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United States Real Estate Investment: The Contract Process

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Introduction

For foreign investors, one of the most important but least understood aspects of an investment in United States real property is the negotiation of a contract of sale and, once the contract is completed, the closing of the acquisition. Because this process differs greatly from the contract process in most other countries, it is a difficult and often confusing period for foreign investors. Yet, if they are to protect their interests, they must not only understand the process but join actively in it. This paper will explain the United States contract process to help foreign investors to participate in it more effectively.

To begin at the beginning, a contract of sale provides the terms and conditions of the transaction. It is the basic means of setting forth the parties' agreement as to the purchase price and terms of payment. If this were all that were required, contracts of sale would be about a page long, and there would be no need for this paper. Rather, as a result of the complexities of United States law and custom, contracts of sale in commercial transactions are often fifty or more pages plus about an equal number of pages of supplementary schedules and exhibits. It is the preparation and negotiation of all this material which sets the contract process in the United States apart from that in most other countries. The differences arise not only because of our common law legal system but also because of our particular approach to our legal system. It is, in large measure, a reflection of the essential *laissez faire* spirit of the United States economic system.

In most other countries either by law (primarily statutory law) or custom, the areas of potential controversy in a real estate transaction are largely limited to price and payment terms. In a fundamental sense, the basic question of the merchantability of the property is not at issue, because, as a result of the applicable statutory provisions, the seller is usually obliged to sell the property in a merchantable condition and the purchaser is generally assured as to its ownership by registration of its title. The question of merchantability really becomes important only after the conveyance of the property if the purchaser discovers that the property's condition does not comply with applicable law.

The situation in the United States is different. As will be discussed more fully below, there is no implied warranty of merchantability in commercial real estate transactions. As a consequence, a contract of sale must deal with the condition of seller's real property, how this will be ascertained and what steps, if any, the purchaser must take to assure that it will receive the real property in the condition bargained for in the contract. Moreover, the United States does not have a general system of government registrations of land titles. As a consequence, a contract of sale must also deal with the nature of the seller's title, how this will be ascertained and what steps, if any, the seller must take to assure the purchaser that it will receive the quality of title bargained for in the contract.

There are many statutes applicable to real estate ownership and operation in the United States. However, very few apply to the actual process and terms of the sale

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of commercial real estate, particularly if one excludes federal and state tax laws. In addition, all but a few of the applicable non tax statutes are waivable by the parties and are generally waived in commercial transactions. For instance, most states have adopted a law known as the Uniform Vendor and Purchaser Risk Act, which governs the rights and obligations of the parties to a contract for the sale or exchange of real estate in the event of destruction of the property or a taking by eminent domain. The Act provides that it is applicable "unless the contract expressly provides otherwise... ", and most commercial contracts do expressly provide otherwise. As the parties to a commercial real estate contract of sale contract out of most statutory restraints, they possess a flexibility in structuring a real estate transaction to satisfy their mutual needs that may not be available in other countries. While flexibility has its benefits, it also may hold risks for a party not used to dealing with such flexibility.

Moreover, most of the real property law in the United States which governs the rights and obligations of a seller and purchaser is common law. This is a body of law based upon decisions of courts, which decisions act as precedents for future decisions in cases involving similar facts. Thus, principles of the common law are determined by inductive reasoning from court decisions rather than, as in the code system, by deductive reasoning from statutory provisions. The common law system has several direct effects on drafting contracts. First, it places a premium on the particular facts of each case. Second, although the basic principles of common law are clear, their application to particular fact situations is often uncertain. Third, the legal principles in real estate are largely derived from the early English common law and have changed remarkably little over time. Thus, in many respects, one is applying 400 year old law to modem transactions. Last, the common law evolves after the fact because final court decisions often are rendered several years after the dispute actually arose. Thus, in areas where the basic real estate law is changing, it may be difficult to predict the course the courts will take. Thus, the parties seek greater certainty by negotiating specific and detailed contractual provisions rather than rely on general principles of law.

In addition, in our federal system, except for tax and environmental matters, almost all relevant real property law is state law. There is essentially no Federal real property law. This alone substantially differentiates United States real estate transactions from those in other countries which generally have a national real property law. Even though our real property law, except for the state of Louisiana, is derived from the English common law, state laws differ widely. Customs and procedures also differ, not only among the states but also within particular states. For example, there are substantial differences in substantive laws and closing procedures between California and New York as well as differences in closing procedures between northern and southern California.

For these and other reasons, the practice has arisen in the United States of using very detailed contracts which attempt to cover all potential disputes between the parties. This approach is essentially self justifying. As lawyers draft ever more detailed agreements, the courts are forced to ever finer distinctions, which drive counsel to cover the issues in ever greater detail in order to anticipate such ever finer distinctions by the courts. This approach in drafting and interpreting legal documents naturally creates substantial issues for the inexperienced foreign investor, making legal advice for the protection of its interests essential. Although the process is cumbersome, expensive, and perhaps frustrating for those investors from different legal and business systems, investors who understand and accommodate the process will be at an advantage.

To focus on the contract process in the United States is to focus both on some broad general themes and on many detailed provisions. However, the intent of this paper is to deal with broad themes that affect the basic process of entering into a contract rather than specific contract provisions, which will be discussed only to explain how they affect the negotiations.

In order to simplify the discussion, this paper will focus on an all cash sale of a major commercial office building (the "Property") by a domestic seller ("Seller") to a foreign investor ("Purchaser"). In addition, annexed as Appendix A is a summary checklist of matters pertinent to such a transaction.

I. Initial Contact

There are, of course, many ways in which the transaction may be initiated. These include an offering by Seller or Seller's broker, an auction by Seller, a contact by Seller's or Purchaser's broker and a contact between the parties themselves.

The sales brochure is a common method used today in major commercial transactions. The brochure generally provides substantial information about the Property, its income and expenses, its location (including statistical information for its metropolitan area) and, often, projections for the Property's performance over a given investment period (generally, 10 years). Often, the brochure will disclose material issues which might affect investment in the Property (such as the presence of hazardous materials (asbestos, PCBs or the like), pending tenant disputes or litigation, present or impending vacancies and other similar matters). On the other hand, the brochure is intended to generate interest in the Property and will thus present information in a favorable manner.

Moreover, the brochure will contain disclaimers as to its information. Unlike a securities prospectus which is intended to be relied upon by the buying public, a real estate sales brochure is intended solely as a marketing document. Neither Seller nor Seller's broker intends that it be responsible for the truth or accuracy of the brochure, and the real estate law, unlike our securities law, does not impose such liability as a general matter.

This raises the first general theme of a real estate acquisition: Seller will attempt to limit to the greatest extent possible its liability for information about the Property given to Purchaser. Except in the cases of deliberate lies or fraudulent conduct, our law does not impose any liability on sellers for undisclosed defects or liabilities in respect of sales of commercial real property. As indicated above, for commercial sale transactions, there is no implied warranty of fitness or merchantability but rather a basic rule of *caveat emptor* — let the buyer beware.

This is an important issue at the initial stage of the contract process: Purchaser must be prepared to undertake its business, legal and physical review (often called due diligence review) of the Property at this time. Although it may be preferable to obtain a post contract period in which to perform the due diligence review, in many cases such a "due diligence review contingency" is unacceptable to a seller.

Again, contrast the United States approach to the civil law system which does imply a warranty of merchantability and discourages a purchaser from conducting a due diligence review as the implied warranty does not extend to matters as to which the purchaser has actual prior knowledge.

Although much of the due diligence review will be carried out by Purchaser's counsel, accountants and other advisors, Purchaser must not only assemble these people at this early stage in the transaction but also be available to participate in the review itself. The due diligence review, as will be discussed further below, generally produces a number of issues which must be resolved, some of which will become business issues to be resolved between Seller and Purchaser. In addition, some of these business issues will not be easily resolved and will rise to the level of business judgments i.e., the issue or the proposed resolution is likely to have a material impact on the financial aspects of the transaction.

This raises the second general theme of a real estate acquisition — in order to make informed decisions, Purchaser must be involved in the entire contract process. Generally, the business issues in a transaction are interrelated, and Purchaser cannot deal with each

separately. Rather, Purchaser must be able to put them into the context of the proposed transaction in order to make sound decisions as to proposed resolutions and the risks or costs associated with them.

The relationship between the business negotiations and the due diligence review often poses another significant issue — albeit a psychological issue — for Purchaser. Foreign investors appear to become "committed" to transactions as soon as general agreement on the business terms is reached. Whether due to a home country ethic (where "handshake" agreements connote more than a basic agreement on terms), the greater simplicity of civil law purchase agreements or to a compelling need to deliver on a transaction once the business terms have been approved by the home country headquarters, this commitment puts the foreign investor at a significant negotiating disadvantage. Americans generally view the handshake agreement on basic terms as a significant milestone in negotiations, but not as the end of negotiations or as a definitive commitment to proceed with the transaction. Americans generally anticipate the due diligence review and the negotiation of the contract of sale to be an integral part of a process. Thus, a premature commitment by Purchaser puts Purchaser at a disadvantage with Seller who is expecting to negotiate with an "uncommitted" Purchaser.

II. Due Diligence

At the initial agreement stage Purchaser must assume that the due diligence review will uncover several important matters but cannot assume that these matters will be properly dealt with (from its perspective) in the contract. For example, one could discover that:

(a) the lease provisions for recovery of cost escalation (which require tenants to reimburse landlord for increases in operating costs and taxes) are inadequate to reimburse landlord fully for all such increases;

(b) provisions of major leases impose special burdens on landlord, such as special service requirements for a major tenant, or grant special rights to tenants, such as rights of first refusal on unleased space or on the sale of the Property;

(c) there are conflicts between expansion rights of tenants;

(d) the Property does not fully comply with local fire, safety, health or zoning codes (such as the recently enacted Americans with Disabilities Act) or requires major repairs;

(e) one or more tenants have financial problems or complaints about landlord services; or

(f) the income or expenses of the Property are not as presented in the sales brochure.

Whatever the issues uncovered in the due diligence review, they are generally reducible to either monetary terms or placing the risk of and liability for future events on one of the parties. To illustrate, the first example given above is basically an economic item whereas the third example is more of a future risk item.

All of the matters uncovered through the due diligence review should, of course, be reflected in either the purchase price or the contract. However, this is a matter of negotiation. Thus, Purchaser should be prepared for this negotiation and should not feel impelled to conclude the contract at either the originally agreed purchase price or on contract terms offered by Seller. The negotiation creates the risk of not being able to conclude the transaction, and this risk must be weighed against not only the materiality of the matters at issue but also the value of the transaction to Purchaser. The better strategy is clearly to avoid undue commitment to the transaction and to be clear that any agreement on price is contingent upon favorable resolution of due diligence review matters and contract terms.

Purchaser will often feel that the due diligence review is too time consuming and that it creates too much uncertainty as to the outcome of a transaction. However, in the United States system, the due diligence review serves to uncover issues that in its home country would likely be discovered only after the transaction had been completed and which would then only be resolved through litigation. Thus, properly pursued, the due diligence review can be viewed as a means to reduce risks and still allow Purchaser to walk away from a transaction without being bound.

Turning to the due diligence review itself, there are several general areas which must be covered.

1. Operational Documents

The leases, services contracts, licenses and permits and other documents pertinent to the operations of the Property must be reviewed by counsel and by Purchaser's financial advisors. Lease agreements in the United States tend to be significantly longer and more complex than leases in civil law countries. There is no "standard" form, and, as with contracts of sale, the parties have significant flexibility to modify the general rules of law by specific agreement. Therefore, Purchaser must carefully review the leases.

The review of operational documents should ascertain whether the financial aspects of these documents are properly reflected in the financial projections for the Property, as well as whether there are any provisions which might have financial or other repercussions. Examples of the latter provisions are those relevant to future financing or sale transactions or which would interfere with any planned alteration or new use of the Property. For example, future lenders will decide whether or not to grant a loan based upon their own due diligence review. If the operational documents do not, for example, contain customary provisions protecting the lender's interests, future financing may be difficult to obtain.

2. Physical Structure

The physical structure must be reviewed by a qualified architectural or engineering firm. This inspection should cover not only the general condition of the Property but also deferred or pending maintenance, presence of hazardous or toxic materials and compliance with current and pending fire, safety, health and zoning codes. These are all important as the costs of compliance in an existing building may be very significant. Furthermore, current Federal and state environmental laws impose very substantial liabilities on owners of properties found to have hazardous or toxic waste problems. Some state laws even require prior governmental approval for transfers of properties which might have such problems. The scope of such laws has expanded greatly over the past few years and is expected to continue to expand in the foreseeable future. Thus, where pertinent, a complete environmental study should be high on the Purchaser's due diligence checklist. Similarly, the recently enacted Americans with Disabilities Act can impose significant costs on an owner for up grading the Property, either currently or as a condition to any renovation — including renovations that are part of a new or renewed lease with a tenant.

3. Title

Title to the Property must be reviewed. This includes obtaining a new or updated survey of the Property from a licensed surveyor. As mentioned above, generally the United States does not have a system of governmental registrations of land titles that creates an irrebuttable presumption of accuracy of title certificates in favor of the bona fide purchaser. Rather, it has a governmental recording office in which matters affecting title are available for inspection. Purchaser must establish for itself not only whether title has been properly conveyed into Seller but also whether the property is subject to any mortgages or other encumbrances. A typical contract provision will provide that Purchaser is to accept title subject to specified exceptions (often called "Permitted Exceptions"). It will also provide that

Purchaser will cause the title to be examined and will obtain a new survey promptly after contract — and will then bring to Seller's attention any matters found in addition to the Permitted Exceptions. As discussed more fully below, this examination of title is usually handled by a title insurance company, and the Purchaser's obligation to acquire the Property is customarily conditioned upon the title company's agreement to issue its title policy in conformity with the contract provisions. Thus, while much of the title review will often occur post contract, Purchaser's counsel must review the Permitted Exceptions prior to the contract signing to ascertain whether they raise any legal, financial or other issues.

4. Financial and Contract Issues

The results of the foregoing reviews must be analyzed for impact upon Purchaser's financial projections as well as upon the proposed terms of the contract. The conclusions drawn from this analysis may have an important impact on the negotiations between Purchaser and Seller. Obviously, they may affect the purchase price. On the other hand, they may suggest that the contract should require Seller to cure or ameliorate certain problems.

The overall complexity of the due diligence review should not be underestimated. It requires a considerable effort by all involved, including Purchaser, and, by its nature, is intended to highlight problems. Hence, at the same time that Purchaser is attempting to close the negotiations with Seller, the due diligence review is often producing new matters which must be resolved. Because the importance of these issues varies broadly and because the issues generally do not arise in a logical and ordered fashion, they can be distracting to Purchaser as well as disruptive in the negotiations. This part of the contract process can be particularly troubling to the foreign investor: while it is generally under significant pressure from Seller and the brokers to reach agreement on the transaction, at the same time it must react and respond to a continuing stream of due diligence issues which it may have little ability to understand and evaluate.

Furthermore, all states in the United States have adopted some form of the English Statues of Frauds, which requires that agreements for the sale of real property be in writing and be signed by the party against whom enforcement is sought. Letters of intent are not common, and thus both parties are seeking to conclude a written and signed contract as promptly as possible. In some cases, in order to accommodate the competing goals of trying to sign a definitive contract quickly and ensuring a complete due diligence review, the parties will sign a contract which provides that Purchaser has a right to complete its due diligence during the contract period and to rescind the contract if material problems are found. However, Seller generally will resist this approach as it, in effect, gives Purchaser an option to change its mind on the acquisition.

Notwithstanding the sensitivity and tension during the due diligence review, Purchaser should attempt to maintain as much flexibility as possible during it. Although this is easy to say and more difficult to do, Purchaser should seek to have the purchase price and other basic transaction terms reflect, to the extent possible, the issues raised during the due diligence review. To do so is basically a matter of the tactics of negotiation which, in turn, requires Purchaser to understand the contract process.

III. The Contract

At some point in the process outlined above, Seller and Purchaser reach sufficient agreement for a contract to be prepared. Customarily this is done by Seller's counsel. It is worth reemphasizing that the preparation of a contract is not a pro forma matter in United States transactions but rather the beginning of another phase in the contract process. Not only is there a wide variety of forms of contracts but also the negotiation of the contract often leads to renegotiation of matters that one party might have thought settled.

A typical contract of sale table of contents would likely include the following:

1. Property:	a general description of the Property, usually supplemented by one or more schedules with detailed descriptions of various components of the Property (the land and significant items of equipment and personal property)
2. Purchase Price:	a description of the purchase price and manner of payment
3. Permitted Exceptions:	a generic list of Permitted Exceptions, usually supplemented by a schedule of exceptions particular to the Property
4. Title and Survey:	a provision governing the quality of title which Seller must convey and Purchaser must accept and providing for Seller's obligation to cure certain title defects
5. Seller's Representations:	a detailed listing of Seller's representations and warranties, usually supplemented by several schedules
6. Purchaser's Representations:	a list of Purchaser's representations and warranties
7. Closing:	a provision setting the time and place of the closing
8. Conditions to Closing:	a detailed listing of the conditions precedent to the closing, which usually includes (a) the acts to be performed by each party, (b) the documents, consents and other instruments to be delivered at the closing and (c) the operation of the Property prior to the closing
9. Operations Pending Closing:	provisions governing how the Property will be operated pending the closing, including provisions detailing Seller's and Purchaser's respective rights to participate in or control decisions regarding new leases and service contracts, lease renewals, tenant defaults and the like
10. Apportionments:	a detailed provision governing the proration of the income and expenses of the Property between the parties as of the closing date
11. Allocations:	a provision governing the allocation of certain expense items to one party or the other
12. Casualty and Eminent Domain:	a provision governing the rights of the parties in the event of casualty to, or a governmental taking of, the Property
13. Brokerage:	a provision governing the payment of brokerage commissions
14. Remedies:	a provision governing the rights of each party in the event of a default by the other party
15. Notices:	a provision governing the giving of notices under the contract of sale
16. Miscellaneous:	provisions generally relevant to the interpretation of the contract

If the foregoing listing has not done so, it is worth reemphasizing that, because of the nature of our law, our contracts are very detailed. While in most civil law countries only the essential economic terms will be memorialized in writing between the parties, Americans attempt to create documents covering all legal and economic issues that might arise between the parties in the future. Often disagreements arise over the particular wording of clauses, even if the general concept is agreed to between the parties. Sometimes the issues have significant financial importance. Often the issues seem to be or are insignificant but the parties are trying to establish a psychological advantage to discourage the other side from seeking favorable contract provisions. This part of the process may be viewed as somewhat like a grand Kabuki dance. There is a strong ritualistic quality to the negotiations, complete with role playing, histrionics and bargaining positions that may seem scripted. It is a process so often repeated in the United States that it generally quickly settles into a pattern of almost predictable thrusts and parries with the participants fitting into predictable roles. In addition, except for matters peculiar to the Property, the basic issues are generally the same from transaction to transaction. However, unlike true Kabuki, the resolution of these issues varies from transaction to transaction, depending upon the bargaining strength and prowess of the parties and their counsel.

This approach to contract making leads to a third general theme: Americans tend to expect strong bargaining over a contract and can often be rude and unreasonable in bargaining sessions. They also, I believe, have come to the conclusion that this attitude gives them a significant advantage over foreign investors who, as a group, have shied away from strong bargaining and will accept unreasonable contract terms. As a consequence, in negotiations with foreign investors Americans seem to stake out somewhat more aggressive bargaining positions. From Seller's perspective, this is a sound tactic as it takes advantage of the perceived reluctance of foreign investors to match a strong negotiating style as well as the perceived commitment of foreign investors to a transaction once agreement on price has been struck.

A. The Contract: Representations and Warranties.

The primary area of negotiation is typically Seller's representations and warranties. As indicated above, our law does not imply into contracts of sale for commercial properties any basic warranties as to the Property or its fitness or liabilities. It is important for Purchaser to understand that, to the extent the contract of sale remains silent, Seller is deemed not to have made representations and warranties for which Seller could be held liable. Protection comparable to a full implied warranty of fitness as established in a civil law system must be obtained through negotiation. However, as Purchaser can perform a thorough due diligence review, it is only theoretical to expect Seller to agree to representations and warranties of that scope. Although much can be ascertained during the due diligence review, Purchaser will generally wish to be assured that it has seen all relevant documents and been told all relevant facts. Purchaser does this through an extensive list of representations and warranties which, in essence, state that Seller has shown Purchaser everything and that there is nothing else material that Purchaser should know or should have seen. Obviously, Seller will generally attempt to limit Purchaser's list of representations and warranties or at least their scope.

This summary of the purpose of representations and warranties highlights two fundamentals of our law and the contract process. First, note that the basic purpose can be summarized rather easily. From that one might think that such a short summary should suffice for the contract. However, such an approach is not used in the United States. In legal documents we deal not with the general principles but rather with the details. Second, note that the summary has both a positive ("Seller has shown Purchaser everything")

and a negative ("there is nothing else material ..."). Again, while one might think that the positive statement renders the negative unnecessary, it is clear that sound practice requires both. There are many court decisions which have turned on the presence or absence of both the positive and negative statements. These two factors obviously make the negotiation more complex and the contract longer.

1. General Issues: Scope and Survival

The area of representations and warranties involves two basic issues: the scope of the matters covered and the survival of the representations and warranties beyond the closing. Focusing on the scope issue, the types of representations and warranties which Purchaser would seek from Seller fall into four general categories:

1. the authority of Seller, including:
    a) the due formation and valid existence of Seller,
    b) the legal power and right of Seller to enter into and perform the contract of sale,
    c) the due authorization and execution by Seller of the contract of sale, and
    d) that the execution and performance of the contract of sale do not breach any of Seller's organizational documents or any law or agreement applicable to Seller and do not require any governmental or other consent;
2. the Property, including:
    a) Seller has good title to the Property, subject to Permitted Exceptions,
    b) the present improvements to and use of the Property do not violate applicable zoning laws,
    c) there is no pending or threatened governmental taking,
    d) all necessary utilities are available to the Property in required quantities,
    e) Seller has not received any notice of violation of any building, fire, environmental, health or other law or of any insurance policy,
    f) Seller knows of no material defect in the condition of the Property,
    g) the Property has direct access to and egress from a public street, and
    h) the appended schedule of real property taxes is correct;
3. the leases and service contracts, including:
    a) the appended schedules of leases and service contracts list all of the leases and service contracts affecting the Property,
    b) Seller has delivered true and complete copies of the leases and services contracts to Purchaser,
    c) Seller knows of no defaults under the leases and service contracts,
    d) the security deposits under and brokerage commissions in respect of the leases are accurately shown on the appended lease schedule,
    e) the appended list of governmental permits is complete, with all permits being in force and transferable,
    f) the listed permits are all that are required to own and operate the Property,

g) the appended list of employees is complete and the relevant details of any union contract are correctly shown on the schedule, and

h) Seller has given Purchaser a true and complete copy of any management agreement and there is no default thereunder, and

4. litigation, including:

a) there is no pending litigation which might adversely affect the sale, and

b) appended is a complete list of all pending litigation, all of which is covered by insurance.

The foregoing is merely a synopsis of the scope of representations which Purchaser would seek. As discussed below, the actual scope of the representations obtained from Seller would likely be more limited. In any event, depending upon the complexity of the Property and the transaction, the actual contract provisions might cover 10 or more pages.

The survival of the representations and warranties needs some explanation because it is another peculiarity of our common law system. Unlike the civil law system, the contract of sale is generally extinguished once the title to the property has passed from Seller to Purchaser. Thereafter the legal relationship between the parties is governed by the deed which is the short, but important, document transferring the title to Purchaser. Again, this is a general principle of the common law, which not only has exceptions but also may be modified by agreement between the parties. As the deed is usually an inappropriate document in which to deal with this particular issue, the parties provide for a survival of specified provisions of the contract.

With respect to survival, the general rule of law is that, unless a contrary intent is expressed, the representations and warranties do not survive the closing and no legal action may be maintained against Seller after the closing for any breach thereof. Although this issue is quite complex, clearly Purchaser can independently satisfy itself by closing as to certain representations (such as Seller's title to the Property) but not as to others (such as that there are no other leases or service contracts than those on the schedules). Thus, the parties typically agree as to the survival (and time periods of survival) or non survival of each item separately.

2. Specific Representations: Authority

The first category (Seller's authority) may surprise the foreign investor because it is not customary in civil law countries to make representations as to a party's authority. It should be added that Purchaser will be expected to make the same representations with respect to its own authority to enter into the transaction (see item 6 in the foregoing chart). Such representations usually do not pose any problem.

3. Specific Representations: Physical Condition of the Property

The second and third categories of representations and warranties listed above (i.e., the physical condition of the Property and the leases and service contracts) are generally the most heavily negotiated and are the most illustrative of the types of issues which arise in this area. For example, in the second category, Seller will likely propose no representations, on the theory that the Property is there and can and should be inspected by Purchaser. On the other hand, Purchaser will presumably request representations covering all aspects of the Property's physical condition. Keeping in mind that there are no implied warranties of merchantability in commercial real estate transactions, the issue generally is settled by making representations only as to matters not reasonably ascertainable by a physical inspection of the Property.

For example, Seller should represent that it has not received any notices from governmental authorities or its insurers as to violations of laws or insurance policies (item 2(e) above) prior to the date of the contract. Purchaser would like this representation to continue to the closing but this is less common. Purchaser is entitled to know about violations because it could be faced with substantial expense and complications if there were outstanding violations at the time of closing. Note that Seller is not representing that the Property is in compliance with laws and insurance requirements but only that Seller has not received any notice to the contrary. Thus, Purchaser is taking the risk of violations as such, but Purchaser may protect itself to a significant extent by having an adequate physical inspection by a qualified firm. By custom, sellers generally do not take the risk of violations after the date of contract, partially out of concern that purchasers might arrange a post contract inspection with the purpose of creating a breach of the representation.

Assuming the parties agree to the foregoing form of representation, they must also deal with at least two further related items. First, they must negotiate the extent to which Seller must cure violations noted in pre-contract (or pre-closing) notices. Generally, Seller will agree to a cure obligation but subject to a relatively modest limit on the total cost (often 1% or less of the purchase price). Seller may elect to spend more, but, if it does not and there are uncured violations, generally Purchaser's only options are to cancel the contract or to close without any further adjustment for the cost of curing violations.

Second, the parties must address Seller's responsibilities for operation of the Property between the date of contract and the date of closing with a particular view to normal maintenance matters. Although a few major transactions may have relatively short periods (30 days or less) between contract and closing, most involve 60 to 90 day periods and a few may involve 6 months or more. Generally, Seller will agree to operate the Property in a commercially reasonable manner prior to closing but will not thereby make itself responsible for violations, except to the extent the violations are cured by ordinary maintenance work.

There are, of course, many variations on the issues pertinent to violations as well as on their resolutions. Although the example indicates the general resolution in many cases, the summary does not show the hours of negotiation which may precede any agreement as well as the complexity of the document provisions which may be required to reflect that agreement. Many foreign investors are perplexed that there are even issues to discuss, assuming that applicable law would make Seller responsible for prompt compliance with building codes, fire, health and safety ordinances and the like, as it does in their home countries.

4. Specific Representations: Agreements Affecting the Property

As listed above, the third category of representations deals with various agreements affecting the Property. In this category, the most important set of documents is, of course, leases. In summary form, Seller will generally represent that the leases it has delivered to Purchaser are the only occupancy agreements affecting the Property and that Purchaser has received complete copies thereof. It is an area in which Purchaser's business and legal due diligence is crucial. Great care must be taken to understand the often complex relationship between the basic business terms of the transaction and the leases and to reflect these in Purchaser's analysis of the Property. Close analysis of leases is particularly important in the 1990's because the tenancies at many properties reflect the weak real estate leasing market that has persisted throughout the United States for some time. Many leases concluded during the past few years include unusual and highly negotiated provisions that can significantly affect the obligations, liabilities and income of owner.

A few matters best typify the many issues which might arise. First, Purchaser must ascertain that the

leases physically match the Property and financially match its projection model. As to the former, on occasion one finds problems such as a tenant which has expanded or relocated without documentation of the change, expansion or renewal options which are in conflict, an over allocation of parking spaces or the like. These matters should be resolved by Seller prior to closing. As to the latter, it is important to establish that Purchaser's financial projections accurately reflect the existing leases as to rental, cost escalation, special services, length of term, renewal and expansion options, cancellation options, rights of first refusal or first offer on available space, brokerage commissions payable in the future and the like. Such projections generally include rental increases based on certain assumptions about the releasing of space when present leases expire, and a mistake in the assumptions may cause a substantial error in the projections.

Second, in the United States tenants generally reimburse landlords for operating costs (including real estate taxes). These cost reimbursement provisions must be closely analyzed as to definitions of operating costs, prescribed means of reimbursement and the like in order to determine not only the accuracy of Purchaser's financial model but also costs of operating the Property which will not be recoverable from tenants. As a result of the tenant-favorable leasing market during recent years, it is not uncommon to find provisions which limit the ability of an owner to pass through to tenants increases in operating expenses and real estate taxes. For example, many leases exclude capital items from the expense reimbursement provisions. Similarly, in some markets, tenants were able to negotiate provisions that protect them from real estate tax increases that may result from the sale of a property.

Third, the impact of any special lease provisions must be analyzed. For example, large, anchor tenants often require that a property be operated to their specifications. Those specifications may not be suitable for other tenants. Likewise, Seller may have granted a tenant a specific concession that Seller can easily provide, but Purchaser cannot. For example, a bank owner may agree to enhanced security service because the bank requires such security itself and thus can provide it to a tenant without additional cost. However, if the bank ceases to be an occupant, Purchaser may be required to retain extra security guards to provide the same service.

Fourth, it is important to understand what may be missing from leases. Lease forms tend to vary greatly among owners and even the same owner may use different forms over time, particularly if it encounters a weak market. Thus, one may well find that "standard" clauses are absent from some or all of the Property's leases. This factor is relevant not only to Purchaser but also to future lenders and purchasers. For example, leases occasionally lack provisions for estoppel certificates (these are statements from the tenants confirming the leases and that there are no defaults thereunder which will prevent the tenant from asserting the contrary toward Purchaser thereafter). In such a circumstance, Purchaser can protect itself by requiring estoppel certificates as a condition to its purchase of the Property. However, the lack of such provisions may impede a future financing or sale as Purchaser has no assurance that it can obtain estoppel certificates in the future.

As should be obvious from the foregoing, a fourth general theme is that the business of acquiring a property is a business of detail. Even if Seller gives all of the "customary" representations, Purchaser must analyze and understand what it is purchasing. Seller's representations are only the starting point as they merely confirm what is. They do not explain the import of what is.

In addition, a corollary fifth general theme is that the ownership of commercial real estate in the United States is for the most part an active business. In many countries, commercial space is essentially net leased. That is, the tenant, not the landlord, is responsible for securing for itself many of the

required services. As a consequence, the operational part of the landlord's business has a relatively narrow scope. Most commercial space in the United States is leased on a so called "full service" basis, meaning that, with few exceptions, the landlord provides all services necessary for occupancy of the space. Thus, the scope of building management in the United States is much broader. This factor not only heightens the importance of the fourth general theme — that the business of acquiring a property is a business of detail — but also requires that Purchaser understand the detail sufficiently to be in a position to manage or oversee the management of the Property after closing.

B. The Contract: Title Provisions

Apart from the representations and warranties, perhaps the next most negotiated provision is the title provision. Again, this often perplexes foreign investors as they are accustomed to a governmental title registration system and to relatively clean titles. As discussed above, in general, the United States does not have a title registration system but rather a title recording system. All matters which affect title are recorded at a governmental office whose records are open for public inspection. Generally a title insurance company, which is a private, state regulated insurer, will undertake to examine the records and report on the status of title. This report gives the name of the current owner of the property and lists all exceptions to such owner's title. Some of these exceptions are generic (such as that the title is subject to applicable zoning laws) and the balance cover matters specific to the property.

Generally, Purchaser will obtain and review a current title report prior to contract. Based on this report, the contract will specifically list those title encumbrances which Purchaser has reviewed and approved. However, there may be errors in the title report (e.g., encumbrances the title company failed to identify), and new encumbrances may arise during the contract period. As a result, the contract must not only specify the Permitted Exceptions (i.e., those approved by Purchaser prior to signing the contract) but also Seller's responsibilities should other exceptions be uncovered during the contract period, regardless of whether such exceptions existed when the contract was signed or came into existence during the contract period. These other exceptions could include claims by suppliers, contractors or the like for goods or services provided to the Property (generally called "mechanics' liens"), tax liens, judgment liens and previously unknown defects in the chain of title. Seller's responsibility for curing these exceptions to title may be heavily negotiated. As the parties are dealing with an unknown, Seller obviously will be very uncomfortable with any substantial responsibility, while Purchaser is likewise uncomfortable with too limited a responsibility on the part of Seller.

Again, the crux of the issue is the use of a recording system rather than a registration system. In a registration system the bona fide purchaser acquiring title from the record owner eliminates a prior owner's right and can transfer a valid title to the next person. Under the recording system the chain of owners through which the title has been passed is subject to examination every time the property is sold. A defect in the chain, even one that goes back a substantial number of years, will affect Seller's good title. There is no simple starting point from which to define one's title (except in the rare instance when one acquires title by patent from the Federal government). To illustrate, over the past twenty years or so, two major lines of cases have undercut long established titles. In the first, best exemplified by the New Jersey Meadowlands case, governmental authorities have asserted their ownership of tidal lands. In the second, numerous American Indian tribes have asserted their ownership of historic tribal lands previously granted (or taken) away without the consent of the Federal government. In both cases, titles thought settled for almost 200 years were held to be vested other than as shown in the title records.

This problem is compounded by the fact that we possess no simple administrative means of clearing title exceptions. Although there are legal processes available, these are expensive and time consuming. Thus, rarely is the record cleared of outdated material. The title companies play an important role here as they often provide affirmative insurance against outdated exceptions to title based upon affidavits from the owner. Although this facilitates current transactions, it continues the existence of unnecessary material on the record.

As a consequence, sellers are very reluctant to agree to cure title defects. Although they will generally agree to cure certain limited categories of items (such as mortgage liens and mechanics' liens created by them), they will also generally limit their responsibility for all other matters to a cost not exceeding a small percentage of the purchase price (usually 1% or less). Seller may elect to cure further defects in order to preserve the transaction. However, if Seller does not elect to effect a cure, a contract will generally limit Purchaser to an election either to close without an adjustment to the purchase price in respect of the defect or to terminate the contract.

Basically, Purchaser's protection is that it is a condition to closing that title be as prescribed by the contract. This approach means that the parties tend to negotiate more strenuously over the definition of the acceptable state of title than over Seller's cure responsibilities. Purchaser thus may have limited rights to require Seller to cure title defects, but Purchaser is not required to close unless title meets the contract terms.

C. The Contract: Remedies for Default

A third area of contract provisions which requires mention is that of remedies for default. Although generally not the most heavily negotiated area, it reflects two very important aspects of the United States legal system. First, as a general matter, penalties *(i.e.*, specified damages which are determined without reference to the actual loss the nondefaulting party might suffer) are unenforceable under our law. Second, our courts do have, and in certain types of cases do exercise, the power of mandatory injunction pursuant to which they will compel a defaulting party to a contract to perform its obligations thereunder.

As to the first aspect of our laws, it is designed to support a basic legal tenet: if a contract is breached, the party breaching it is responsible in damages for the breach or, if appropriate, may be required to perform by court order. This tenet would be undercut if penalties were enforceable, because the parties would then, in effect, be permitted a remedy outside the judicial system. The courts have recognized a limited exception to the unforceability of penalties, however, to cover circumstances in which it may be difficult or impossible to determine actual damages at the time of contract and the parties agree at that time upon a fair and reasonable amount of damages (called "liquidated damages"). This exception is particularly relevant to real estate as it forms the basis for our rules on downpayments. As a general matter, the parties to a real estate contract of sale may provide for a reasonable downpayment, which is subject to forfeiture in the event of a default by the purchaser.

As to the second aspect of our laws, the power of the courts to compel performance of a contract arises from the principles of equity, one of the primary parts of the English legal system adopted in the United States. These principles permit a court to order performance of a contract of sale by a defaulting party where the subject of the contract is unique or special property and where monetary damages are inadequate to make the non defaulting party whole. The principles of equity are a particular relevance to real estate contracts of sale, because each parcel of real estate has historically been recognized as unique. As a result, real estate contracts of sale have generally been subject to enforcement in equity.

Taken together, these two aspects of our law have generated a generally accepted custom of providing that, if the Purchaser defaults, the downpayment will constitute liquidated damages and, if the Seller deliberately defaults, Purchaser will be entitled either to rescission of the contract and return of the downpayment or to specific performance of the contract by mandatory injunction.

Although there are many other contract provisions which are important and are often subject to substantial negotiation, the representations and warranties, title and remedies provisions illustrate much of the basic process involved in negotiating contracts. The process is obviously closely tied to our legal system and hence reflects customs and practices which differ substantially from the code law system.

It must also be noted that the assumed transaction for this paper has been a clean, all cash sale. Many investments involve other major components such as financing (whether provided by Seller or a third party lender), a lease (whether to Seller or an affiliate), a joint venture agreement or a management contract (whether with Seller or a third party manager). Each such component involves another negotiation and separate documentation, often to be handled at the same time as the contract negotiation. Obviously, this adds to the complexity of the contract process and the demands on the Purchaser's time and attention.

IV. Post Contract

The execution and delivery of the contract is not the end of the process. There are usually a substantial number of conditions to a closing and, in our typically American fashion, a substantial number of documents required to effect the closing. In a major commercial transaction there can be 100 or more closing documents, each intended to memorialize or effectuate a provision of the contract. Just as the first act of a play sets the stage for the second act, the process leading to the contract sets the stage for the post-contract and closing period.

Four important activities of Purchaser occur during this period. First, Purchaser must put itself in a position to close. Among other things, this may involve obtaining governmental consents, making financial arrangements for the closing, securing insurance coverage and making provision for the other matters which must be in place at the closing, particularly Purchaser's management system.

The matter of property management must be emphasized, as it has special pertinence to beginning investors. For the most part, as noted in the fifth general theme discussed above, real estate investments require daily, on site management. Even foreign investors experienced in real estate in their home countries must make provision for management in the United States. Given differences in business practices and legal matters, simply shifting home country employees to the United States may not be a sufficient solution. Obviously, for investors who do not have available employees, the issue is more acute. Although it is beyond the scope of this paper to explore this matter in detail, it is clearly a matter to be resolved prior to closing.

Second, besides production of closing documents (which is mostly handled by Seller's counsel), Purchaser must be prepared to handle the closing apportionments and allocations. This is one of the important contract provisions not discussed above and is one in particular that requires Purchaser's attention. Apportionments and allocations can, depending on the size and type of the Property, be quite complex. As the net results, in effect, form part of Purchaser's opening books on the Property, they are matters with which Purchaser and its property manager should be familiar. For example, cost escalation is generally billed currently, subject to year-end adjustment. Not only must Purchaser be prepared to take over this billing after closing but also it must understand the procedures used to formulate the estimates of costs and the apportionments between Seller and Purchaser so that, when the year

end results are known, it can prepare such reapportionment as may be required.

Third, particularly where the period between contract signing and closing is more than 30 days, Purchaser may have to respond to various requests from Seller for consents and approval as to operational matters. The prime example in this area is new leases. The contract will likely have a provision, often a complex provision, governing the Seller's right to terminate or amend existing leases and to make new leases prior to closing. In addition, the contract will also cover Seller's rights and obligations with respect to other operational matters, such as service contracts, alterations and the like. In each instance, subject to various guidelines, Purchaser's consent or approval of the action will generally be required, usually within a rather short time period (5 or so days). Thus, even before the closing, Purchaser must be prepared to make operational decisions with respect to the Property.

Fourth, Purchaser must ascertain whether the representations and warranties given by Seller are correct as of the closing and whether the conditions to closing have been satisfied.

The final formal step in the contract process is the closing where all obligations set forth in the contract, especially the transfer of title by delivering the deed, are consummated. This is generally a working, rather than ceremonial, session which takes several hours and, in the case of large or complex transactions, may involve a pre closing which extends for a day or more. As indicated above, in a significant transaction there may be 100 or more documents to approve or execute as well the final details as to title and funds transfers to work out. On most occasions, the closing, and pre closing if there is one, are a time for principals to watch their counsel work and, when necessary, sign documents.

In some locations in the United States, title company closing escrows are used. This is an arrangement whereby the necessary documents and funds are deposited with the title company, which handles the details of closing and informs the parties upon completion. When using a closing escrow, the parties may not even meet to sign documents.

In both cases closings are private proceedings and involve neither an appearance before a notary nor an appearance at the governmental recording office. Although the details of the procedure depend upon local customs and recording practices, the title company (or a local lawyer representing the title company) handles the administrative act of recording title documents, and the parties conclude the closings (i.e., disburse funds) based upon the title company's assurance as to the proper transfer of title.

If the description of the United States real estate contract process has given the impression that it is peculiar to our systems of law and business, then this paper has served its purpose. This peculiarity is heightened by the immobile nature of real estate, which makes it particularly subject to local customs and practices, and by the fact that most applicable law is state law, which varies from state to state, rather than a uniform Federal law. Thus, it is important that foreign investors approach the contract process as an educational process, attempting to understand why each aspect of it is necessary. While it is important to have good counsel and advisers to help guide the foreign investor through the process, it is essential that the foreign investor itself take part in and learn from the process, because understanding the process is an important part of any real estate investment program.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

For more information on the topics covered in this article, please contact:

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Investor's Checklist

The following is a summary checklist of matters likely to be involved in the acquisition of a commercial office building. Adjustments to the list would be required for other types of properties, such as hotels (where the personal property aspects of the transaction are more significant). In addition, each transaction as well as each property is unique, creating special issues and differing emphases on similar issues.

I. Initial Contact:

1. Availability of advisors, as required:

   a) counsel

   b) accountants

   c) broker/real estate consultant

   d) financial advisor

   e) architect or engineer

   f) appraiser

   g) translator

   h) analyst (if not part of b, c or d)

2. Benchmarks for investment: Purchaser and its advisors should make a preliminary determination of the basic requirements for an acceptable transaction, including:

   a) price range

   b) terms - cash vs financing

   c) Purchaser's special conditions - such as governmental approvals

   d) property requirements - such as a required leasing status or approval of transfer (first mortgagee, manager, other)

   e) timing of closing - such as year-end

3. Strategy for negotiations: Purchaser and its advisors should agree upon a strategy for the negotiations, including:

   a) how, when and by whom the initial approach should be made

   b) who shall lead the negotiations

   c) lines of reporting and decision-making

   d) terms of initial offer

II. Due Diligence:

1. Leases, including:
    a) rental
    b) term
    c) expansion and renewal options and rights of first refusal
    d) cost escalation
    e) services
    f) assignment and subletting rights of tenants
    g) “standard” clauses: estoppel certificates, subordination, landlord transfers, non-recourse
    h) special or unusual provisions

2. Service contracts, including:
    a) cost
    b) term, including cancellation provision
    c) scope of services
    d) transferability

3. Permits and licenses, including:
    a) cost
    b) term
    c) transferability
    d) availability to Purchaser

4. Management contract, including:
    a) fees
    b) term, including cancellation provision
    c) scope of services
    d) transferability

5. Utility services, including:
    a) owner’s deposit
    b) availability and/or limitations

6. Property, including:

   a) general condition/deferred maintenance

   b) hazardous and toxic materials (asbestos, PCB, etc.)

   c) fire, health and safety code compliance, including pending changes to such codes and deferred compliance permitted by law

   d) zoning code compliance

   e) condition and adequacy of basic building systems

   f) proposed capital improvements (including compliance with Americans with Disabilities Act)

   g) adequacy of parking

7. Insurance, including:

   a) current coverage and its cost and transferability

   b) proposed revisions to coverage

8. Personal property, including:

   a) building computer equipment and software

   b) basic maintenance equipment

9. Title, including:

   a) current title report and survey

   b) copies of recorded documents

   c) violations

   d) real property taxes

10. Litigation, including:

   a) any affecting Seller which might affect the transaction

   b) accident and other litigation “affecting” the Property and insurance coverage thereof

11. Income and expenses, including:

   a) comparison of actual to Purchaser’s pro forma

   b) delinquencies

   c) escalation billings

   d) employees (especially union contracts, if applicable)

e) accrued lease brokerage commissions

f) pending and prospective tenant improvement costs

g) special costs Purchaser might incur (increased real property taxes, insurance premiums, service contracts costs, management fees, accounting costs and the like)

h) projected closing apportionments and allocations

12. Contract issues: Purchaser and its advisors will decide which of the matters arising during the pre-Contract due diligence review should be covered in the Contract, by such means as special representations or conditions to the closing.

III. Contract:

1. Purchaser's special requirements, including:

a) governmental consents

b) financing conditions

c) tax structure - timing or formation of investment structure

d) form and availability of downpayment and balance of purchase price

2. Economic issues, including:

a) special or unusual obligations of Purchaser under the Contract

b) resolution of due diligence review items

3. Basic provisions: does Purchaser understand the basic terms of the Contract and its rights and obligations thereunder.

IV. Post-Contract:

1. Completion of due diligence, including:

a) title matters

b) matters relevant to Seller's representations (particularly those which do not survive the closing) and conditions to closing

2. Finalization of Purchaser's pro forma

3. Preparation for closing, including:

a) payment of purchase price (including finalization of any financing arrangements)

b) designation and authorization of signatory for documents

c) production of Purchaser's closing documents, particularly governmental licenses, approvals

and consents, evidence of corporate existence and approvals and the like which come from third-parties

d) review of Seller's closing documents and the closing procedures

e) review of apportionments and allocations

4. Resolution of operating matters, including:

a) insurance coverage

b) Property management and/or supervisory management

c) service contracts

d) Purchaser's bank accounts

e) relocation of Purchaser's management employees, including visas

f) possible transitional management by Seller's manager

g) formulation of Purchaser's accounting procedures, opening books of account and related matters

h) production of preliminary operating and capital budgets and leasing plan for property and budget for maintenance of Purchaser's investment structure

V. Closing:

1. Payment of purchase price

2. Execution of closing documents

3 Satisfaction of any special conditions

VI. Post-closing:

1. Finalization of apportionments and adjustments

2. Implementation of management systems

3. Bonne chance!