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## **The Sale & Purchase of Non-Residential Properties The Term Sheet and Often Missed Due Diligence and Liability Concerns**

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- A. The Term Sheet or Letter Of Intent** The Term Sheet, also known as a Letter of Intent (LOI) sets forth the basic terms and conditions of the real estate transaction. It is often used as a preliminary document that is incidental, but not integral to the ultimate transaction because it is defined as “non-binding,” “confidential,” “preliminary,” or “expiring”. However, for the reasons set forth below, such a view is not prudent as often the Term Sheet is in fact one of the key contractual documents as the deal moves towards closing. What are the key items that should be included to minimize risk and to protect parties against potential liabilities?
- B. Should the Term Sheet Be Limited and Brief or Comprehensive?** Often the potential parties involved in a transaction will prepare a Term Sheet to flush out how close they actually are to reaching an agreement as to a transaction, and where the areas of dispute are. While the Term Sheet is typically a shorter document than a Purchase and Sale Agreement (“PSA”), it is essential that it accurately and completely defines the potential deal points because the Term Sheet will usually be looked upon as defining the terms and conditions to be included in the PSA. Further, despite the fact that the Term Sheet is a preliminary document, it still can be argued to be a source of liability. It is prudent to use the Term Sheet as a checklist in preparing the actual lease. It is both the source of the lease terms, and a cross-check as to the completeness of the Lease. Although, the Term Sheet is generally a non-binding document it is enforceable from the standpoint that this was the intent agreed upon by the respective parties.
- C. The Term Sheet In a Lease Transaction** As with sales transactions Term Sheets needs to be specific as to all of the material deal points. The Term Sheet is essentially a snapshot of the quantifiable specific points of each transaction. In a commercial lease transaction there are several critical items that would be included, such as a description of premises (i.e. address, suite number, etc.), the exact size of the space being leased, the payment terms, and whether or not the area is being leased on usable or rentable area calculations. It also includes the floor location in a multiple floor building, proposed commencement and termination date of lease, the lease term, base rental rate with reference to full service, gross, modified gross, or net lease type. In addition to this, it should include mention of specific lease increases and the exact periods to which the rental adjustments are to occur, as well as a description of operating expenses or the calculation of operating expenses. Tenant improvement allowance, and other various items such as options to renew, parking charges, initial monetary deposits (i.e. 1st month’s rent and security deposit), request for financial information on tenant by landlord, and termination dates for the Term Sheet to expire should be listed. Signature blocks for both parties would normally be included at the end of the Term Sheet. Many times the terms in the Term Sheet are described by reference to a standard provision in a widely accepted form such as a statement that a provision in the lease will conform to a provision in the Standard AIR Office Gross Lease.



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**D. What are Sources of Potential Liability?** Sources of potential liability tend to evolve around fraud, or concealment of claims. The property owner may argue that the potential buyer negotiated, and executed the Term Sheet knowing that the potential buyer could not perform, and just wanted to discourage others who might be interested in the property from making an offer. The potential buyer may argue the reverse that the Seller engaged in negotiations suggesting terms he/she actually never intended to agree to, or could not perform, leading the potential buyer to focus on this particular property and not on other potential investments.

To adequately protect against potential liability issues, a Term Sheet should include at least the following critical items:

1. A description of the property under discussion and specifically whether personal property, easement, right of way, and licenses impacting the property are under consideration.
2. The proposed purchase price and how it is to be paid. If financing is involved the description, amount of the financing and the timeline of the financing should be included. Reference should also be made as to the amount of the deposit, on what terms it will be non-refundable, and whether it will be released to the seller or held in escrow.
3. The nature and level of the due diligence, and due diligence period.
4. An “as is” provision if applicable.
5. A Confidentiality Clause that survives the termination of the Term Sheet.
6. A provision that there are no representations made and no liability associated with the Term Sheet, and that there is no reliance.
7. A statement that both parties were represented by brokers and/or counsel.
8. A time period in which commence of the drafting of the PSA must start, and when the PSA must be executed.
9. Reference to any special conditions.
10. An integration clause which incorporates all prior discussions and negotiations.

**E. How Does the PSA Differ From The Term Sheet?** The PSA and Term Sheet focus on essentially the same areas, except the PSA contains far more detailed and complete language, and once signed it becomes a binding document. There are various PSA forms available such as the CAR form, but these forms may prove to be incomplete, too generic, or not accurate in reflecting the terms and conditions of the transaction in all respects. If a Purchase Sale Agreement is used, the form can in some instances be modified by an addendum that deletes or changes provisions.

**F. What Are the Typical Areas Of Litigation Arising From a PSA** The common areas giving rise to disputes are listed below. Correspondingly, these are the areas that require particular attention, and must be crafted very carefully.

1. Deposit When a deposit becomes non-refundable it often leads to disputes between a buyer, and a seller of property. This typically arises as a result of the buyer termination of the transaction, and demanding that the deposit be returned. The seller may argue either that the buyer breached terms of the PSA, or is otherwise not entitled to the return of its deposit under the express contract provisions. It is essential that the contract terminations provisions are very detailed, and that general provisions prohibiting binding modifications are not documented in writing. A “time is of the essence” provision should be included in the PSA.



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2. Inaccurate or Incomplete Disclosures An “as is” Provision or Waiver will generally not be a protection against a lawsuit where there has been a material misrepresentation or concealment by the Seller or Seller’s agent, nor will the Buyer’s negligence in failing to discover the defect. Thus, the failure to disclose a material fact can constitute actionable fraud to the same degree as making a material misrepresentation. Therefore, it is extremely important that all possible environmental and property conditions, or potential governmental actions that are under consideration, may affect the property be disclosed by the Seller.

One recent issue that has brought this to light is the Federal Government’s crackdown on marijuana dispensaries – and the resulting refusal of banks to lend on properties that lease to a these business. While legal in California, the dispensaries remain illegal under federal law, which is the banks’ primary directive. Increasingly, banks are refusing to offer refinancing – or are even suing – borrowers who have signed leases with marijuana dispensaries based on the idea that they are breaking federal law, and therefore, are in breach of contract. As such, disclosing any such leases to a potential buyer is critical.

Another example, is a recent suit where a broker represented a buyer of an apartment complex. The seller knew - but failed to disclose - that the adjoining contiguous property was an operating house of prostitution. A lawsuit was filed that resulted in a six figure settlement in favor of the author’s clients. In another suit, the author represented a seller who had failed to disclose window, and ceiling leaks in various units, as well as leaks in a central water heating system. In yet another case, the property was on a hill side. The seller knew the property was at risk of a landside based on unstable soils conditions. The seller did not disclose this, and the buyer did not investigate soil conditions. After the sale closed the property slid, and became essentially valueless. Despite a provision in the PSA and the buyer’s arguable negligence, the buyer recovered a seven figure fraud judgment at trial.

3. Limitations on Recovery Many times both the buyer and seller will want to limit their potential liability if they are found to have breached the terms of the agreement. These limitations may or may not apply if issues of fraud or concealment exist. Limitations may be as to a dollar amount or a category of expense (such as due diligence costs of the seller).

**G. Using Due Diligence to Protect against Potential Liability** A thorough due diligence process helps parties understand, and proactively manage how various issues may affect the value and liabilities associated with a property during transactions, or throughout ownership/operation. The level of due diligence required depends on, amongst other things, the risks created by the past uses of the property, the client’s risk tolerance, and the value of the transaction. Below are some critical due diligence items that should be carefully considered prior to the execution of the Purchase and Sale Agreement.



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- 1 **Environmental Issues** A thorough environmental due diligence process is a critical part of sound risk management practices. It will help determine whether environmental issues may be present that could cause financial hardship, it will satisfy All Appropriate Inquiry requirements to qualify for CERCLA liability protection or gauge whether a property might have a reduced selling price due to contamination. The process may consist of a basic assessment – such as a Desktop Environmental Report, a Transaction Screen Assessment, or a more thorough Phase I Environmental Site Assessment. Based on the results of these initial assessments, subsurface investigation and remediation activities may be required to clean up a site and achieve regulatory closure.
- 2 **Building Condition and Structural Issues** Engineering due diligence is an important part of the property transaction process that provides information about physical risks relating to a property and can help identify effective solutions to minimize these risks. Like environmental due diligence, there are a variety of ways to evaluate the physical condition of a property, including property condition assessments, capital expenditure reports, accessibility studies, seismic risk assessments, as well as structural inspections and design. The scope of work for these services may vary significantly based on the client's individual needs (for example, a lender may not require the level of detail that the buyer would be interested in). An adequate assessment will identify any liabilities associated with a property, and give owners/operators a better understanding of the short and long term investments needed to manage risk and maintain the asset.
- 3 **Permitting and Compliance Issues** Are there any compliance issues that could affect the value of the asset and the viability of the transaction? Parties should assess compliance with local and federal zoning codes, accessibility requirements (such as ADA), environmental regulations, hazardous materials, management requirements, health and safety regulations as stipulated by organizations such as the Occupational Safety Health Association (OSHA) and National Fire Protection Association (NFPA). In today's increasingly complex regulatory landscape, a comprehensive compliance audit is critical to limit legal and financial liabilities.
- 4 **Assessing Tenants** Even if rents are current and at market, problems may still arise as to tenants threatening rent strikes, demanding unreasonable repairs and improvements, or filing grievances with governmental agencies such as the Better Business Bureau etc. Often this does not become apparent until after closing.
- 5 **Demographic Changes In the Community** Long term demographics can have a drastic effect on property values and rents, and it is important these are assessed prior to closure.
- 6 **The Economic Trends** Similarly, buyers and sellers should carefully consider any planned changes to local employment, retail, construction, traffic, parking, and a host of other concerns as these can have a great impact on rents, and market value.



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- 7 **Flexibility In Time** Often a buyer or seller is trapped as the closing date nears by such things as a delay in financing, a cloud on title, a permit or license issue, or a delay in repairs being completed. Often these can be resolved by a Post-Closing Agreement where the closing occurs, and title is transferred with rights as to the open item reserved. However, just as often these time issues lead to intense negotiations of adjustments in the deposit provisions, increased deposits or adjustments in the price in order to keep the transaction from being terminated. Provisions can be built into the agreement that allow for extensions in either a general form, or as to specific possible areas of delay.
  
- 8 **Government Agencies** The views and attitudes of the Planning Commission and other Agencies' responsibilities may dramatically affect the viability of a proposed project, and its cost and time to complete. For example, certain projects may be desired by the local government and result in the availability of permit, fee or tax deferments, waivers, or rebates. Obstacles and additional costs may be created for other situations that are seen as extremely negative due to any host of factors, including whether the community wants this type of project (ask Wal-Mart), building standards, the time and cost to obtain permits, building and environmental standards, traffic abatement requirements, parking requirements noise abatement requirements, etc. Simply using an out of area architect or contractor instead of a local consultant may create significant and costly impediments to a project's viability. These concerns must be explored by the Buyer contemplating a project in a new locale. As discussed, a thorough due diligence process will identify such issues before a substantial amount of money and time is committed to a transaction or project.
  
- 9 **Potential Sources of Financing** In some types of areas, or related to certain types of projects, governmental financing may be made available on very favorable terms. Wherein other instances, financing may be either extremely limited or very expensive.

### **No Deal Without a Term Sheet**

The importance of the Term Sheet in the real estate purchase and sale project cannot be overstated. As a matter of practicality, it not only sets the tone of the transaction going forward, but typically is looked upon as the source of the terms of the Purchase and Sale Agreement. It also will be one of the documents looked upon as defining the intent and expectations of the parties if a dispute arises. In a dispute, the Term Sheet is also often looked upon as evidence of fraud by the Seller, and whether there was justifiable reliance by the Buyer. Therefore, viewing a Term Sheet as an immaterial document because it is generally not binding is unwise. It is also prudent for an appropriate level of due diligence to commence during the time the Term Sheet is being negotiated, and documented, and before the Purchase and Sale Agreement is executed in order to minimize risk and protect against potential liabilities.



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