The Business Gazette
FRIDAY, SEPTEMBER 26, 2003 • WWW.GAZETTE.NET

Commercial real estate: The contract is the king

If you are buying commercial real estate, a well-crafted contract is worth its weight in gold. Every buyer's contract should have a risk-free period (generally 30 to 60 days) within which to conduct "due diligence." This is the "study period" in which the buyer hires engineers, architects, surveyors and other professionals to make sure the property can be used for the buyer's intended purpose. It is during this time that the buyer also makes sure he has the cash or the financing in place to make the deal. If he decides the deal is not good for him, he can cancel and get his deposit refunded.

Arthur Blitz

Arthur H. Blitz is a principal and real estate attorney with Paley Rothman in Bethesda. He can be reached at 301-951-9327 or @ablitz@paleyrothman.com.

Every buyer's contract should contain a laundry list of seller's warranties and representations, which provide protection for the buyer. The seller warrants that he has good title, that there is no pending or threatened litigation, that the seller is not in bankruptcy and has the right to sell the property, that there are no tenants, that there are no liens on the property (or if there are, that the seller will pay them off), that the property complies with the environmental laws and that the seller has all the necessary licenses and permits for the property and will assign them to the buyer at closing. The more "reps and warranties" the better for the buyer.

The contract should also include a strong default clause, providing not only for damages but also for "specific performance" and attorney's fees if the seller defaults. A provision for "consequential damages" is also good for the buyer. I have seen default clauses disguised as "standard clauses," which says that if the seller defaults, the buyer's only remedy is to receive a refund of his deposit. In that situation, the seller cleverly crafted a contract which gave him the right to "walk," leaving the buyer with nothing but a refund of his deposit.

The buyer will want other clauses to protect his interests. If the property is damaged by fire prior to closing, the buyer needs a clause that will give him a right either to cancel the contract or, alternatively, go to closing and take the insurance proceeds. Without such a clause, the buyer could be forced to take a fire-damaged property and still pay the full purchase price. Also, he should have a clause that allows him to cancel if the property becomes subject to eminent domain, if the zoning laws change prior to closing, if a major tenant leaves unexpectedly or if any of the seller's warranties turns out to be untrue in any material way. In short, the buyer needs a lot more protection than the seller and must make every effort to incorporate these clauses into the sales contract.

Watch out for transfer and recording taxes. In some jurisdictions, they can run upwards of 10 percent of the purchase price. Provisions should be made for either splitting or sharing these taxes, and not always on a 50-50 basis. Sometimes a 50-50 split can trap an unwary buyer. For example, if there are any agricultural "roll back" taxes — meaning taxes payable to the county when what was formerly farm land gets converted to commercial use, such as a housing subdivision — then the buyer could find himself paying tons of "roll back" taxes, which should have been paid by the seller.

Finally, if either buyer or seller has any plans for a Section 1031 "Like Kind Exchange" – an IRS provision that allows the seller to defer paying any income tax on the profits from his sale — then an appropriate clause must be in the contract. Without such a clause, which is cost-neutral to the other party, one may be unable to take advantage of this favorable IRS provision.