencies have been satisfied.

The earnest money will often serve as liquidated damages in the event that the buyer breaches the purchase agreement. If the parties intend for the earnest money to serve this function, they need to be quite clear in their drafting. Different jurisdictions apply different standards as to when parties may make use of liquidated damages[17] and also have different rules about the contractual mechanics of accomplishing this result.[18]

If the earnest money is to serve as liquidated damages, then the parties must be particularly careful when they agree to the size of the payment. At minimum, the seller will want to be sure that the amount is sufficient to cover its net carrying costs for the duration of the due diligence period plus some of the subsequent time during which the property is back on the market. These seller carrying costs include interest on its own mortgage, real property taxes, and insurance and maintenance costs, minus anticipated income from tenant rents and other sources. After all, if the buyer breaches the purchase agreement two months after executing it, then the seller is right back where it started and has incurred the extra costs of carrying the property for at least these two months. If the seller fears that it will not obtain the same price in a subsequent sale, it must also consider the extent to which the liquidated damages need to make it whole for this anticipated price differential. Conversely, the buyer will want to keep the payment as small as possible so that its losses after a breach will be minimized.

The seller may end up suffering no financial loss at all if the buyer breaches. The property may be economically productive, with income exceeding expenses, and it may appreciate, allowing the seller to find another buyer who is willing to pay an even

higher price for the property. These matters may be difficult to estimate in advance, which helps explain why the parties may wish to use a liquidated damages provision in the purchase agreement rather than trying to reconstruct these figures in court later on. Use of a liquidated damages provision allows each of the parties to know from the outset the precise consequences of a breach by the buyer.

The parties should be sure they are clear about their understanding of the term "liquidated damages." If they intend for retention of the earnest money to be the seller's sole remedy, they should state this unequivocally. If they fail to do so, then a court might later award the seller additional damages. Recall also that some states will specifically enforce contracts for the sale of land even if it is the buyer that breaches, which means that the buyer needs to be sure that the liquidated damages remedy supersedes the specific performance remedy.

Even if the parties do not formally agree to treat the earnest money as liquidated damages, that may turn out to be the practical effect of the payment. If the buyer breaches, the seller may decide to retain this amount rather than seek actual damages.[19] This is particularly true if the buyer is a thinly capitalized entity that might prove to be judgment-proof even if a lawsuit succeeds. The buyer, meanwhile, may decide that there is little reason to seek to recover the earnest money if it faces a certain counterclaim from the seller for the seller's actual damages. Thus, the payment may function as liquidated damages even if the parties have not technically agreed to use these funds in this way. The likelihood of this outcome increases the closer the size of the payment is to the seller's actual losses, because neither party will have much to gain by contesting the matter.

Caution: In some states, the earnest money must be placed in an interest-bearing account. In these cases, the parties should be certain to state when, where, and how the deposit is to be invested and to specify which party is to receive the benefit of the interest on the deposit.

Caution: Note that in the event of a default on the purchase agreement, the brokerage agreement between the seller and the seller's broker may provide that the broker is entitled to a portion of its commission, often as much as one-half of the total. If the seller has such an agreement with its broker, then the seller may not enjoy the entire benefit of the deposit.

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§ 2.18 Escrow for Earnest Money

While the buyer and the seller may trust each other, the buyer may be uncomfortable with the thought of the seller holding a large sum of the buyer's money. If the deal proceeds to closing, then the buyer needs only to pay the balance, but if the seller breaches or if the buyer fails to close for an excusable reason, the buyer may worry that the seller will not return the earnest money. For this reason, the parties often will agree that the payment will be held in escrow by a third party.

The parties and the escrow agent need to be clear as to the escrow agent's responsibilities and liabilities, either in the purchase agreement or in a separate agreement. For example, suppose the seller claims that the buyer has breached but the buyer denies it. Each party may demand payment from the escrow agent, and the escrow agent may find itself defending a lawsuit even if it acts properly. For this reason, all parties, and especially the escrow agent, should insist on a clear escrow agreement. This agreement should state explicitly when the escrow agent may and must turn the escrowed funds over to one of the parties and also should specify procedures for the escrow agent to follow if it is unsure which party is entitled to the funds.

The escrow agreement should state whether the escrowed funds bear interest, which party will receive that interest, and how the funds are to be invested. This issue obviously is more critical if the amount of earnest money is large or if the purchase agreement will not be performed for many months after its execution.

Caution: The parties may prefer to have one of the lawyers serve as the escrow agent. In many instances, lawyers will elect not to serve in that role or will be prohibited from doing so by their firms' policies. The lawyer should be cautious before agreeing to serve as escrow agent, because the lawyer represents one party while the escrow agent must treat two or more parties impartially.[20] This inherent conflict might disqualify the lawyer from continuing to represent his client in the event of a subsequent dispute between the party that it represented in connection with the purchase agreement and the opposing party. It may be wiser from the lawyer's point of view to select a title company or another third party to act as escrow agent. Nonetheless, it still is customary in some states for lawyers to serve in this capacity.

Comment: Prudent sellers will require that the earnest money be held by an escrow agent located in the same state as the seller. If the seller does not do this, the seller may have to seek recourse out of state if there is a dispute over this amount.

§ 2.19 Sale or Removal of Personal Property

Purchase agreements often address personal property issues and not just real property matters. In some cases, the personal property may be a critical aspect of the deal, and the value of the personal property may equal or exceed the value of the land and improvements. A partnership that is purchasing a hotel with the idea of running it as an ongoing business, for example, will have little interest in outfitting an empty building. In other cases, such as the sale of agricultural property that is to be subdivided for residential use, personal property will not be a factor in the transaction or will be undesirable to the buyer. Even if personal property is not a major component of the transaction, inclusion of a personal property provision in the basic purchase agreement will remind each party to think about this issue.

The purchase agreement needs to address the fate of all personal property located at the site and should clarify which party will own this personal property after the deal closes. It should provide a mechanism for transferring title to this property, which does not pass by deed.[21] The parties also need to investigate the extent to which a sale of personal property subjects the transaction to sales taxes. To the extent there is or may be sales tax liability, the agreement obviously needs to allocate responsibility for paying it.

Comment: Defining the intellectual property to be sold or retained is an increasingly important and complex task drawing on skills that may be less habitual to the real estate lawyer. Careful attention should be given to computer programs associated with the operation of the property, billing and collection software programs, trademarks, copyrights, and agreements with providers of cable and information services.

If the buyer does not wish to acquire some or all of the personal property at the site, then the purchase agreement should state

whether the seller is responsible for removing this property and repairing any damage that results from this removal. If the personal property has no value to the buyer and is expensive to remove, then this property is a liability rather than an asset. In the hypothetical hotel, for instance, if the buyer intends to gut and rehabilitate the property immediately after the purchase, it can save a substantial amount of money if it convinces the seller to remove all of the personal property at its own expense.

Caution: One of the most important elements of the seller's personal property may be a liquor license or a gaming license. If the license can legally be transferred, it is essential that the purchase agreement spell out whether or not the license is a part of the personal property that the buyer is acquiring, whether the buyer must pay additional compensation for the license, and who is responsible for applying for and prosecuting the transfer of the license. Often, though, liquor licenses and gaming licenses cannot be transferred and the buyer must initiate its own application for a new license.

Caution: In some states, the rate of the sales tax on the personal property may far exceed the rate of the transfer tax and recording charges incurred upon transfer of the real property. Therefore, the purchase agreement should allocate the purchase price carefully between real and personal property and should specify which party bears the responsibility for payment of sales taxes. This is particularly important in cases such as industrial facilities, which may contain expensive manufacturing equipment.

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§ 2.20 Seller's Representations, Warranties, Covenants, and Indemnities

Two of the primary purposes of the purchase and sale agreement are the obtaining of information and the allocation of risk.[22] Each party needs to ascertain information about the other, and the buyer needs to learn as much as it can about the real estate before the closing. The parties can use the purchase agreement as a method of unearthing this critical data. One way of accomplishing this result is by asking the other party to state in the purchase agreement exactly what it knows, with contractual remedies available for breach. The representations, warranties,

covenants, and indemnities contained in the purchase agreement are designed to achieve this outcome.

Be aware that representations, warranties, covenants, and indemnities differ from one another and sometimes appear in different parts of the purchase agreement. It has become fairly common of late for drafters to place the representations and warranties toward the beginning of the document, with the covenants and indemnities appearing in a later section, alongside the closing conditions. This later section helps each of the parties—and particularly the buyer—focus on all of the events that must take place before that party is required to close. While the form document in this book follows that format, the sections that follow treat all four of these types of provisions together, because of the significant overlap among them. Whether the drafter chooses to group these provisions together in the purchase agreement or to treat them separately is largely a matter of personal drafting style.

In brief, a "representation" is a statement of current fact, such as, "The Seller represents that there are no tenants currently occupying any portion of the property." A "warranty" is a statement or promise of future fact, such as, "The Seller warrants that there will be no tenants occupying any portion of the property on the closing date," although the terms "representation" and "warranty" often are used interchangeably. A "covenant" is a promise of future action, such as, "The Seller covenants that it will remove all tenants currently occupying any portion of the property by the closing date." An "indemnity" is a promise to make the other party whole in the event that a representation or warranty proves to be untrue or a covenant is not performed. For example, the purchase agreement might state, "The Seller agrees to indemnify the Buyer and hold the Buyer harmless against any expenses that it incurs, including reasonable attorneys' fees and costs, if any of the Seller's representations or warranties is untrue in any material respect."

For ease of drafting, the parties might not include all of these statements in full. For example, the representations section of the purchase agreement might include a long list of representations, including the representation that there are no tenants, and a subsequent warranty section simply might state, "The Seller warrants that all of its representations will remain true through the closing date." The legal effect is the same as in the prior paragraph. Although the indemnity then might seem superfluous, it provides the basis for recovery of attorneys' fees and costs.

Comment: Bear in mind that many sellers are single-purpose entities. Representation, warranties, and indemnities from sellers of this type will be of little use to the buyer if the seller distributes the sale proceeds to its members immediately after the closing. In cases in which the seller entity continues to have assets, the seller often seeks to limit the time for which the indemnity will survive to six months or a year.

To understand better the distinctions among these different provisions, assume that a buyer is purchasing an office building that the seller had managed as rental property but that the buyer wishes to use as its own offices. This buyer does not want any preexisting tenants to be leasing space when it acquires title and wishes to address this concern in the representations, warranties, covenants, and indemnities of the purchase agreement. It should be apparent that this buyer's concern can give rise to all four of these provisions. If the seller has told the buyer that the property currently is vacant, then the buyer should request the stated representation and warranty.[23] If, however, the seller has informed the buyer that two holdover tenants remain in occupancy, then the seller cannot give that blanket representation, and the buyer will be more concerned about receiving the warranty, the covenant, and the indemnity.[24] The buyer that wishes to acquire a vacant building will want all four of these provisions included in the document, but its emphasis and level of concern will differ depending on whether the property currently contains tenants or not.

Comment: In many cases, the practical differences among representations, warranties, and covenants may be somewhat illusory, and a prudent buyer will often demand all three. The specific importance of the indemnity provision is that it gives the benefited party the right to attorneys' fees, legal expenses, and other associated costs. It is wise to spell out the entitlement to these fees and costs with precision in the indemnity.[25]

The buyer uses these provisions in the purchase agreement to gather information and confirm its understandings about the property. If the buyer does not yet know whether there are any tenants in occupancy or does not wish to rely on what the seller has stated orally, then the buyer can seek relevant representations, warranties, covenants, and indemnities. If the seller provides these assurances, then it has made a written commitment and the buyer can look to its

contractual remedies if the statements turn out to be inaccurate. If the seller refuses to offer these assurances, then the buyer is alerted to possible problems before it signs the purchase agreement and can investigate on its own or withdraw from the transaction at an early stage.

The party asked to provide a representation must decide the extent to which it feels comfortable making this statement in the purchase agreement. If this party knows the statement to be untrue, then it will breach the purchase agreement as soon as it signs it and will leave itself open to a claim for damages. If this party believes that the statement is generally true but is subject to certain exceptions, it should be sure to modify the representation to list these exceptions, either in the body of the document or in an exhibit to the purchase agreement. By listing these exceptions, the representing party both avoids breaching the agreement and discloses important information to the other party. In some cases, the party asked to make an absolute statement may believe the representation to be true but may lack certainty. This party may respond by modifying the representation and limiting it to the best of the representing party's knowledge. Lawyers for buyers and sellers spend many hours negotiating which representations will be made absolutely and which will be limited to the best of the representing party's knowledge.

Comment: Terms such as "to a party's knowledge" and "to the best of a party's knowledge" may have different connotations in different jurisdictions. In some jurisdictions, a party is under a good-faith obligation to have made inquiry, and a representation made "to the best of a party's knowledge" means that this party will be deemed to have made a study or analysis in order to form the basis for its representation.

Comment: Very frequently, a party that is a business entity may give a representation that is limited to the knowledge of named individuals within the entity. This limitation may be very important to a company that has a large number of employees, that has experienced significant turnover in personnel, or that has extensive (or disorganized) business records. It is increasingly common to define a party's knowledge with reference to the actual knowledge of one or more specific individuals, sometimes with no inquiry required and other times based on a specified scope of inquiry.

Note that many of the matters that are addressed in representations, warranties, covenants, and indemnities will also be the subject of closing conditions and that the accuracy of these representations and warranties and the performance of these covenants may also be conditions precedent to the other party's obligation to close. Closing conditions are discussed in more detail in subsequent sections of this chapter.[26]

Agreements to purchase commercial property may include detailed lists of representations, warranties, covenants, and indemnities, especially those provided by the seller. Sometimes, however, the seller may be perfectly willing to allow the buyer to inspect the premises for itself as a means of determining whether the property is acceptable but may not wish to provide any information directly to the buyer. In some cases, this may be an entirely reasonable position for the seller to take. The seller may recently have acquired the property itself and may not know much more about the property than the buyer does. In other cases, the seller simply may be attempting to negotiate a favorable purchase agreement with little risk of personal liability. The trend in recent years has been for sellers to provide fewer representations and for buyers to rely more heavily on their own due diligence investigations, particularly if the issue in question is one that the buyer can investigate on its own.

Whatever the seller's reasoning, the buyer must decide the extent to which it is willing to rely entirely on its own investigation, without the inclusion of any of these provisions in the purchase agreement. The buyer also must be sure that the agreement provides it with the time and the access to the property it will need to undertake its own investigation. In addition, the buyer needs to retain the right to terminate the purchase agreement without penalty if its due diligence discloses unacceptable problems, because it will have no other contractual recourse. The lawyer's tasks in this setting are to advise the buyer of these risks, to help the buyer undertake its own investigation of the property, and to assist the buyer in deciding whether any risks it discovers are acceptable.

The sections that immediately follow describe the seller representations, warranties, covenants, and indemnities that often appear in a purchase agreement. The buyer may want to include variations of all of these provisions, while the seller is likely to be far less accommodating. Later sections will address typical buyer representations, warranties, covenants, and indemnities.[27]

Even if the seller insists that the buyer take the property "as is," these sections of this book will remind the buyer what the relevant issues are and alert the buyer to the risks it will face if it agrees to a purchase agreement that lacks these protections. They help the buyer prepare a checklist of the issues that it must investigate on its own. They may help the buyer negotiate a more favorable list of closing conditions—a seller that will not provide representations, warranties, covenants, and indemnities probably recognizes the buyer's heightened need to address these matters in closing conditions. And they help the buyer decide what price it is willing to pay, since a purchase agreement with fewer protections for the buyer may translate into a reduced purchase price.

To avoid continually restating the awkward phrase "representations, warranties, covenants, and indemnities," this book sometimes will refer to these provisions collectively as "representations" but will not do so in situations in which the distinction matters. Remember, however, that most of the issues discussed in the sections that follow may also be addressed in contractual warranties, covenants, and indemnities, and not just in representations.

Caution: It is very dangerous for a party to give a "continuing representation" as to a factual matter, in which the party states that its representation was true on the date it was made and also will be true as of the date of the closing. If something changes, the party will be liable for a misrepresentation. The better course of action in this situation is to require the party to disclose any relevant change and to make the nonoccurrence of any change that would materially adversely affect the other party a condition precedent to the other party's obligation to close. This protects the representing party from liability for damages for misrepresentation if a change occurs after the purchase agreement is signed.

Caution: As will be detailed later, the use of "as is" language does not necessarily insulate the seller from liability.[28] A seller that is aware of a dangerous condition, a serious environmental problem, or another condition that would prevent the commercial buyer from using the property for its intended purpose would be required under the laws of many jurisdictions to reveal the problem to the buyer or to the broker, who in turn would be required under applicable brokerage standards to reveal the condition to the buyer. In residential transactions, many states now require extensive disclosures by the seller.