

Forward Purchases (2.0)

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Real estate investors are increasingly utilizing a “forward purchase” structure to acquire desirable assets early in their life cycle. In a forward purchase transaction, a buyer and seller enter into a purchase and sale agreement at a set or calculated price for an asset that is either in pre-development or under development but not yet complete.

A forward purchase transaction can be attractive to both buyers and sellers. Among other advantages, a buyer can avoid a bidding and marketing process that would typically accompany a completed or stabilized asset and may also obtain greater insight into the physical characteristics of the project during the development period. A seller, on the other hand, might shorten its hold period, realize its gains sooner, increase its rate of return on invested capital and potentially use the certainty of exit to obtain more favorable construction financing. Although a

forward purchase is not a new transaction structure, increasingly, forward purchases are a component of REIT share sales and opportunity zone transactions.


Transaction Structure:

The forward purchase agreement includes complexities not typically found in a sale of a commercial asset. Most importantly, the agreement must contemplate the expectations of buyer and seller for the completion of the asset. In addition, given that development projects often require certain changes that cannot be anticipated, the purchase agreement should retain appropriate flexibility that enables the seller to complete the project (and satisfy the conditions precedent to closing) yet provide sufficient monitoring by the buyer over the development period.

Obligation to Complete:

Generally, the seller will be required to cause the project to be

substantially completed in accordance with the plans and specifications that the buyer reviewed and approved during its diligence period. A buyer often requests inspection, monitoring and/or approval rights over various aspects of the project, such as material changes to the plans and specifications or changes to project approvals. In certain situations, either the buyer or seller (or both) may retain rights to require changes to the plans at their cost, particularly in connection with tenant requirements. The seller must balance these rights against the rights that may be provided to other third parties, such as lenders (through completion guarantees), partners (through joint venture agreements), contractors (through general contracts) and other third parties. For these reasons and others, a seller may be hesitant to add an additional approval of the buyer for anything other than major changes. Further, the seller would likely want to



maintain its existing relationships to the greatest extent possible and to avoid conflict with a new representative of buyer. The forward purchase agreement must balance the buyer's rights for information with the seller's need for operational flexibility and certainty of closing.

Conditions of Closing: Forward purchase agreements typically set forth a number of conditions precedent to the buyer's obligation to close, including receipt of all necessary approvals and payment of applicable costs. The details are important. For example, is "completion" defined as the right to occupy the asset (substantial completion) or full completion (finishing the punch list and providing post-closing deliveries)? Which party confirms completion for the buyer—the seller's architect or a third party (which, from the seller's perspective, introduces a non-controllable condition of closing)? What evidence will be provided that the project is completed in a lien free manner? Does the buyer take leasing risk, or does completion include tenant improvement work and occupancy by tenants? Because a failed buyer's condition excuses buyer's performance, a seller will seek to narrow the buyer's closing conditions as much as possible.

Other Questions: The buyer and seller should expect a robust discussion of key terms both in the letter of intent and the forward purchase agreement. For example:

- What, if any, recourse (such as guarantees or holdback of funds)

secures the seller's obligation to complete any post-closing work?

- Is the seller permitted to use the buyer's earnest money deposit in completion (and, if so, what assurances does the buyer possess if the seller does not perform)?
- Who provides warranties of condition (such as the general contractor or the subcontractors)?
- What is the required condition of the buyer's title insurance policy at closing relating to the status of the work?

As with any transaction, reputational considerations—such as the track record of the owner and developer in similar projects—may help the parties mitigate transactional risks.

Current Market Practice – Effect on Financing; REIT Share Sales:

If a forward purchase agreement is executed at the commencement of a transaction, the seller may be able to obtain more favorable terms with its construction lender if its lender (through a tri-party agreement with buyer and seller) has the right to cure any defaults by the seller and cause the buyer to acquire the asset upon satisfaction of the conditions precedent, thereby decreasing the lender's payoff risk.

From a buyer's perspective, since the buyer's lender cannot rely on a stabilized rental stream to support the collateral if the buyer acquires the asset upon completion, the buyer should seek to understand potential

debt financing at closing and any credit support or other covenants that may be required by its lender.

Finally, with REIT share sales becoming more common for sellers to accommodate the tax structuring of foreign investors, certain sellers are starting to structure their forward purchases as forward purchases of REIT shares, creating additional complexity.

Opportunity Zone Transactions:

The new opportunity zone provisions under US tax law add a wrinkle to a Forward Purchase 2.0 transaction. If a project is located in an opportunity zone, an opportunity zone buyer may acquire an asset near, but prior to, completion and still satisfy the opportunity zone requirement of placing the asset into service during the buyer's period of ownership (attaining a certificate of occupancy

and commencing depreciation). In the process, such a buyer may substantially reduce its development risk and invest its capital on an accelerated basis.

Conclusion:

Although complex, forward purchases are once again attractive to buyers and sellers—often with benefits to both. Interested parties should review the economic, legal and tax impacts with their legal and tax advisors.

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