SESSION 107

Commercial Real Estate Purchase Agreement Panel: 7 Key Issues for Your Next Deal

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COMMERCIAL REAL ESTATE PURCHASE AGREEMENT PANEL:
7 KEY ISSUES FOR YOUR NEXT DEAL

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I. WHO GETS THE MONEY? EARNEST MONEY DEPOSITS IN COMMERCIAL PURCHASE AND SALE AGREEMENTS

(Lloyd G. Kepple, Esq., Fox Rothschild LLP, St. Paul, MN, November 2, 2017)

A. IN GENERAL

1. In connection with the purchase and sale of commercial real estate, it is customary for the buyer to deposit earnest money ("Earnest Money") concurrently with execution of the purchase and sale agreement ("PSA"). These materials will discuss basic issues relating to Earnest Money deposits ("Earnest Money Deposits")

B. AMOUNT AND FORM OF EARNEST MONEY DEPOSIT

1. Amount of Earnest Money. The amount of the Earnest Money Deposit is a negotiation between the seller and the buyer. While a negotiation can produce any result, the Earnest Money Deposit is generally an amount of between one percent (1%) and five percent (5%) of the purchase price set forth in the PSA.

    a. With respect to larger real estate transactions, the amount tends more towards the lower end of the percentage spectrum, and with respect to smaller commercial deals, the amount can approach the higher end of the percentage spectrum.

2. Form of Earnest Money.

    a. Cash Deposits. In nearly all commercial real estate transactions, the Earnest Money Deposit in the form of a cash deposit placed with the escrow agent ("Escrow Agent").

        (i) The transmittal of the Earnest Money is often by wire transfer to the account of the Escrow Agent.

        (ii) Other forms of transmittal of the Earnest Money Deposit are also used on occasion, including certified check and, in the cases of smaller transactions, simple personal or uncertified funds via check which will need to clear before the Deposit is officially recognized.

    b. Non-Cash Deposits. While cash is generally the rule, I have seen certain transactions where letters of credit or even promissory notes have been utilized, but these alternatives are rarely utilized.

C. TIMING OF DEPOSIT AND INTEREST

1. Initial Deposit. The initial deposit of Earnest Money ("Initial Deposit") is generally deposited concurrently with the execution of the PSA or in rare cases, within a short designated period of time (one to two business days) following execution of the PSA. In many cases, and particularly so with respect to purchases of existing income property, the Initial Deposit is the only deposit, and there are not subsequent deposits made during the due diligence and pre-closing process.

2. Additional Deposits. In other cases, and particularly so with respect to development deals, there are one or more additional deposits of Earnest Money ("Additional Deposits") beyond the Initial Deposit made during the course of the transaction.

    a. The most common circumstance under which an Additional Deposit is made occurs upon the expiration of the due diligence period ("Due Diligence Period", also called "Inspection Period" or "Feasibility Period", depending on the nature of the transaction). If the buyer elects to proceed with the transaction and make the Additional Deposit following the expiration of the applicable Due Diligence Period, the Additional Deposit, together with the Initial Deposit, are generally deemed nonrefundable (or "Hard Earnest Money"). This action by the buyer is also sometimes referred to the buyer "going hard" with the Earnest Money Deposit.

    b. In some cases, the buyer may request an extension of the Due Diligence Period to complete due diligence or address an issue that has come up during due diligence. Depending on the circumstances, sellers are sometimes willing to grant extensions of the Due Diligence Period upon the deposit by seller of a special Additional Deposit. The circumstances of such due diligence extensions and amounts of additional Earnest Money are typically a matter of negotiation at the time the extension issue is addressed, although in some circumstances the PSA will specifically describe such extension rights in favor of the buyer and specify and amount of additional Earnest Money to be deposited in connection with the exercise of such extension rights.

3. Additional Staged Deposits on Development Deals. In a development deal under which it is contemplated that the buyer will be seeking various governmental approvals to proceed with the development, it is not unusual for the PSA to provide for a timeline of contemplated development approvals and corresponding required Additional Earnest Money along the way of achievement of those approvals. It is also not uncommon for portions of the Earnest Money Deposit to become nonrefundable (i.e., "go

hard") at various stages of the development process. This is a matter of negotiation based on the unique components of the development deal.

D. WHO IS THE ESCROW AGENT?

1. Title Company. In most commercial real estate purchase and sale transactions, the buyer is seeking title insurance and an insured closing. In addition, the buyer may be financing the transaction, and the buyer's lender will require an insured closing insuring the first priority status of the mortgage loan or other security granted by the buyer to secure repayment of the loan. Accordingly, in the vast majority of commercial real estate transactions, the title company will serve as the Escrow Agent and hold the Earnest Money Deposit.

    a. The terms governing the Escrow Agent are typically set forth in a written document. Attached as Exhibit A to these written materials is a Deposit Escrow Agreement ("Escrow Agreement") in the form we often utilize with respect to commercial real estate purchases and sales. The Escrow Agreement is attached as an exhibit to the PSA and is also executed as a separate document concurrently with PSA execution by the seller, the buyer, and the title company.

        (i) It is also not uncommon to find the terms of the escrow arrangement set forth in the PSA rather than set forth in a separate Escrow Agreement, in which circumstances the title company will execute the PSA for the limited purposes of agreeing to the escrow provisions set forth therein (whether by joinder or by direct execution with such limitations specified). In California deals, this is routinely the case. Also in California, there is utilization of free-standing authorized commercial escrow companies who often operate independently of title companies.

        (ii) While it is rare, some title companies or title agents will require their own Escrow Agreements, although a well crafted PSA will generally contain the provisions that a title company or other Escrow Agent requires to be included in the document. See Sections IV(D)(H) and (K) of the attached Deposit Escrow Agreement for an example of provisions that Escrow Agents generally require for self protection in connection with escrow arrangements.

2. Other Escrow Arrangements. In rare circumstances, the parties will agree to utilize an Escrow Agent other than a Title Company.

    a. Attorney as Title Agent. In some limited circumstances, and particularly in smaller commercial real estate deals, the parties

provide for the attorney of the seller or buyer to act as escrow agent. This is a potentially dangerous arrangement for the attorney that risks violation of ethical provisions. It is not recommended, because an attorney can get squeezed between his or her obligations as an escrow agent and his or her advocacy role on behalf of the client.

(i) If asked by a client or other parties to serve as an Escrow Agent, the attorney should decline, and it is likely that the rules of the law firm (driven by the professional liability carrier) may not allow the law firm to serve as an escrow agent. In some circumstances, if such restrictions do not exist and if there is no feasible alternative, an attorney should take on the role of an Escrow Agent only after fully disclosing the potential conflict to both parties and obtaining express consent of all parties in writing that if a conflict should arise, the attorney would represent only the attorney's client and would not be permitted to represent any other parties to the agreement. Best rule, however, is to always avoid this circumstance.

b. Seller Acting as Escrow Agent. While rarely seen in the context of a commercial real estate transaction, sellers are sometimes designated as the holding party of the Earnest Money Deposit. The perils of this arrangement for the terminating buyer are obvious. If the buyer elects to terminate prior to the expiration of the Due Diligence Period, the disappointed seller will be the party obligated to refund the Earnest Money. A disappointed seller is much more likely to seek reasons why it is entitled to retain Earnest Money (i.e., claiming lack of diligent inspection by the buyer or failure to return certain required documents). Accordingly, buyers are well advised to insist on the title company being utilized to hold Earnest Money in connection with commercial real estate transactions.

E. INTEREST ON EARNEST MONEY

1. Most PSAs and Escrow Agreements require the Escrow Agent to deposit the Earnest Money into an interest-bearing segregated account (and in many cases an account with a financial institution insured to the maximum extent possible by the FDIC). The interest accrues as part of the Earnest Money Deposit to be applied with the Deposit to the purchase price at closing (assuming the transaction proceeds to closing) or refunded to seller or buyer as the case may be, pursuant to the terms of the Escrow Agreement.

F. REFUNDABILITY/FORFEITURE OF EARNEST MONEY

1. Refundability of Earnest Money Deposit to Buyer.

   a. Prior to Expiration of Due Diligence. Most commercial PSAs provide that the buyer has the right to terminate the PSA prior to expiration of the Due Diligence Period and receive a refund of the Earnest Money Deposit.

      (i) The refundability right of buyer upon termination is generally unconditional, although in some cases negotiated conditions will be placed upon the return of the Earnest Money by the seller. Such conditions might include (A) the return of due diligence information and other documents furnished by the seller to the buyer during the Due Diligence Period or (B) certification of the buyer backed by lien waivers (and in some cases, a sworn construction statement) evidencing payment in full of vendors who accessed the property during due diligence to make sure that no liens are filed upon the property following the termination of the PSA and the return of the Earnest Money. If the parties have agreed that the Earnest Money is an unconditionally refundable prior to expiration of the Due Diligence Period, consider including the buyer provision set forth on the attached Deposit Escrow Agreement in Section IV(A).

   b. Title Matters. Under some PSAs, the title review period is on a separate time track from the Due Diligence Period. And generally no matter what the time threshold, the buyer retains the right to terminate the PSA if the seller is unable to produce the required title at the time of closing.

      (i) In addition to a refund of the Earnest Money Deposit, a buyer may seek to negotiate in the PSA the right to obtain reimbursement (usually up to a capped amount) of its due diligence costs if the acts or omissions of a seller following the expiration of the Due Diligence Period cause a title issue which frustrates the buyer's plans for the property and causes the buyer to terminate the PSA. An example would be, in a development transaction, the granting by seller during the due diligence process of an easement in favor of a third party that frustrates the intended use of the property by the buyer.

   c. Casualty and Condemnation. The terms of the PSA typically grant the buyer (and in some cases the seller) the right to terminate the

PSA with respect to certain casualty and condemnation events. Buyers will typically seek to have the right to terminate upon the occurrence of any casualty or condemnation event, whereas sellers will typically seek to require a threshold level of casualty or condemnation resulting in damage or destruction or taking in an amount greater than a specified amount (e.g., 20%) of the purchase price.

d. Failure to Satisfy Buyer Conditions. Most commercial PSAs provide that in the event buyer conditions are not satisfied on or prior to the closing date, than the buyer will have the right to terminate the PSA. An example would be, on an existing income property, the failure of the seller to furnish clean tenant estoppel certificates from the required percentage of the existing tenants (assuming the seller is not permitted to ameliorate said failure by furnishing its own seller estoppel certificates).

e. Seller Failure to Close. Commercial PSAs almost uniformly grant the buyer the right to terminate the PSA and obtain a refund of the Earnest Money Deposit if the seller fails to close. This presumes that the buyer will elect termination and return of the Earnest Money Deposit as its remedy—buyer may also have negotiated a right to seek specific performance.

2. Forfeiture of Earnest Money Deposit to Seller.

a. Failure of Buyer to Close or to Satisfy Seller Conditions. To the extent the buyer fails to close on the closing date specified under the PSA or to the extent buyer fails to perform certain conditions required to be performed by buyer under the PSA, most commercial PSAs grant the seller the right to terminate the PSA and retain the Earnest Money Deposit as liquidated damages. In some cases the PSA will also provide that the seller has a specific performance right, although seller exercise of a specific performance right is generally extremely challenging. as a practical remedy. If the parties concur that the seller the unilateral right to obtain payment of the Earnest Money Deposit from the Escrow Agent, consider including the pro-seller provision set forth in Section IV(A) of the attached Escrow Deposit Agreement, although note that it is relatively rare for a seller to obtain such a provision in a Minnesota deal due to the statutory notice requirements of Minn. Stat. Section 559.21.

(i) **Note: Minn. Stat. Section 559.21 requires that the seller give the notice of termination in accordance with Section 559.21 (subd. 4), which requires 30 days' notice to seller in accordance with the statutory requirements**

prior to any effective termination occurring. While reference to 559.21 is not typically included in PSAs, it is a statutory requirement that must be observed by terminating sellers.

G. ANCILLARY ISSUES AROUND EARNEST MONEY.

1. Transmittal of Estoppels. Some buyers will require the Earnest Money to go hard before being obligated to transmit tenant estoppel certificates to the tenants for execution prior to the closing. This approach can put time pressure on the timely closing of the deal, although it may be workable if there is sufficient time prior to closing or if the seller has confidence that its property management relationship is sufficiently strong to obtain estoppels on an expedited basis.

2. Leasing Restrictions. The ability of the seller to continue leasing the property following PSA execution and pending closing is a matter of negotiation that is covered in a well crafted PSA. Any such ability of the seller to so lease the property without full buyer consent is typically confined to specified leasing parameters which and terminates once the Earnest Money goes hard, meaning the seller must thereafter obtain buyer consent to any subsequently executed lease.

EXHIBIT A

DEPOSIT ESCROW AGREEMENT

TO: _____ Title Insurance Company
_____
_____
_____

RE: Title Commitment No. _____ with respect to property known as _____in _____, _____

DATE: _____, 20__

I. PARTIES

A. Seller: _____
_____
_____
_____

B. Buyer: _____
_____
_____
_____

C. Escrow Holder: _____
_____
_____
_____
_____

D. Buyer's Counsel: _____
_____
_____
_____
_____

E. Seller's Counsel: _____
_____
_____
_____
_____

II. PRELIMINARY STATEMENTS

Concurrently with the execution and delivery of this Deposit Escrow Agreement, Seller and Buyer have executed and delivered a certain Purchase and Sale Agreement, dated _____, 20___ (hereinafter referred to as the "Agreement"), a copy of which has been provided to Escrow Holder. Capitalized terms not otherwise defined herein shall have the meaning ascribed to such terms in the Agreement. Under the terms of the Agreement, Seller has agreed to sell to Buyer a parcel of real property known as _____ located in _____, _____.

A. Pursuant to Section ___ of the Agreement, within two (2) Business Days of the execution and delivery of the Agreement, Buyer is required to deposit with the Escrow Holder the sum of _____ ($_____) (together with any interest earned thereon hereinafter referred to as the "Deposit"), to be held by Escrow Holder pursuant to the terms and provisions of this Deposit Escrow Agreement.

B. Pursuant to the Agreement, (i) under certain circumstances Seller and/or Buyer has the right to terminate the Agreement and, in such event, the Deposit is to be returned to Buyer and (ii) in the case of Buyer's default, the Deposit is to be paid to Seller, as liquidated damages. Buyer and Seller covenant and agree to execute and deliver to Escrow Holder joint written instructions to pay the Deposit to the party entitled to receive same pursuant to the terms of the Agreement.

C. Provided that the Agreement has not been terminated, the Deposit is to be applied towards the Purchase Price at Closing as set forth in the Agreement.

III. DEPOSIT OF DEPOSIT; INVESTMENT DIRECTIONS

A. On or before the date of acceptance hereof by Escrow Holder, Buyer has deposited the Deposit with the Escrow Holder in accordance with the Agreement. By its execution hereof, Escrow Holder acknowledges receipt of the Deposit.

B. Escrow Holder is hereby authorized and directed to invest the Deposit or any portion thereof in interest bearing account(s) with a financial institution whose deposits are insured by the Federal Deposit Insurance Corporation or in accordance with further written direction of Seller and Buyer (or Seller's and Buyer's counsel). Unless otherwise provided pursuant to the provisions of Section IV hereof, such investment shall be for the benefit of Buyer. The Federal Taxpayer Identification Number of Buyer is _____.

IV. INSTRUCTIONS

A. The Escrow Holder is instructed to hold and invest the Deposit, until the Escrow Holder is in receipt of (i) a joint written direction from Seller (or Seller's Counsel)

and Buyer (or Buyer's Counsel) or (ii) an order, judgment or decree addressed to Escrow Holder which shall have been entered or issued by any court and which shall determine the disposition of the Deposit;

[PRO-BUYER ADDITIONAL PROVISION: <u>provided, however</u>, that in the event Buyer terminates the Agreement pursuant to Section ____ of the Agreement, then Escrow Holder shall release the Deposit to Buyer within two (2) Business Days after written direction from Buyer or Buyer's counsel]

[PRO-SELLER ADDITIONAL PROVISION: <u>provided, however</u>, that in the event Seller terminates the Agreement pursuant to Section _____ thereof, then Escrow Holder shall release the Deposit to Seller three (3) Business Days after direction therefor from Seller or Seller's counsel by written notice. [NOTE THAT IN MINNESOTA THIS PRO-SELLER PROVISION IS SUBJECT TO THE 30-DAY CANCELLATION REQUIREMENTS OF MINN. STAT. SECTION 559.21(4).]

B. Any party delivering a notice required or permitted hereunder shall simultaneously deliver copies of such notice to all parties listed in Section I of this Deposit Escrow Agreement. All notices required herein shall be sent in accordance with Section 10 of the Agreement.

C. Except as otherwise expressly set forth in this Agreement, Escrow Holder shall disregard any and all notices or warnings given by any of the parties hereto.

D. If Escrow Holder obeys or complies with any order, judgment or decree of any court with respect to the Deposit, Escrow Holder shall not be liable to any of the parties hereto or any other person, firm or corporation by reason of such compliance, notwithstanding any such order, judgment or decree be entered without jurisdiction or be subsequently reversed, modified, annulled, set aside or vacated. In case of any suit or proceeding regarding this Deposit Escrow Agreement to which Escrow Holder is or may be at any time a party, Seller and Buyer shall each be liable for one-half of all such costs, fees and expenses incurred or sustained by Escrow Holder and shall forthwith pay the same to Escrow Holder upon demand; provided, however, that in the event Escrow Holder is made a party to any suit or proceeding between Seller and Buyer, the prevailing party in such suit shall have no liability for the payment of Escrow Holder's costs, fees and expenses and the non-prevailing party shall be liable for the entire costs, fees and expenses sustained or incurred by Escrow Holder and shall pay the same forthwith to Escrow Holder upon demand.

E. Escrow Holder is not to be held responsible for any loss of principal or interest which may be incurred as a result of making the investments or redeeming said investment for the purposes of this Deposit Escrow Agreement.

F. In no case shall the Deposit be surrendered except (i) in the manner specifically described in this Deposit Escrow Agreement; (ii) pursuant to a written instruction signed by Seller (or Seller's Counsel) and Buyer (or Buyer's Counsel); or (iii) in obedience to the process of order of a court as aforesaid.

G. All fees of Escrow Holder shall be borne by Seller and Buyer as set forth in the Agreement.

H. Except as to deposits of funds for which Escrow Holder has received express written direction from Seller and Buyer (or Seller's and Buyer's Counsel) concerning investment or other handling, the parties hereto agree that Escrow Holder shall be under no duty to invest or reinvest any portion of the Deposit at any time held by it hereunder; provided, however, nothing herein shall diminish Escrow Holder's obligation to apply the full amount of the Deposit in accordance with the terms of this Deposit Escrow Agreement.

I. Any order, judgment or decree requiring the Escrow Holder to disburse the Deposit shall not be binding upon Buyer or Seller as to the ultimate disposition of the Deposit unless and until a final, non-appealable order, judgment or decree is entered by a court having jurisdiction thereto.

J. This Deposit Escrow Agreement and all provisions hereof shall be binding upon and shall inure to the benefit of the parties hereto and their respective legal representatives, successors and permitted assigns.

K. In the event of any dispute between the parties hereto as to the facts of default, the validity or meaning of these instructions or any other fact or matter relating to the transaction between the parties, the Escrow Holder is instructed as follows:

(i) That it shall be under no obligation to act, except under process or order of court upon joint written instructions of Seller (or its counsel) and Buyer (or its counsel), or until it has been adequately indemnified to its full satisfaction, and shall sustain no liability for its failure to act pending such process or court order, notice or indemnification;

(ii) That Escrow Holder may, in its sole and absolute discretion, deposit the Deposit described herein or so much thereof as remains in its hands with the United States District Court sitting in _____, _____ and interplead the parties hereto, and upon so depositing such property and filing its complaint in interpleader it shall be relieved of all liability under the terms hereof as to the property so deposited, and furthermore, the parties hereto for themselves, their heirs, legal representatives, successors and assigns do hereby submit themselves to the jurisdiction of said court and do hereby appoint the then Clerk, or acting clerk, of said court as their agent for the service of all process in connection with such proceedings.

L. [INCLUDE ONLY IF BUYER IS A TRUSTEE, PENSION FUND, OR SIMILAR ENTITY] In accordance with the declaration of trust of Buyer, notice is hereby given that all persons dealing with Buyer shall look solely to the assets of Buyer for the enforcement of any claim against Buyer as neither the trustees, officers, employees nor shareholders of Buyer assume any personal liability for obligations entered into by or on behalf of Buyer.

This Deposit Escrow Agreement may be executed in one or more counterparts, each of which shall be deemed an original. Said counterparts shall constitute but one and the same instrument and shall be binding upon each of the undersigned individually as fully and completely as if all had signed but one instrument and shall be unaffected by the failure of any of the undersigned to execute any or all of said counterparts.

[THE REMAINDER OF THIS PAGE HAS BEEN INTENTIONALLY LEFT BLANK]

IN WITNESS WHEREOF, the undersigned have executed this Deposit Escrow Agreement as of the date and year first above written.

SELLER: _____
a _____

By:_____
Name: _____
Its: _____

BUYER: _____
a _____

By:_____
Name: _____
Its: _____

ACCEPTED AND AGREED TO this
_____ day of _____, 20__.

_____ TITLE INSURANCE COMPANY

By:_____
Name: _____
Its: _____

II. CONTINGENCIES - WHAT'S REASONABLE AND WHAT'S NOT?

(Debra K. Page, Lindquist & Vennum, LLP, St. Paul, MN, November 2, 2017)

A. **OVERVIEW**: Contingencies are often the most highly negotiated portion of any commercial real estate Purchase Agreement. To the extent that knowledge has value, Buyer may obtain knowledge of the Property to be purchased during the contingency period without the financial risk of an absolute purchase. The Seller is able to limit information until a "sale" has been accomplished, but Seller also faces both a delay in the closing and the risk that the sale may not occur due to a defect in the Property or the failure of another condition.

B. **PURPOSE**: Contingencies allow Seller and Buyer to finalize all binding sale terms, subject to the occurrence of specific events. Essentially, the parties have an agreement, with the opportunity to terminate. Negotiation of contingencies should balance Seller's need for the certainty of a sale with Buyer's need for certainty as to the condition of the Property and/or the available uses of the Property.

C. **ELEMENTS**.

1. Benefitted Party. The determination of the benefitted party is crucial to provision of termination rights. Generally, the non-benefitted party (typically Seller) may not terminate the Agreement for failure of a contingency unless otherwise specifically stated. Patterson v. Stover, 400 N.W.2d 398 (Minn.App. 1987); Teachout v. Wilson, 376 N.W.2d 460 (Minn.App. 1985).

2. Scope. The non-benefitted party will desire to limit the scope to a specific concern (e.g. obtaining a building permit for a specifically defined facility) to avoid discretionary termination on the part of the benefitted party. In contrast, the benefitted party (typically Buyer) seeks broad opportunities to determine the feasibility of purchase, to investigate and, if necessary, to terminate the Purchase Agreement.

3. Timing. The same deadline need not be used for each contingency, however, timing should be clearly stated for each contingency.

    a. Determination of Contingency Date. Some Purchase Agreements set forth a specified "Contingency Date" whereby each contingency must be satisfied or deemed waived. Other Purchase Agreements set forth the number of days from the execution date of the Purchase Agreement for various contingencies, which number of days may vary from contingency to contingency.

    b. Extensions of Contingency Date. The parties may desire for the opportunity to extend the contingency period(s). The Buyer may desire extensions to provide additional time for inspection, etc.

The Seller may be of two minds as to extension: either (a) Seller may desire extensions to "keep the deal alive" or (b) Seller may not desire extensions to bring some certainty to the Agreement within a relatively short period of time. Negotiation considerations include the length of time for extensions, the number of extensions and whether or not additional earnest money (refundable or nonrefundable) is required for an extension.

4. Standard of Satisfaction. Standards for satisfaction or failure of contingencies may range from (a) simple receipt of a document; to (b) the "sole discretion of Buyer" as to the form and content of the document; to (c) "reasonable opinion as to whether satisfaction has occurred"; to (d) "conditions which allow for continued use of Property in the manner used as of the date of this Agreement". Typically, Seller seeks a specific objective standard, while Buyer seeks a broader, more discretionary standard. The standard may be limited by conditions required for Buyer's proposed use of the Property (which favors Buyer), as opposed to conditions required for continuation of the current use of the Property (which favors Seller).

5. Standard of Proof. Seller may desire to require Buyer's production of written materials documenting failure of contingency to confirm the failure of the contingency and avoid discretion on the part of Buyer. Other Sellers desire these materials to provide them with the knowledge necessary (a) to make improvements to the Property prior to remarketing for resale or (b) to negotiate a more accurate subsequent Purchase Agreement for the resale of the Property.

6. Required Diligence to Satisfy. An express obligation to act with due diligence and in good faith during the available contingency period gives the non-acting party (typically Seller) grounds for claiming default, retaining earnest money, seeking damages or perhaps enforcing specific performance. Where the standard of diligence is not set forth in the Agreement, implied covenant of good faith may apply to prevent one party from depriving the other of the benefit of the bargain. H Enterprises International, Inc. v. General Electric Capital Corporation, 833 F.Supp 1405 (D.Minn. 1993). However, Minnesota courts have been reticent to apply good faith to sales contracts. The Seller may require an opportunity to be informed of contingency status at certain intervals, with opportunity to terminate Agreement for failure to exercise good faith.

7. Payment and Entry Responsibility. The benefitted party is not always the party responsible for the cost or provision of inspections or other materials. Because Seller may desire receipt and ownership of written materials generated in the course of any given contingency, Seller may be willing to pay for the cost of those materials. Sellers should also consider the result of mandatory reporting requirements for certain previously

undisclosed conditions (typically arising from environmental investigation) and the desire to control the reporting and subsequent processes. In this event, a Seller may also be willing to pay for the cost of the inspection (Phase I or Phase II).

8. Opportunity to Require Cure. In lieu of termination, the parties may desire to either have the opportunity to cure or require the cure of any condition of the Property not determined to be satisfactory during the contingency period. The nature of the failed contingency may determine the desired approach, for any given contingency.

   a. Buyer's Cure. Buyer may prefer to have the opportunity to cure the failed condition (to confirm the sufficiency of the cure), with the cost of the cure to be deducted from the purchase price. In this event, Seller will desire to limit or cap the expenditure to be deducted.

   b. Seller's Options. Seller may prefer either (a) the opportunity to cure (which opportunity also carries the right to control the cost of the cure) or (b) the right to terminate in lieu of effecting or paying for a cure.

9. Cooperation of Non-acting Party. Certain contingencies undertaken by Buyer will require the cooperation or action of Seller, e.g. subdivision, rezoning. These property status changes should be conditioned upon closing in the event the transaction is not consummated. Provision should be made for costs incurred by Seller in connection with the cooperation or action. If Seller's costs are paid by Buyer, typically, only out-of-pocket costs are paid and Seller incurs the administrative or personal burden of the review of Buyer's work and/or the time incurred for required appearances before public bodies or review boards.

10. Waiver. Waiver rights are generally imperative for Buyer. Failure to provide for waiver may result in Seller's refusal to close the sale (due to changed circumstances) for the express failure of a contingency which was of less significance to Buyer.

   a. Exercise of Right. Which party(ies) can exercise the waiver right? Unilateral rights should be clearly stated.

   b. Mechanism. Is waiver of a contingency automatic or does the Agreement require written notice of waiver? Buyer may be held to have effectively waived contingency where Buyer continues to exercise its rights under Purchase Agreement. Patterson v. Stover, supra at 401.

11. Termination. The Purchase Agreement should confirm the manner in which the Agreement will be terminated upon exercise of a contingency.

The Seller may desire to clearly provide for automatic termination in event of failure of contingency to avoid need for cancellation of Purchase Agreement. Where a term essential to the final bargain is dependent upon a contingency, the provisions of Minnesota Statutes § 559.21 do not apply. Romain v. Pebble Creek Partners, 310 N.W.2d 118, 122 (Minn. 1981) (contingency for parties' agreement as to financing is an essential term of the Purchase Agreement). Nonetheless, Sellers may desire to obtain a quit claim deed from Buyer coincident with the termination effected by the exercise of a contingency. In the event of termination, Sellers should also use caution to require a return of any other materials provided to Buyer during the course of the inspection or contingency period.

12. Earnest Money. If a contingency is exercised, will Buyer be entitled to a return of all or part of the earnest money?

D. GENERAL CATEGORIES

1. Approval for Terms of Sale.

   a. Internal. Either party may require contingency for approval by board of directors, partners, trustee in bankruptcy, or executive committee.

   b. External. The Seller may require a contingency for partial release of mortgage or approval for prepayment not otherwise allowed under Seller's contractual agreements with third parties.

2. Approvals for Use of Property.

   a. Governmental. Buyer may require contingency for confirmation of availability of rezoning, subdivision, environmental permits, building permits or sign permits. Seller prefers specificity because Seller may be able to satisfy contingency on Buyer's behalf if Buyer is not proceeding diligently and in good faith.

   b. Private. Buyer may require contingency to obtain franchise rights for specific use or to obtain a tenant (or a franchisee) for proposed use.

   c. Site Assembly. Where Buyer requires adjacent property(ies) to complete the intended development, the Purchase Agreement may be contingent upon Buyer's successfully obtaining purchase agreement from those neighboring property owner.

3. Approval of Condition of Property.

   a. Physical Condition/Inspection. Buyer may desire a "free look" into all aspects of building and land, including (a) review of soils

(for compaction, elevation, etc.), (b) roof report, (c) inspection of all building systems and equipment, or (d) opportunity for percolation tests.

b. Availability of Utilities/Services. Particularly for undeveloped property, Buyer may require confirmation of availability of utilities. Buyer should use caution to obtain information as to availability, location and condition of water and sewer systems (public or private), particularly in areas outside MUSA line.

c. Environmental. Even where Seller provides environmental warranties and representations, Buyer will desire opportunity to confirm environmental status of Property. Phase I is typically required for financing purposes. Buyer should obtain from Seller all written environmental information available to Seller prior to commencing new environmental reviews.

d. Access. Buyer may require availability of certain or increased access to the Property. This may be particularly necessary where a change in use of the Property is contemplated.

4. **Approval of Income/Expenses of Property**.

a. Review of Existing Contracts. Buyer will want Seller to provide all existing maintenance, management and/or service contracts and/or equipment leases for Buyer's review and satisfaction with terms. Buyer may also desire that contracts be confirmed with estoppel certificates from Seller and other parties to such contracts, if necessary for Buyer's continued operation of the Property.

b. Termination of Existing Contracts. Buyer's proposed use of the Property may require Seller to terminate certain existing contracts and/or leases and provide written confirmation of such termination.

c. Review of Existing Leases. Buyer will require contingency for its satisfaction with terms of leases.

d. Estoppel Certificates from Tenants. Buyer (and Buyer's lender) will require that all leases be confirmed with estoppel certificates from each tenant. Buyer should attach the form of the desired estoppel certificate to the Purchase Agreement and indicate that contingency requires all estoppel certificates to be executed and delivered to Buyer. Seller should confirm that form of estoppel certificate promised to Buyer is obtainable pursuant to the terms of the lease(s).

e. Certified Rent Roll from Seller. Buyer will require receipt of rent roll, certified by Seller to be accurate.

5. Approval of Title. Title examination is typically not set out as a specific contingency. Acceptance of state of title, however, remains a contingency to closing. Good practice lists title as one of the contingencies and refers to the title examination section, to clarify that marketable title is a condition precedent to closing.

6. Financing of Purchase.

   a. Assumption of Existing Financing. Assumption contingency should include (a) specific approval of existing lender, (b) approval of Seller as to form of release, (c) approval of Buyer as to terms of financing, and (d) party responsible for payment of assumption fees. Buyer should review certified copies of documents and obtain certification from the lender as to the balance and other terms as well as to the nonexistence of defaults.

   b. Commitment from New Lender. Seller will prefer more objective criteria for determination of satisfaction of financing contingency, whereas Buyer will desire flexibility in determining available financing options. Seller's preference sets out details as to maturity, amortization, acceptable rates, and loan-to-value amounts. Buyer prefers to refer to "loan terms acceptable to Buyer".

   c. Satisfaction of Financing Contingency. A Buyer is financially ready and able to perform pursuant to a financing contingency if Buyer has obtained a binding commitment for a loan for the purchase by a financially able third party, irrespective of whether the loan will be secured in whole or part by the Property to be purchased. Jones v. Amoco Oil Co., 483 N.W.2d 718, 722 (Minn.App. 1992); ERA Town & Country Realty, Inc. v. TEVAC, Inc., 376 N.W.2d 526, 528 (Minn.App. 1985).

7. Confirmation of Status at Closing. Buyer will desire entire purchase contingent upon Seller's confirmation of Seller's warranties and representations by means of a bring down certificate. Buyer may also desire confirmation of condition, inventory, personal property by inspection.

E. INTERRELATION WITH OTHER PORTIONS OF PURCHASE AGREEMENT. The contingency section must interrelate with other portions of the Purchase Agreement to avoid qualification or limitation of the contingencies on the part of Buyer.

1. Representations and Warranties. Representations and warranties provide a base for Buyer's investigation and inquiry regarding the Property and offer Buyer an additional remedy regarding the purchase of the Property.

However, Buyer should use caution to not over-rely on representations and warranties and should continue to use due diligence by inspecting the Property. Alternatively, Seller should use caution to not make representations or warranties which are later determined to be untrue on basis of Buyer's investigation and inquiry.

2. As-Is Condition. Where Buyer has extensive contingencies and inspection rights, Seller will desire that the sale of the Property be in its AS IS condition and refrain from extensive Seller representations. However, most Buyers desire a representation regarding the condition of the Property, notwithstanding the inspection contingency.

3. Indemnities. As with representations and warranties, Buyer will desire indemnities regarding the representations, warranties and condition of the Property to provide an additional remedy regarding the sale and the Property. Again, Buyer should not rely on the indemnities as a substitute for contingencies and should continue to use due diligence by inspecting the Property. On the other hand, Seller should confirm that any indemnities are limited to known facts.

4. Confidentiality. Seller may require that information provided to Buyer for review be held confidential. Where documentation must be provided to a lender or other third party, the same concerns may apply.

5. Right to Enter Property. Where contingencies include physical inspections of the Property, the Purchase Agreement should specifically set out the right on the part of Buyer to enter the Property. The Seller may desire to limit entry to only certain defined activities. Any right to enter should be accompanied by an indemnity as to liabilities arising out of the entry onto (and tests and investigations of) the Property. Buyers should be careful to avoid liability for conditions discovered during inspection**.**

III. CASUALTY AND CONDEMNATION IN PURCHASE AGREEMENTS.

(Debra K. Page, Lindquist & Vennum, LLP, St. Paul, MN, November 2, 2017)

A. **OVERVIEW**: Casualty and condemnation clauses are often the most overlooked portion of any commercial real estate Purchase Agreement. Many attorneys use their time and energy to cut the best deal and don't spend time on these "lesser" provisions.

B. **LEGAL IMPACT**: Law varies from state to state on risk assumption in a purchase agreement.

1. Equitable Conversion. Equitable conversion has its roots in common law and held initial significance for inheritance and testamentary transfers. In contracts, equitable conversation determines that the risk belongs to the Buyer, whose right is personal property. This results in Buyer's requirement to purchase the Property following damage, destruction, or condemnation without recourse against Seller (unless Seller caused the damage) and without a reduction in the purchase price.

2. Uniform Vendor and Purchaser Risk Act. First enacted in 1935, the UVPRA was intended to protect the Buyer before closing and Seller after the closing. It avoids equitable conversion by placing the risk of loss on Seller (unless Buyer has earlier taken possession). UVPRA is premised on the tenet that the party in possession bears the risk. 13 states have adopted the UVPRA to date, including South Dakota, Wisconsin, Illinois and Michigan.

3. Silence as to Risk. Where the Purchase Agreement is silent as to risk, in those states which have enacted the UVPRA, the risk lies with Seller and in other states, equitable conversion may or may not control.

4. Minnesota Law. Minnesota has not adopted the UVPRA and Minnesota courts have not resolved the issue of Seller/Buyer risk. Tollefson Dev., Inc. v. McCarthy, 668 N.W.2d 701 (Minn. Ct. App. 2003); Gilles v. Sprout, 196 N.W.2d 612 (Minn. 1972). It is, therefore, essential that all purchase agreements cover risk responsibility carefully.

C. **CASUALTY CLAUSE ELEMENTS**.

1. Notice from Seller. The Seller is the party with the information about the casualty and is required to provide notice to Buyer. Query whether "immediate" notice if performable or enforceable?

2. Threshold for Trigger of Rights. *De minimus* damage should not result in termination of the transaction if the repair can be effected promptly. The threshold which allows for Buyer's termination or other rights can be quantified by (a) the cost of the repair, (b) the percentage of the Property

damaged, or (c) by reference to the continued use of the Property in the same manner. If "materially" or "substantially" are used for the threshold of damage, the parties should expect a dispute about those terms absent better definition.

3. Rights upon Trigger. The casualty clause should clearly describe the rights of the parties.

   a. Repair/Rebuilding. Is repair or rebuilding required? If so, by whom? Will the repair or rebuilding allow for a delay in closing or must it be completed by closing (considering practical inability to do so)? If Buyer intended to demolish the building for another development, the Purchase Agreement may provide for full demolition and removal of debris, as opposed to rebuilding.

   b. Payment for Repair/Rebuilding. Are insurance proceeds to be used for repair/rebuilding? If so, clear assignment of all proceeds and claims should be provided if Buyer is to repair. And, consideration should be given to the deductible amount. If Buyer is to repair, a credit for the deductible should be provided against the purchase price.

   c. Termination. When termination is allowed, is Buyer the only party to exercise that right? Is termination an option or does the Purchase Agreement automatically terminate in such event? In the event of a total casualty, Seller may desire to terminate the Purchase Agreement and start fresh with the Property. The property may actually have greater value without the building or improvement.

   d. Resulting Changed Condition. The Buyer may have concerns about changed soil or other conditions caused by a fire or other *force majeure* event. The Buyer may require the right to investigate those conditions prior to exercising its rights.

4. Insurance Settlement. The Buyer will want Seller to include Buyer in any insurance settlement discussions.

5. Insurance Requirements. The casualty section should specifically require Seller to maintain insurance at replacement value until closing. Assignment of both the claim and the proceeds should be clearly set out. And, the parties should agree that all executed assignment documents be provided at closing, if not before.

D. CONDEMNATION CLAUSE ELEMENTS.

1. Notice from Seller. The Seller is the party to whom information about any condemnation will be provided and is required to provide notice to Buyer.

Care should be taken to describe both pending and threatened eminent domain actions, as well as time period for reporting notice to Buyer.

2. Threshold for Trigger of Rights. The issues here are similar to casualty. However, "partial" or "temporary" or "construction" condemnation actions should be clearly dealt with, as the impact of these may be borne only by Seller, depending on the length of time of the Purchase Agreement. Certainly, *de minimus* condemnation should not result in termination of the transaction and may not result in a reduction of the purchase price. As with casualty, the threshold which allows for Buyer's termination or other rights can be quantified by the percentage of the Property taken, or by reference to the continued use of the Property in the same manner. Again, avoid "materially" or "substantially" unless later dispute is desired. Consideration should be given to the nature of the Property, as well. A downtown property may not be able to sustain any condemnation without significant loss, given the location of the Property upon the block.

3. Rights upon Trigger. The condemnation clause should clearly describe the rights of the parties.

   a. Repair. If the taking is of an access point or roadway, is repair required? If so, by whom? Will the repair allow for a delay in closing or must it be completed by closing (considering practical inability to do so)?

   b. Termination. When termination is allowed, is Buyer the only party to exercise that right? Is termination an option or does the Purchase Agreement automatically terminate in such event?

4. Condemnation Proceeds. The party to receive the condemnation proceeds should follow the party who will bear the loss by reason of the condemnation. For temporary or construction eminent domain matters, Seller may well be the party to bear the loss if the closing of the purchase follows the expiration of the condemnation. But, if the condemnation results in an easement that restricts access or parking, Buyer is more likely to bear the loss. Are insurance proceeds to be used for repair/rebuilding? If proceeds are to be assigned to Buyer, clarity as to the assignment of all proceeds and claims should be provided.

5. Condemnation Settlement. The Buyer will want Seller to include Buyer in any condemnation settlement discussions.

E. INTERRELATION WITH OTHER PORTIONS OF PURCHASE AGREEMENT. The casualty and condemnation sections must interrelate with other portions of the Purchase Agreement to avoid qualification or limitation of the contingencies on the part of Buyer.

1. Representations and Warranties. Representations and warranties should include reference to no existing casualty or condemnation, including pending or threatened actions.

2. Closing Documents. The list of closing documents should reference any assignment documents required by reason of casualty or condemnation arising during the term of the Purchase Agreement.

3. Right to Enter Property. Where Buyer has a limited right to enter the Property for a limited time period, that time period should be extended in the event of casualty or condemnation to allow for Buyer's review of existing conditions.

IV. PRIMER ON RIGHTS OF FIRST REFUSAL, ETC.

(Larry M. Wertheim, Esq., Kennedy & Graven, Chtd., St. Paul, MN, November 2, 2017)

A. OPTION TO PURCHASE.

Irrevocable offer by owner to sell property on the terms specified in the option, which the prospective buyer may accept by exercise at the holder's option during the option period.

1. Holder of option controls whether and when (during the option period) to exercise.

2. Price can be fixed or established by appraisal procedure or other formula.

3. Generally, most advantageous to holder of option as holder can typically exercise at any time during the prescribed option period.

4. Generally, most disadvantageous to owner as owner is basically precluded from marketing the property during the option period.

B. RIGHT OF FIRST REFUSAL (ROFR).

Typically, right of holder of ROFR to purchase the property on same terms and conditions as offer from third party that owner has accepted.

1. Holder of ROFR does not control timing; dependent on trigger of third-party offer.

2. As ROFR is generally right to purchase at same terms as third-party offer, holder of ROFR does not control the price.

3. As a result, less advantageous to holder of ROFR as compared to option.

4. While ROFR does not absolutely preclude owner from marketing the property during the option period, risk that the third party offeror will, without any fault, lose the right to purchase the property to the holder of the ROFR can make it hard to find a third party willing to negotiate a purchase agreement subject to a ROFR.

5. Owner and third party can only proceed with purchase if holder of ROFR waives (or fails to timely exercise) the ROFR.

C. RIGHT OF FIRST OFFER (ROFO).

Generally, right of holder of ROFO to be offered the property before owner can market the property to others.

1. Holder of ROFO does not control timing; ROFO triggered when owner desires to sell the property before third-party is identified.

2. Price established by notice from owner to holder of ROFO.

3. If holder of ROFO declines to exercise, owner is free to sell to any third party for a specified period of time at or above a price (or at % discount of that price) specified in notice to holder of ROFO.

4. More advantageous to owner than ROFR as owner decides when and on what terms owner would be willing to accept and avoids problem of negotiating with third party under cloud of ROFR; may allow owner to discount price after exposure to the market without going back to holder of ROFO.

V. CASE STUDY OF HAZARDS OF RIGHT OF FIRST REFUSAL. CITY CENTER COMMONS, LLC. VS. DESOTO ASSOCIATES, LLC, 2017 WL 1436093 (MINN. APP. 2017).

(Larry M. Wertheim, Esq., Kennedy & Graven, Chtd., St. Paul, MN, November 2, 2017)

A. AMBIGUOUS DESOTO ROFR.

Lot 5, a vacant lot owned by the Forest Lake Economic Development Authority (EDA), was subject to a declaration containing a certain ROFR in favor of DeSoto:

The EDA hereby grants to DeSoto a ninety (90) day right of first refusal to participate with the EDA (on an equal basis) in any development of such Lot 5 (although Desoto acknowledges that the EDA is allocated all fair market value with respect to Lot 5 in its undeveloped state in all events).

1. What exactly does DeSoto, the holder, have a right to refuse?

2. Typically, a ROFR is a right of the holder to refuse (or accept) purchase of the property on the same terms and conditions as contained in an offer from a third-party offeror.

3. Here, the facts that Lot 5 was vacant, the ROFR specifies a right to "participate" with the owner "on an equal basis," and that the owner is "allocated" the value of Lot 5 in its undeveloped state suggests that the ROFR is something other than a right to pre-empt an outright purchase of the property by a third party. Arguably, this ROFR is just a right (somewhat undefined) granted to DeSoto to co-develop Lot 5 and share with the EDA in the profit from only the EDA's development of the Property. If that's the case, DeSoto's ROFR does not apply to an outright sale by the EDA of an undeveloped Lot 5.

B. PURCHASE AGREEMENT WITH THIRD-PARTY OFFEROR CITY CENTER.

The EDA received a favorable third-party offer from City Center to purchase outright Lot 5. City Center planned to construct a building on Lot 5 and lease it to the Credit Union.

1. The EDA insisted that its purchase agreement with City Center (the Purchase Agreement) contain the following Paragraph 25:

2. Notwithstanding any contrary provision contained in this Agreement, [the EDA's] obligations under this [Purchase] Agreement are conditioned and contingent upon waiver of the right of first refusal of DeSoto . . . (the "Right of First Refusal"). As soon as possible after the Agreement Date,

[the EDA] shall send written notice to DeSoto advising DeSoto of DeSoto's rights under the Right of First Refusal with respect to this Agreement as well as requesting DeSoto's waiver of the Right of First Refusal with respect to this Agreement (collectively, the "Right of First Refusal Notice"). . . . Notwithstanding any contrary provision contained in this Agreement, in the event that DeSoto exercises the Right of First Refusal with respect to this [Purchase] Agreement, this [Purchase] Agreement shall be null and void as between [the EDA] and [City Center] and the Earnest Money shall be refunded to [City Center]. (Emphasis Supplied)

3. Per the Purchase Agreement, the EDA sent a letter to DeSoto, the ROFR holder, advising DeSoto that it could "exercise" the ROFR by sending timely notice and depositing substitute earnest money. In response DeSoto, who, at about the same time, entered into a separate purchase agreement to sell Lot 5 to the same Credit Union, sent a notice purportedly exercising the ROFR and deposited the earnest money.

4. Based upon DeSoto's "exercise" of the ROFR and pursuant to Paragraph 25, the EDA sent notice to City Center declaring the Purchase Agreement null and void.

5. In response, City Center sent a letter to the EDA claiming that the ROFR didn't grant DeSoto the right to step into the shoes of City Center's Purchase Agreement. Countrarywise, DeSoto claimed that the ROFR did grant that right and insisted in proceeding with its purchase of Lot 5.

C. THE LITIGATION.

1. Despite the suggestion of the EDA that one of the parties commence a declaratory judgment action, City Center, the third-party offeror, sued DeSoto, the putative holder of a ROFR, alleging claims of tortious interference with contract and prospective economic advantage. The EDA was not named in the litigation.

2. DeSoto moved for summary judgment and the district court granted summary judgment in favor of DeSoto and dismissed City Center' lawsuit on the grounds that, under Paragraph 25, the Purchase Agreement was null and void and therefore, DeSoto did not interfere with the Purchase Agreement.

3. On appeal, the Minnesota Court of Appeals affirmed the grant of summary judgment to DeSoto on the grounds that since the Purchase Agreement was contingent on DeSoto's waiving its ROFR and since DeSoto did not waive its ROFR, the Purchase Agreement "was not breached when the EDA did not sell Lot 5 to City Center." As a result, without a breach of contract by the EDA, City Center was unable to establish the necessary

element of intentional procurement of a breach of contract by the EDA and its claims for tortious interference failed.

4. It is noteworthy that the Court of Appeals observed in passing that "Contrary to City Center's assertions, resolution of this case does not require us to determine the meaning of DeSoto's rights of first refusal under the [Declaration]."

D. <u>MORALS OF THE STORY</u>.

1. In drafting the ROFR, be careful what you intend to give the holder a right to refuse. If you intend to create a ROFR that grants something other than a right to step into the shoes of a third-party purchase agreement (e.g., a right to co-develop the property), say so explicitly and expressly.

2. If an owner is in any way uncertain as to whether a ROFR is applicable to a third-party offer, the owner should error on the side of caution and make any acceptance of the third-party offer contingent on the waiver of the questionable ROFR. If, instead, the EDA had acted on the supposition that the Purchase Agreement did not trigger DeSoto's ROFR, but it ultimately turned out that the ROFR did apply, failure to make the Purchase Agreement subject to the ROFR (and offer Lot 5 to DeSoto) would likely expose the EDA to either a claim by City Center for breach of the Purchase Agreement or a claim by DeSoto for failure to honor the ROFR, or both. On the other hand, there's no percentage in guessing since if the owner makes the accepted offer subject to the ROFR and purports to honor what might be an inapplicable ROFR, the worst that can happen is that, as in the Court of Appeals case, the owner will end up selling the property on the same terms to the what-might-be-an-undeserving party, rather than to the original third-party offeror. As City Center Commons LLC v. DeSoto Associates, LLC recognized, since the Purchase Agreement provided that it would terminate if DeSoto exercised its (questionable) ROFR, the EDA is immunized against claims by the third-party offeror City Center. The upshot of all of this is that, although delayed because of the litigation, the EDA gets to sell Lot 5 just as it originally agreed to, albeit with a different buyer.

3. In theory, a declaratory judgement action involving the three parties would have clearly resolved the issue of a questionable ROFR so that the parties could proceed accordingly. However, such an action may not be available due to costs of litigation, the delays involved in prosecuting a lawsuit while keeping a transaction in limbo, or possibly an unwillingness of one or more of the parties to recognize that an opposing party may have a colorable claim.

4. Most interestingly, as previously noted, due to the terms of the City Center Purchase Agreement and the nature of its lawsuit, the Court of Appeals

found it unnecessary to determine, as a threshold matter, whether the ROFR actually gave the holder the right to step into the shoes of the third-party offeror. Thus, in this case, the ROFR contingency in the Purchase Agreement and the tort lawsuit all may have had the effect of legally converting what, in actuality, might have been an irrelevant right to participate in a vacant land development into a full-blown regular ROFR giving the property to otherwise-undeserving holder.

VI. TRUST ME, WE NEED THE TIME! SELLING LAND TO A DEVELOPER – DEALING WITH ENTITLEMENTS

(Patrick E. Mascia, Briggs and Morgan P, St. Paul, MN, November 2, 2017)

A. INTRODUCTION

Developable land within the city is scarce. Therefore, real estate developers are focusing on creatively utilizing the few remaining sites or redeveloping obsolete uses into modern, functional space. This often requires rezoning, subdivision and other entitlements from the governing jurisdiction. Depending on the size of the project and the ordinances of the governing jurisdiction, a general list of potential necessary entitlements is as follows:

1. Rezoning / Comprehensive Plan Amendment

2. Site Plan Approval

3. Preliminary Planned Approval

4. Subdivision Approval

5. Environmental Review (AUAR, EIS, EAW)

Obtaining these entitlements takes time. Four to six months from the time the Developer submits the application is not out of the question. If environmental review is involved, a year or more is typical. Not all real estate lawyers do land use work, but we need to have a basic understanding of entitlement / land use regulations in the governing jurisdiction to properly advise our clients. We must also have a basic understanding of the development process and what a developer is required to produce and submit to obtain these entitlements. Finally, if we are representing the seller, we need to understand our client's motivation for selling. Price? Timing of close? Closing certainty? Understanding these things will help us prepare a reasonable purchase and sale contract.

> KEY ASSUMPTION: THE LAND SALE TRANSACTION BENEFITS THE SELLER AND THE BUYER. THEREFORE, EACH PARTY WANTS THE TRANSACTION TO CLOSE. OUR JOB IS TO FACILITATE THAT.

For purposes of this presentation, I assume the transaction is typical and not extreme. In other words, the land price negotiated is not so cheap that the buyer will acquire the land regardless of entitlement risk. Similarly, the land price is not so high that the seller is willing to wait forever. In a typical transaction, finding the right balance between price and risk for both sides is not easy, but it is the art of the deal.

This presentation is intended as a general overview of the development and underwriting process for a typical developer and to suggest alternatives for reasonably accommodating that process in a purchase and sale agreement with a developer. Each transaction is unique and these alternatives are not intended to cover all situations. There is no form that applies to all transactions – creativity is valued!

B. DEVELOPMENT PROCESS

1. Development Costs

In a typical development process, the developer invests significant time and money into the project before submitting any applications to a municipality. The amount invested depends on the size and type of project and can range from a single industrial building (perhaps a $25,000-$50,000 investment) to a multiple phased, mixed use development (multiple millions). These costs are incurred for the following purposes:

a. Due Diligence (title, survey, Phase I, geotech, building hazardous materials studies [if demolition is involved], infrastructure studies)

b. Site Planning

c. Building design (schematic design, design development, construction drawings)

d. Infrastructure design (roads, water, sanitary sewer, storm service, etc.)

Each project requires a team of architects, engineers and lawyers. Often, this team is assembled during land negotiations, sometimes not. Assembling the team and doing the work takes time. In most cases, the developer will not make a significant investment on engineering and design until it has the land under control.

2. Project Feasibility

a. Underwriting / Pro Forma

The land price is often negotiated by the developer based on a pro forma the developer prepares on the equivalent of a napkin. Experienced developers have a general idea of the land price it can afford to pay for a particular project, making assumptions about infrastructure costs, building shell cost, tenant improvement costs, soft costs and rents. The developer makes those assumptions based on its experience in the marketplace and negotiates land price accordingly. However, once the developer puts the land under contract, it must confirm these assumptions. At this point,

the developer is not seeking final price confirmation and a final budget – the pro forma is a living document that may change up to the date construction commences. The strength of any pricing / cost exercise depends on the level of design. Schematic design is fluffy – construction document pricing is much more firm and, depending on the form of construction contract, perhaps absolute. Pricing and market risk is a development risk — in negotiating purchase agreements, developers will try to eliminate it or at least minimize it. Finding the tipping point is the art of the deal for both sides.

b. Return Expectations

What is or is not feasible from a return expectation standpoint depends on the developer and the developer will not disclose its numbers. A long term holder/investor will focus on cash on cash yield (annual return on total project cost). A merchant builder will focus on value creation (margin between sale price and total project cost).

c. Conclusion

The developer is checking the feasibility of the project on an almost daily basis. At the time the developer applies for entitlements, the developer will at least generally believe the project is feasible. If it cannot get to this level, it will terminate the contract. If it can, it will move forward in the entitlement process.

C. ENTITLEMENTS

1. Pre-Application

In many cases, as part of its feasibility analysis, the developer will meet with city staff and generally discuss the project. The goal of this meeting is to introduce the project, the developer's vision for the project and to gauge the city's interest in the project. The city has significant authority with respect to land use matters; therefore, depending on which entitlements are necessary for a project, the city will push back — sometimes hard. No one wants a land use lawsuit, even if the City's response pushes the boundaries of legality; therefore, this is a negotiation. The city's response can range from:

a. "Love it, let's go! Let's collaboratively define the entitlement process and we will push this through quickly."(Rare)

b. "Don't even try." (Rare)

c. "This looks OK. I think we can get the council to support this, but we will require you to _____" (fill in the blank with any number of strings that may be attached to the approval, most with cost attached). (Typical)

This meeting, or these meetings, are critical. They provide the developer with important intelligence to analyze risk.

2. Application

The entitlement process officially commences with an application (and payment of a fee). Many cities require the developer to establish an escrow to cover the city's third party and other costs around the time of the application. The application (once the City deems it "complete") starts the clock on Minnesota's "60 day rule" with respect to certain entitlements. The 60 day rule gives the city 60 days to approve or deny an entitlement requested in a "complete" application. If the city does not act in that time period, the application is deemed approved. The statute give cities the ability to extend the 60 day period to 120 days under certain general circumstances. In reality, most cities immediately extend the 60 day period or they send the developer a letter explaining why the application is incomplete, thus tolling the start of the 60 day rule clock.

3. Contents of Application

The required contents vary by municipality and depend on the type of entitlement the developer is seeking. For most project approvals (not including re-zoning), the developer must include design documents and plans (site plan, electrical/lighting plan, stormwater plan, landscaping plan, etc.). At this point, the city is not concerned with the interior of the building (therefore, the city does not need construction documents); the City is focused on the exterior and how the building will look and function. Therefore, required plans typically fall between schematic design and construction documents (referred to as "design development" or "DD" drawings).

Preparing design development documents, which expand upon very basic schematic/concept designs into building functionality and building systems, takes time and costs money. In a typical development process, the developer will incur design development costs only after (i) land control, and (ii) a general determination of project feasibility. Once the developer decides to incur the cost, the design development process starts and may take a couple of months to complete. At that point, the developer can submit an official application and start the "60 day" clock.

D. NEGOTIATING THE PURCHASE AND SALE AGREEMENT

1. Introduction

Now that the stage is set, how does the seller negotiate the land sale deal? The buyer may be making a significant investment and is taking risk. The seller has its own goals and motivations. As counsel to the seller (and buyer), we must balance the risks and motivations and attempt to come up with reasonable solutions.

2. Steps to Take

a. Seller Due Diligence. We think of due diligence as a buyer task. However, the Seller must also engage in due diligence. For the most part, this means asking questions and discerning the buyer's motivations and risks, such as the following:

(i) Is the buyer credible in the marketplace and does it have the ability to perform? Does the buyer require financing?

(ii) What is the buyer's vision for the project?

(iii) How much time is reasonably required?

(iv) How much money will the buyer invest in pre-development expenses? What level of investment is required to commence the entitlement process?

(v) How long will the entitlement process take and what is the city's likely reaction to the project?

(vi) How do I protect my client through the entitlement process if the land sale goes awry?

Asking the right questions is important. Developers will generally not disclose confidential information (return expectations, margins, potential tenants, etc.), but will often be transparent about process, timing and design/engineering/due diligence costs. Understanding the developer' risks and motivations helps you craft a better contract for your client.

3. Crafting the Contract

a. Negotiations with respect to accommodating a developer buyer's desire for time to acquire project entitlements usually involves the following standard purchase and sale agreement provisions:

(i) "Due Diligence Period" or "Feasibility Period"

(ii) Earnest Money

(iii) Representations and Warranties/Affirmative Covenants

(iv) Default

b. All of these provisions, to a certain extent, are linked and function together. The following are such suggestions for crafting a contract that balances each side's risks and rewards.

(i) Feasibility Period Staging. The feasibility period should be tied to a reasonable period of time for the buyer to reach an acceptable level of risk before buying the land. The buyer will always try to push the time period out as far as possible. Consider staging the feasibility period. With this approach, the buyer gets a short period of time (perhaps 60-90 days) to perform all physical, title/survey, Phase I and document review due diligence. If the buyer does not terminate the contract during that initial feasibility window, the buyer waives the right to terminate the contract for those matters. The buyer would then have a longer period of time to obtain entitlements and approvals, etc.

(ii) Earnest Money Deposits. Earnest Money can also be staged with the staged feasibility period. Initial earnest money does not need to be a large amount if it covers a short window. Consider requiring the buyer to make additional and progressively larger Earnest Money Deposits at various milestones during the development process. This helps keep the buyer's feet to the fire.

(iii) Feasibility Period Extensions. If the buyer believes the initial feasibility/entitlement period is tight, the buyer may request extensions for some flexibility. Consider conditioning the extension on (i) some of the earnest money becoming non-refundable (subject to Seller default); (ii) buyer's deposit of additional, non-refundable earnest money; or (iii) requiring an additional, non-refundable deposit that is not applied to the purchase price.

(iv) Affirmative Covenants. You should consider requiring the buyer to share information and due diligence reports. You should also consider requiring the buyer to (i) apply for entitlements on or before a certain date; (ii) invite a seller representative to attend meetings with the city; and (iii) do other things that are under buyer's control on or before specific milestones. SIDE NOTE: the buyer will also

require certain levels of cooperation from the seller. Most cities will require the property owner to sign (or consent to) all development applications. Depending on what the city requires, indemnities may be important in the contract. The seller's lawyer must understand these city requirements on the front end to appropriately draft the contract.

(v) Default. Termination and retention of earnest money for buyer's default is typical. If seller defaults, termination with an earnest money refund and specific performance are typical; however, it is reasonable for the buyer to request the right to sue for direct (not consequential) damages, such as out of pocket costs, etc. Consider agreeing to a liquidated amount. If the Seller defaults and has agreed to pay the buyer's out of pocket costs, consider requiring the buyer's consultants to provide reliance letters to the seller to perhaps avoid re-inventing the due diligence wheel on the next deal.

VII. REPS AND WARRANTIES FROM BUYERS IN PSAs – WHAT'S FAIR AND WHAT'S NOT?

(Patrick E. Mascia, Briggs and Morgan P, St. Paul, MN, November 2, 2017)

(Discussion from Podium)