Press Release | January 18, 2018

Alternatives to the Traditional Purchase and Sale Agreement

After the real estate market crash of the late 2000s, institutional lenders imposed tight restrictions on lending that prohibited many investors from obtaining the necessary financing to move transactions from due diligence to closing. Investors, needing to become creative to close deals, have responded in the years since by spurning or supplementing such financing with private equity from funds and high net worth individuals. These supplemental sources of financing have helped revitalize real estate markets and submarkets across the United States, but not every investor has equal access to the same amount of capital or identical financial motivations. Before blindly entering into a purchase and sale agreement, landlords, tenants and investors must think beyond that contract and consider alternative strategies to acquire or dispose of real property. Below is part three of a three-part series on alternative acquisition and disposition strategies.

Lease Purchase

A Lease Purchase is a combination of two separate contracts (a Lease Agreement and a Purchase and Sale Agreement) that are tied together by their terms. The Lease Agreement is a standard lease, in which the tenant agrees to lease space from the landlord for a certain term. At the end of the term, the tenant will purchase the property from the owner. The Purchase and Sale Agreement is also standard and binds the landlord-seller to sell its property to the tenant-purchaser following the expiration of the lease term and the due diligence period. Since the sale is contracted to occur, barring any amendment or termination of either agreement, and barring title, financing, and other due diligence-related issues, both parties are incentivized to maintain and repair the property during the lease term. The landlord-seller will not want the property to deteriorate during the lease term because such a change could dramatically lower the value of the property and result in a reduced purchase price at closing. The tenant-purchaser, as the future owner of the property, will want to ensure the property is not in a state of disrepair so that it can maximize the property's attractiveness to prospective tenants, lenders, and purchasers.

In the event either contract is terminated, the relationship between the contracts is severed. Since the landlord is taking a significant risk by entering into a Purchase and Sale Agreement well in advance of the sale date, the Lease Agreement is certain to include extensive default language that will provide the landlord with the right to terminate the Purchase and Sale Agreement in the event of the tenant's default. The landlord may also require that the tenant pays a larger security deposit or other up-front fee to make the landlord feel more comfortable about tying up its property.

Lease Option

Similar to a Lease Purchase, a Lease Option also has two components: a Lease Agreement and an Option Agreement (also called a Purchase Option Agreement). During the term of the lease, the tenant has only the rights expressly granted to it in the lease. This includes rights pertaining to permitted use, quiet enjoyment, maintenance, repair, parking and any other term that typically appears in leases. In this respect, a lease option is more restrictive to the tenant than a contract for deed (which I covered in a previous discussion) is toward the purchaser. However, unlike in a contract for deed and unlike with a Lease Purchase, the tenant in a lease option has not agreed to purchase the property at the end of the term.

There are several ways to draft a Lease Option. One way is to draft the document such that when the tenant makes monthly rent payments, a portion of each payment is credited toward the purchase price. The tenant may find this arrangement to be favorable because the balance of the purchase price at the time of the acquisition will be lower than the original amount, which will translate into less financing. Another method is to simply provide the tenant with the option to purchase the property at full price at the end of the term with no draw down. Regardless of how the Lease Option is structured, the landlord will require the tenant to pay an option fee, the amount of which will depend on the value of the property and the leverage held by both parties.

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