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Contract Tactics To Avoid Surprise Post-Closing Leasing Costs

By **Shannon Snell** (January 29, 2020, 3:35 PM EST)


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Potential buyers and lenders evaluate existing leases of stabilized properties and anticipated lease income of value-add projects in determining which assets to acquire or finance. Rental income, whether existing or potential, is a critical consideration when appraising any real estate investment opportunity, and it is imperative to protect the buyer's revenue stream against unanticipated or unaccounted for leasing costs which may arise post-closing.

This article will focus on tactics buyers should implement during purchase agreement negotiations to avoid inadvertently assuming the cost of rent concessions and lease inducements granted to tenants by the seller.

Identifying Leasing Costs

Leasing costs are expenses that the landlord has agreed to incur for the benefit of the tenant under a lease, and are typically offered to induce the tenant to lease space within a certain project.

Depending upon the lease and attractiveness of the tenant, these costs can range from thousands to millions of dollars, and may take the form of actual out-of-pocket costs paid to the tenant (including improvement and other allowances granted to the tenant to renovate its premises), construction costs incurred by the landlord in improving the tenant's space, fees paid by the landlord on the tenant's behalf (including brokerage commissions and fees) and rent concessions or free rent.

At the closing of a real estate transaction, the buyer will assume the seller's interest in the leases and become responsible for all landlord obligations — including those pertaining to leasing costs. It is therefore important that the buyer understand what leasing costs will remain outstanding on the closing date, and that the buyer obtain a credit against the purchase price or a purchase price reduction in the amount of the leasing costs for which the seller is appropriately responsible.

Alternatively, if the applicable leasing cost pertains to unfinished work, the buyer may require that the seller complete the work on a post-closing basis, but such an arrangement would require that the buyer grant the seller a license to access the property and implicate additional considerations (including insurance and indemnification requirements).

Negotiating the Purchase Agreement to Adequately Address Leasing Costs

Buyers may be unable to obtain access to leases and related information to verify leasing costs prior to opening escrow and officially commencing diligence, and should therefore negotiate the purchase agreement with the assumption that such costs may be outstanding at closing. Leasing cost protections are incorporated into the purchase agreement by way of a seller representation, a leasing cost proration provision and an estoppel closing condition requirement.

A seller representation is a certification regarding the condition of the property, which, if discovered to be false, allows the buyer to terminate the purchase agreement and recover its deposit, or sue the seller and recover damages if the transaction closed prior to such discovery.

In addition to other standard representations, the buyer should require that the purchase agreement include a representation that there are no outstanding leasing costs which have not been paid, performed or credited, as applicable, except to the extent expressly set forth on an exhibit attached to the purchase agreement. If the exhibit is inaccurate, and additional leasing costs of which the buyer had no prior knowledge surface post-closing, the buyer may sue the seller for breaching the representation to recover such amounts.

Note that purchase agreements typically impose a damages floor (i.e., the buyer may not sue the seller for breach unless its actual damages exceed a certain threshold) and cap (i.e., the buyer may not recover more than a certain amount) with respect to the breach of a seller representation, and that the lawsuit itself will result in additional cost to the buyer.

Buyers should therefore incorporate additional protections under the prorations provision of the purchase agreement to provide a streamlined recovery opportunity before resulting to litigation, and additionally consider exempting breaches of the leasing cost representation from the damages floor and cap.

The prorations section of the purchase agreement sets forth in detail how property costs (including, without limitation, taxes, utilities, service contract fees, rents and leasing costs) will be allocated on the closing date. Typically, the seller is responsible for all costs which accrue during its period of ownership, and the buyer is responsible for all costs following the closing.

However, the buyer should receive a credit for all leasing costs which will be outstanding as of closing, unless the buyer had the opportunity to approve of the leasing costs prior to the seller's execution of the applicable lease — although such amounts may not be payable to the tenants until well after the closing date, market rationale provides that the buyer should not bear the financial burden of the seller's bargain.

The proration section should therefore provide the buyer with the appropriate leasing cost credit, and set forth a streamlined procedure by which the buyer may recover a shortfall if the credit is insufficient to pay for the actual amounts of the leasing costs post-closing. This recovery mechanism typically requires that the buyer provide the seller with a written demand and reasonable evidence of the actual amount incurred by the buyer for the leasing costs, and is particularly relevant if the buyer assumes unfinished landlord work, as construction costs are difficult to determine with certainty prior to completion.

Finally, the closing conditions section of the purchase agreement sets forth circumstances which either the buyer or seller has stated must occur prior to a specified time, or the benefiting party may terminate the purchase agreement. Buyers of tenanted commercial properties should, as a rule, require that the seller obtain an estoppel certificate from each tenant as a condition to the closing (subject to certain exceptions for small tenants of multi-tenant properties), failing which, the buyer may terminate the agreement and recover its deposit.

An estoppel is a certification signed by the tenant which confirms the accuracy of material information contained in the lease, and which estops, or prevents, the tenant from contradicting those certifications following the closing. The buyer can therefore manage the tenant's leasing cost expectations, and be confident that it will not incur unexpected out-of-pocket construction, improvement or abatement costs, if the tenant's estoppel certifies that all landlord work has been completed, all improvement allowances have been fully disbursed and all free rent periods have fully elapsed.

Understanding Leasing Costs Prior to Closing

Although the buyer may have incorporated adequate protections into the purchase agreement to address an insufficient leasing cost credit, buyers should still understand the leasing costs they will assume as part of their diligence, to avoid an unnecessary dispute post-closing. In performing such diligence the buyer should request all leases, estoppel certificates, construction contracts and the rent roll, in addition to any documents necessary to evidence specific leasing costs identified by the buyer during the course of its diligence.

Buyers should review each lease in detail, as all leasing costs, with the possible exception of brokerage commissions, should be identifiable from the lease agreement itself. However, the buyer may be unable to determine the amount of such leasing costs from the leases, and should request supplementary documentation after determining which categories of leasing costs exist.

As noted above, the best way to confirm outstanding leasing costs is through a tenant estoppel certificate. The tenant will be bound by the certifications in the executed estoppel, and the buyer's exposure to the tenant can therefore be determined based upon such document.

Note that the estoppel certificate typically will not provide all necessary information regarding the landlord's construction obligations, as it will certify as to whether or not work is outstanding, but will not set forth the cost to complete such work. Therefore, if any landlord improvements will be incomplete as of the closing, the buyer should also request construction contracts, or bids if contracts have not yet been entered into, setting forth the cost necessary to complete any unfinished landlord work.

Construction contracts are critical to the buyer's diligence, as they will identify the scope of work the landlord has undertaken to perform and anticipated cost to complete such work. Moreover, the buyer will likely assume those construction contracts at closing, and it is important that the buyer approve of the terms of such agreements.

The rent roll will confirm whether tenants have commenced paying rent and set forth rental amounts, which may aid the buyer in determining whether any abatement periods have elapsed, and should also conform to the terms of the leases and the offering memorandum (if any).

Finally, in the event the leases reference any additional specific leasing costs (which might include, without limitation, the landlord's agreement to obtain a liquor license for the tenant's premises, buy furniture on the tenant's behalf, or grant a rent reduction in the event of a certain occurrence) the buyer should request tailored information necessary to fully understand the remaining outstanding amount of such costs.

Conclusion

Unanticipated and unaccounted for leasing costs can create significant financial risk to buyers of tenanted properties if not adequately addressed and analyzed prior to closing. Buyers should therefore conduct comprehensive leasing cost diligence to understand the costs they will assume as the new owner of the property, in addition to incorporating protections into the purchase agreement to provide for the appropriate credit against the purchase price and post-closing recovery opportunities.

Although the foregoing recommendations provide a general framework for reviewing leasing costs and negotiating leasing cost provisions, the specifics of each transaction should be evaluated individually in consultation with legal counsel.

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