NEGOTIATING THE MIXED USE PROJECT CONTRACT OF SALE: 
MORE OF THE SAME OR NEW TERRAIN?

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Other parts of the program discuss the need for modesty when making demands of a seller in a contract of sale to be competitive in today’s frothy investment environment. The same goes for due diligence requests, with sellers offering views more like those of a ground floor studio rather than a lush rooftop garden. Meanwhile, the buyers’ hedges, often in the form of representations and warranties, are being lopped off like overgrown shrubbery.

If the world were populated only by buyers and sellers, the current form contract of sale might fit on the back of a napkin: “as is, where is”. (We doubt that the napkin would be absorbent enough to clean up an environmental hazard). This is a reality faced by suitors who can surely gain certain concessions but nevertheless must be nimble, with a strong sense of priority, to obtain the nod as the anointed buyer.

With lenders as part of the mix, a near certainty in complex, mixed use* acquisitions, the equilibrium shifts again. Given the difference in risk profiles between an equity investor and the non-recourse single asset lender, care must be taken to insure that lender expectations can be met so as not to wind up with a purchaser committed to buy and a lender refusing to fund.

The issues multiply when one further considers market and legal differences between mixed use and single asset projects, given the simple fact that mixed use assets involve more component pieces, and inevitably a larger number of boxes on the closing checklist. Some items may not multiply in number – survey, title, or environmental – but may mushroom in complexity. Other items, particularly property-specific documents including management agreements, hotel franchise and operating agreements, leases (commercial, retail, or residential) and estoppel letters, will actually increase in number. Management of the relationship between the components (such as by way of a reciprocal easement agreement or condominium declaration) creates a layer of complexity in and of itself.

All of this leads to the question – in negotiating the contract of sale for a mixed use project where the acquisition is to be financed, is it simply more of the same exercise, or rather is it unfamiliar, uniquely challenging terrain?

Our initial conclusion, derived partly from reviewing loan documentation related to a number of acquisitions, is that a mixed use acquisition raises the same broad set of concerns that one is likely to consider in the single asset context. But, however similar or dissimilar the line-item concerns, taking a full-project view will enable the parties to establish a logical framework for allocating risk across the whole transaction consistent with the relative risks, priorities and cash flow projections of each component.

* Discussion of a mixed use project contemplates both a project comprised of one or more improved land parcels which are interdependent upon one another for services, access, etc., as well as a complex on a single parcel which has multiple uses such as hotel, residential, office and retail.
Some of the material concerns a lender is likely to bring to the table in negotiating a typical non-recourse loan are sketched below for discussion. Lest we become mired in abstract resolutions of concrete issues, we merely intend to propose consideration of the interaction between (i) closing the loan and (ii) contract of sale approaches with suitable purchaser protections and a real opportunity to prevail over other bids.

Before delving into a volume of specifics, we emphasize some principles which can be readily translated into actions that raise the probability of overall success in the kind of undertaking described herein:

1. **Equity will be required to shoulder certain risks relative to the newly acquired project that the seller is not prepared to backstop and that the lender is not positioned to accept.** Equity inevitably is required to close the gap. The availability of information is the single most critical component of putting equity in the best position to address the needs of the lender. (Equity may show that the risks are reasonable in light of the returns or demonstrate that a risk thought to exist does not or has been mitigated). Hence, access to information – whether in the form of documents, other writings (e.g., tenant files), the minds of management, the know-how and eyes of the on-site manager or public records - must be obtained and preserved at all costs. Even an indemnity protecting against loss from a state of affairs is not a substitute for knowledge and analysis of the state of affairs and an affirmative decision with respect to the same. The indemnity might be an outgrowth of that analysis or may plug the hole relative to some unknown surrounding it, but it is not a substitute. Information begets analysis, analysis begets solutions and multiple solutions beget a closed transaction. So the channels for information flow must be kept open. This mandates that job one is contractual access to the seller, its people and its files.

2. **Think exit before entering a multi-use project.** Identifying the possible exit strategies early will allow analysis to proceed on the possibility and probability of implementing that strategy as the transaction marches forward. Sale of the project in its entirety is, of course, an obvious approach, but breaking the project into pieces should be equally obvious. Both the physical and legal impediments to such division need to be considered as does the structuring of the debt to facilitate the sale of individual components at different points in their life cycles. Keeping the end game front and center should help in evaluating the importance to the buyer of the myriad of material provided.

3. **We are all familiar with the dynamic that unfolds when a seller, an equity player, and a lender meet around the table.** Sellers want the highest price, with little or ideally no attendant risk. Equity is willing to take a bet – that it knows the market best, has identified opportunities the others don’t see, and/or that it can run the project better and generate higher returns. Lenders come to the table looking for an honest profit for the use of their resources – with risk limited to reflect the agreed but usually “fixed” return.

Drafting any contract involves allocating risk between the parties in a way that conforms to their particular business models and risk profiles. It does no more good to ask a lender to “go with its gut” than it does to ask an equity investor to split its profits down the middle with the lender. Often, the operative goal in negotiating sessions is merely to allocate risks among the parties. We recommend that attention also be paid to pricing the risks and figuring out which party can bear them at the lowest cost.
In negotiating a contract of sale, counsel should constantly consider whether there are any risks that can be dealt with so as to leave the lender closer to its desired level of risk without making the seller (or equity participants) tangibly worse off. Naturally, such “inefficient risks” should be eliminated to the extent that they cannot be expected to lead to a higher payoff for any of the parties.

4. Finally, partner up with your lender as early as possible. Lenders today are quite willing – indeed anxious – to become partners in the process of permitting their borrower/buyer to successfully bid on and acquire an asset, and one should seek to take advantage of that willingness. Lenders make their living lending, and will work with buyers to help them accomplish a closing. We recognize, however, that lender involvement does not signal capitulation but rather openness to thoughtful analysis and, hopefully, practical solutions. Starting early both permits the time to identify issues, uncover acceptable solutions, identify “deal points” which need to be addressed, and determine “acceptability” levels for relevant items. Typically, the sooner the lender is involved in that process, the better, as this will allow the lender to take some ownership over the kinds of analysis which need to be performed even if it will not ultimately own the risk.

The financing of a stabilized mixed use project (and of course its acquisition) on a non-recourse basis requires that the mortgage lender ultimately be satisfied with the condition of the property and its income generating capacity. Hence, the need for significant investigation before closing. As to the physical elements, physical access is usually enough to address lender concerns. Satisfying the financial elements of the transaction usually requires a combination of physical access, the provision of information with respect to the property’s past performance and representations and warranties to confirm the financial assumptions underlying the transaction.

In the recent Time Warner Center transaction in New York City (granted a development rather than stabilized property sale), the lender was reported to have separated the overall property loan into individual pieces based on the market risk of each component. Time Warner, for example, was required to take its own office space so there was effectively no market risk associated with the portion of the loan attributable to that space. The Mandarin Hotel space was similarly resolved. The other pieces – retail, remaining office, and residential – all had market risks. The pricing of the mortgage covering the overall property reflected the added market risk of each component.

The following chart may be helpful in discussing and tracking the types of risks that must be priced, allocated, mitigated, or merely analyzed in relation to each component of a mixed use project. As with the Time Warner Center, the scope of risk will vary by component but eventually will come together into a single transaction that will ultimately be viewed by sellers, purchasers, lenders and the larger business community as one big pie. All of the parties should keep an eye on the pie when negotiating gritty details associated with a single slice.
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<thead>
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<th>Lender Imperative</th>
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<tr>
<td>Property-Wide Expert Reports</td>
<td></td>
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<tr>
<td>Understand true property value</td>
<td>Ensure access for appraisal</td>
<td>Generally, seller permits diligence reviews by purchaser but assumes no responsibility for content of reports or appraisals. Multiuse may complicate expert analysis, but legal requirements probably not affected.</td>
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<td>Ensure adequate engineering and structure, and building code compliance</td>
<td>Ensure access for engineering experts and obtain prior reports through access to files</td>
<td>Discoveries of defects may ultimately impact pricing and/or lead to seller obligation to correct if timely identified.</td>
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<tr>
<td>Understand boundaries of property and encroachments</td>
<td>Ensure access for survey and obtain prior versions</td>
<td>Simply more of the usual survey and survey certification exercise.</td>
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<td>Identify and off-load title risks</td>
<td>Limit conditions of title to identified items at signing and those created in accordance with the contract of sale</td>
<td>Living elements – such as leases – are usually the areas requiring more meaningful discussion; more but not different in mixed use acquisition.</td>
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<td>Eliminate any liens related to municipal violations or taxes</td>
<td>Ensure ability to contact governmental agencies to obtain evidence of violations</td>
<td>Relatively easy risk to identify and eliminate.</td>
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<td>Assess risk of environmental liability and/or disruption to project cash flow</td>
<td>Ensure access and ability to disclose results; R&amp;W(^1) as to actual knowledge (maybe)</td>
<td>Borrower/buyer is usually required to assume risk with little support from seller; reliance on expert report usually sole protection.</td>
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\(^1\) Representations and Warranties