

COVID-19 and the Real Estate Sale Agreement — The Post-Closing Rent Collection Problem

*Mark D. Yura**

This article is intended to identify, and make some recommendations with respect to, a feature of purchase and sale agreements which has not typically received much attention, but which will have heightened importance in the wake of the COVID-19 pandemic. More specifically, the contractual provision which sets forth the agreement of the parties with respect to delinquent rent at the time of closing. In particular, what are the responsibilities of the seller and purchaser relating to the collection of such rent, and what is the allocation between them in the event that such rent is collected after the closing?

Whether a rental-producing property is commercial, multi-family or otherwise, a would-be purchaser is relying upon its income stream in calibrating its expectations for the property's performance (and determining an appropriate purchase price). Different methodologies are available for calculating value. One method consists of measuring an asset's effective net operating income and dividing it by a selected capitalization rate. Another entails cash flow assumptions over the expected life of the investment, application of a formula for discounting that cash flow to arrive at a present value, and calculation of the resulting internal rate of return ("IRR") or other return based on an assumed cost. Regardless of the methodol-

ogy, the relevance of the asset's operating statement is critical.

Background

Purchase and sale agreements for income-producing property will often include provisions for the handling, as of the closing date, of delinquent payments of rent, pass-throughs or other revenue items. Ordinarily, other than in the case of unusual circumstances (a distressed asset, as an example), the seller of the property has not experienced significant rental delinquency at the time of closing. The dollars are not material in relative terms and the seller's concern regarding the ultimate collection of these amounts is not particularly acute. As a result, it is generally appropriate to

*Mark D. Yura is a partner at DLA Piper concentrating his practice in real estate transactional matters. He may be contacted at mark.yura@dlapiper.com. The author notes: "I wish to acknowledge the contributions of my colleague, Ross Green, as well as that of Stevens A. Carey, of Pircher Nichols & Meeks LLP, to this article. Their characteristically valuable insights and suggestions led me to a more nuanced analysis of this topic, and the issues and solutions discussed herein. Thanks, as well, to my colleague Leigh Abrams Waterman, for her unstinting editorial excellence."

allocate rental collected post-closing using more or less the following contractual formulation:

Purchaser shall use reasonable efforts (but without any obligation to commence any litigation, take any legal action or incur any material expense), during the period commencing with Closing and ending six (6) months after Closing¹, to collect and promptly remit to Seller any [Uncollected Rents] or other amounts due Seller for the period prior to Closing²; provided that all amounts received by Purchaser after Closing shall, unless designated by the payor as applicable to a period prior to Closing, be applied, first, to amounts due Purchaser for periods from and after Closing, and second, [if collected during the aforesaid six (6) month period] to be paid to Seller.³ The provisions of this section shall not be merged with the deed but shall survive Closing.

COVID-19

Where, however, extraordinary circumstances such as COVID-19 exist, we very likely can expect properties under contract to be sold to have a significant rental delinquency at the time of closing. Given various legislative and executive actions at the state, federal and local level, not surprisingly there were material delinquencies⁴ on the part of tenants, for the period beginning in April 2020 and which will persist at least for the duration of the pandemic. Indeed, in the multifamily context, federal legislation (the CARES Act) in effect excuses tenants from their current responsibilities to pay rent in buildings subject to certain federally backed multifamily mortgage loans for the 120 day period commencing March 27, 2020 (the enactment date of the CARES Act), and potentially even longer where landlords in these buildings seek forbearance relief from their lenders. These landlords may not evict tenants on account of nonpayment of rent or other charges and are restricted from imposing late fees. Other state and local legal

authority confers similar relief to residential and commercial tenants. Predictably, tenants (even able ones) have delayed rent payments and market conditions are limiting the ability of residential and commercial tenants to satisfy their rental obligations, at least on a current basis.

Responsibility for Collecting (and Allocating) Rents

Once these extraordinary conditions come to pass, how do the parties fairly allocate responsibility for collecting (and allocating) rents? In particular, is it sufficient for a seller to rely upon the reasonable efforts of a purchaser to collect post-closing rent, when (A) the magnitude of the rental delinquency amount is far more significant, and (B) the collection of at least a material portion of the delinquent amount will likely be an issue due to tenant circumstances resulting from the pandemic?

For instance, consider the following examples (Assume no rent is paid for three months starting April 1, 2020 and closing of the subject property occurs on June 15, 2020 — therefore, as between the seller and the purchaser, seller is the owner of the property for 2.5 months of the three month rent abatement period, or approximately 0.83 of such period; purchaser is the owner for roughly 0.17 of such period. Further, assume that purchaser acts reasonably in its collection efforts):

- Tenant A remains in possession, and on July 1, 2020 resumes scheduled payments of rent and concurrently commences repayment of the accrued and delinquent rent in accordance with its agreement to make 12 (equal monthly) payments over a 12 month period.

- Tenant B remains in possession until August 31, 2020, and on July 1, 2020 resumes scheduled payments of rent, but pays rent only on July 1 and August 1, 2020. Back rent is uncollectible.
- Tenant C remains in possession until August 31, 2020, and on July 1, 2020 resumes scheduled payments of rent, but pays rent only on July 1 and August 1, 2020, and one additional month's worth of rent as a termination payment. All other back rent is uncollectible.

In each case the economic relationship between purchaser and seller is subject to a different outcome, given the standard formulation discussed above.

In the first example, Tenant A repays the rent for the period both prior to and after closing, albeit over an extended period of time. In such event, the 12 months of delinquent rent repayment would result in purchaser receiving, in full, the rental for its 0.17 share in months one and two; seller receives its 0.83 share in full over months three through 12. Other than with respect to the time value of money, seller and purchaser are treated equitably.

In the second example, Tenant B does not pay any rent for the abatement period. Neither seller nor purchaser is made whole, but as between the two of them, neither is disadvantaged in relative terms. Each is at risk for their respective portions of the rent abated.

In the third example, Tenant C pays some, but less than all, of the rent for the period of abatement. This is where things get interesting. Under the standard formulation, the purchaser and the seller each receive 0.50 of the termination payment (i.e., their respec-

tive share of rent for June 2020), even though the seller's loss factor is 0.83. While the interest of the purchaser and seller should at least in theory be aligned in connection with the collection of back rent, sometimes this is not possible and where the delinquent rental for the seller's period of ownership is significant and collection is ultimately unsuccessful, it wreaks a material hardship on the seller.

Alternatives

So, given these disparate outcomes, and the absolute dollars which seller might lose in the event of the failure or inability of the purchaser, post-closing, to collect seller's share of pre-closing rent delinquencies, what are reasonable strategies for the parties to consider in their purchase and sale agreements? Here are some alternatives:

- 1) Instead of relying on the purchaser to collect delinquent rent attributable to the seller's period of ownership, the seller instead asserts the position that purchaser provide a full credit for the delinquent amount at closing. While historically rental delinquencies have not typically been handled between the parties in this manner (and the relatively low magnitude of rental delinquencies have made this item of limited importance), a seller with significant leverage might require this. In essence, this approach transfers the entire risk of non-collection of the delinquent amounts to the purchaser, converting the purchaser into a de facto guarantor of unpaid rent. Naturally, most purchasers will vociferously object, and given the uncertainty of collecting these amounts, it is not an

equitable arrangement. For this reason, this approach should be discouraged.

- 2) A variation on Alternative 1 would be to discount the credit to the seller. The amount of the discount would be a negotiated percentage of the outstanding delinquency amount, which the parties agree reflects the likelihood of collection, or such allocation of the risk of non-collection that the parties determine to be fair. Similar to Alternative 1, most purchasers would not be willing to assume the risk of under-collection, especially since it would be impossible to predict how long the rental abatement might last at the time of closing. A purchaser might assume such risk only if the discount is so substantial as to confer a potential windfall. However, for just that reason, this will probably not be acceptable for a seller.
- 3) Each of seller and purchaser retain their respective rights with respect to enforcing their remedies as against delinquent tenants. Each party has a right to pursue delinquent rent independently of the other, provided that the seller has no right to seek eviction against the defaulting tenant. This approach may have superficial appeal as it vests in the seller more control over the outcome; however, it does not effectively address the underlying problem. Further, this approach will result in clogged courts with unnecessary duplicative claims and will yield aberrational results arising from a race to the courthouse. Accordingly, this approach, too, should be discouraged.
- 4) The fairest approach is for the parties to

agree at the closing, that (after application to current rents) any dollars received by the purchaser post-closing are applied on account of the rents for the period of deferral, regardless of when such amounts are actually paid. The amounts collected are then apportioned to purchaser and seller⁵ in proportion to their respective loss factors, i.e., in our example 83/17. The purchaser, the party in the best position to deal with the tenants, is then incentivized to maximize its efforts to collect 100 percent of all rental delinquencies. This approach eliminates skewing the calculation by the "duration (or denominator) effect" i.e., it has the virtue of adjusting the allocation of rents to reflect the relative loss to the parties (that is, the longer the ultimate rental abatement, the greater the share of payments to be apportioned to the purchaser). With this approach, the formulation set forth above would be revised as follows:

(a) For purposes of this section, the following definitions shall apply:

(i) "*Rent Abatement Period*" shall mean, as applicable to any tenant by virtue of [Applicable Law] or consensual agreement, the period for which such tenant is excused from the obligation to make current payments on account of rent or other amounts to which the landlord is entitled under a lease or occupancy agreement.

(ii) "*Uncollected Rent*" means all rent, or other payments for which any tenant is responsible under the terms of a lease or other occupancy agreement, which is unpaid at Closing, for any period including but not limited to the Rent Abatement Period applicable to such tenant, including such amounts as to

which the legal obligation to pay is excused by [Applicable Law] or consensual agreement; provided, however, that any amounts which are not being paid by a tenant because of a default, or an alleged default, on the part of Seller or any other person acting as landlord under the lease or occupancy agreement shall not be deemed to be Uncollected Rent. Without limitation of the foregoing, Uncollected Rent shall be broadly defined to include any rent, pass-throughs, occupancy charges, amounts payable in the nature of rent, interest accruals or other amounts which are payable by a tenant to Seller or any other person under a lease or other occupancy agreement.

(b) Purchaser shall use reasonable efforts (but without any obligation to commence any litigation, take any legal action or incur any material expense), during the period commencing with Closing and ending six (6) months after the later to occur of Closing and the end of the Rent Abatement Period, to collect and promptly remit to Seller any Uncollected Rents due Seller for the period prior to Closing; provided that all amounts received by Purchaser after Closing⁶ shall, regardless of any designation by the payor as applicable to any specific period i.e., prior to or after Closing, be applied: first, to Purchaser for amounts due for the then current period and for any other period during Purchaser's period of ownership occurring from and after the end of the Rent Abatement Period; second, [if collected during such six (6) month period]⁷ to Purchaser and Seller, respectively, for all amounts due for the Rent Abatement Period, in proportion to the respective amounts of Uncollected Rent for such period owing to each of such parties; and, third, [if collected during such six (6) month period] to Seller for any amounts for any period prior to the Rent Abatement Period [and any amounts not applied in accordance with the foregoing shall remain the sole property of Purchaser]. The provisions of this

section shall not be merged with the deed but shall survive Closing.

Conclusion

There may be other approaches which evolve to address this issue which has not required significant attention in the past but, now and for the foreseeable future, merits closer attention. Regardless, buyers and sellers of income-providing real estate should consider including language in purchase agreements in order to deal with the allocation of risk for delinquent rent and related classes of income in a thoughtful and equitable manner.

NOTES:

¹There is typically some "sunset" on purchaser's obligations, the length of which is negotiated. Six months is a commonly agreed sunset period.

²Sellers are frequently permitted under purchase and sale agreements to pursue tenants independently for pre-closing rental delinquencies, with the limitation that no claim for eviction may be made. Even in ordinary circumstances this is not ideal. In the context of the COVID-19 pandemic, it is to be highly discouraged. See the discussion *supra*.

³A variation on this provides that first, amounts are prorated between the parties for the month in which closing occurred, second, paid to the purchaser for the post-closing period, and, third, paid to the seller for the delinquent rent for the period prior to the month in which closing occurred.

⁴A threshold question to consider is whether the concept of "delinquent" rent is even applicable. For example, landlords and tenants are currently entering into lease modification arrangements which acknowledge an abatement of rent for an agreed-upon period and repayment over a scheduled period. Likewise, local legislative or regulatory authority might legally excuse rental payments during the COVID-19 pandemic, making this (i.e., "delinquency") terminology problematic. The drafters of any documents should consider a broad definition of "delinquency" in anticipation of these circumstances. Note that the language recommended for inclusion in purchase and sale agreements above altogether avoids use of the term "delinquency" or any derivations.

⁵Purchasers should review loan and other documents closely to determine whether application in this

manner violates any covenants, i.e., no assignment of rents to any other party or “transfer” of property in violation of any restrictions on transfer. In addition to constituting a likely default, breach of these covenants might trigger liability to indemnitors under carve-outs to the non-recourse provisions of loan documents.

⁶There may be circumstances where discrete amounts should be dealt with separately. For example, a tenant’s required contribution toward the expenditures paid by seller (as landlord) in the buildout of commercial

space, if not paid by tenant, appropriately might be made the subject of an independent collection right in favor of seller, or seller might be entitled to a preferred priority in the purchaser’s post-closing collection waterfall.

⁷Deletion of the bracketed provisions in this formulation may be negotiated by the parties but, especially where the magnitude of the delinquent amounts is significant, it may not be reasonable to deny seller a share of collections simply because they are received after the six month period has elapsed.