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Key Points in Commercial Real Estate Purchase and Sale Contracts: Negotiating Covenants Between Signing and Closing, and Allocation of Closing Costs

Authors: Zlata Fayer, Allison S. Mercantini
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In a multipart series, we're examining important points to consider when negotiating commercial real estate purchase and sale contracts from the perspectives of buyers and sellers. Our prior posts addressed negotiating contract terms regarding payment of the purchase price and deposit, the due diligence period, title and survey matters, and representations and warranties. In this post, we are focusing on negotiating terms in a commercial real estate purchase and sale contract (the contract) regarding covenants between contract signing and closing, which is a significant negotiation point because covenants govern what the parties can and cannot do during this period. We will also focus on negotiating the allocation of closing costs, which is important because these costs directly affect the economics of the transaction.

Covenants Between Contract Signing and Closing

A buyer will want strong covenants to minimize the buyer's risk during the period between contract signing and closing, and a seller will want to maximize the seller's flexibility to manage the property. Covenants that are typically negotiated include:

1. entering into new leases, terminating or amending existing leases, offering rent reductions or concessions, and making certain capital expenditures;
2. entering into, modifying, or terminating material contracts;
3. changing insurance coverages;
4. allowing any new encumbrances such as new debt or easements;
5. making alterations or improvements; and
6. settling any litigation.

From a buyer's perspective, covenants, along with strong seller representations and warranties and conditions precedent to the buyer's obligations to close, are of utmost importance to a buyer. Covenants protect the buyer's assumptions about the property and the value of the real estate during the risk period. The seller still controls the property during this time, and covenants ensure that the buyer receives the same asset they agreed to purchase. For example, strong buyer-friendly covenants will prevent a seller from entering into new leases or terminating or modifying leases without the buyer's consent, increasing operating expenses, failing to maintain the property, or allowing any new encumbrances. It is critical for a buyer that the contract provides buyer remedies in the event a covenant is breached, such as a termination right and reimbursement of costs.

From a seller's perspective, the seller is still the owner until closing and will want to preserve the ability to manage the property, including any leases. It will be important for a seller to maintain the ability to act without delay by avoiding buyer consent requirements for routine actions with respect to management of the property. This includes a broadly defined ability to operate in the ordinary course of business consistent with past practices.

Both parties will benefit from certain covenants, including:

7. risk of loss covenants which clearly state what happens in the event of a casualty or condemnation;
8. insurance covenants which ensure that the property remains insured and that the seller will remain compliant with its lender's requirements;
9. covenants which require mutual cooperation with respect to financing, title matters, estoppels, and closing deliverables;
10. materiality qualifiers which clarify when a buyer will have remedies for a breach and protect a seller from a buyer claiming a breach for immaterial issues;
11. confidentiality covenants which protect strategy and avoid disruption; and
12. reconciliation covenants which provide for fair allocation post-closing and limit future claims.

A notice and cure period for breach of any covenant will also protect both parties by preventing an accidental or technical default.

Allocation of Closing Costs

Closing costs in a commercial real estate transaction are often significant and variable and therefore have a meaningful impact on the overall economics of a transaction. Each party will want to negotiate responsibility for closing costs to optimize its deal economics. Typical closing costs may include title insurance and endorsements, surveys, costs of curing any title or survey defects, environmental studies, recording fees, real estate transfer fees, and legal fees. All of these costs can have an impact on the seller's net proceeds and the buyer's total investment. If not negotiated in the contract, disputes may arise, which in turn may lead to closing delays.

A buyer typically expects to pay costs related to its financing, the survey, the buyer's own legal fees, due diligence costs, costs of recording the mortgage and deed, and title insurance endorsements and the lender's policy of title insurance. However, a buyer will want the contract terms to shift responsibility to the seller for costs that are related to the seller's ownership of the property such as curing title and survey defects and removing liens and other encumbrances. Depending on local custom, a buyer will also want to avoid paying any real estate transfer taxes or for the owner's title insurance policy. In addition, if issues arise during the buyer's due diligence investigations, buyers will want the contract to provide remedies that do not involve reducing the purchase price since that may require lender approval, affect appraisals, result in seller resistance, and delay closing. Instead of a reduced price, a buyer should look to negotiate contractual remedies such as closing cost credits, escrows, and the seller paying for corrective costs such as environmental remediation and additional title endorsements. These routes ensure that the buyer receives the asset in the condition bargained for, while preserving financing terms, valuations, and keeping the timing of closing on track.

A seller typically expects to pay costs related to its ownership of the property and its obligation to convey clear title. These costs usually include removing any liens and other encumbrances, curing any survey and title defects, the seller's own legal fees, and costs of preparing the deed and seller documents. In addition, depending on local custom, a seller might expect to pay for any real estate transfer taxes and the owner's title insurance policy. A seller will typically resist responsibility for the buyer's financing costs, discretionary due diligence, and costs of any upgrades or improvements that the buyer may request.

A seller will also want to ensure that the contract provides sufficient caps on any uncertain costs such as removing nonmonetary title and survey defects, environmental clean-up, repair obligations, escrows, the survival of indemnities after closing, and any credits to the buyer. By negotiating contractual caps on costs that

are uncertain, difficult to predict, and can escalate quickly, a seller can effectively limit its financial exposure while still providing reasonable remedies to the buyer.

Negotiating clear responsibility for costs in the contract allows buyers and sellers to manage risk, control deal economics, and avoid delaying the closing. Addressing closing cost allocation up front in the contract helps prevent problems and results in a more predictable path to closing for both parties.

What's Next: Negotiating the Letter of Intent

In our next post, we will examine the role of the letter of intent and offer guidance for buyers and sellers on developing a clear term sheet that outlines key deal terms and serves as an effective roadmap for the contract negotiations.

If you have any questions about drafting and negotiating commercial real estate purchase and sale contracts or handling any aspects of transactional real estate matters, such as commercial leasing, acquisitions and dispositions, title matters, diligence, and financing, contact Allison S. Mercantini and Zlata Fayer.