COVER YOUR BASES

DOES YOUR LISTING AGREEMENT COVER ALL POSSIBILITIES AND PROTECT YOUR FEE WHEN THE DEAL CHANGES?

By Jim Hochman

A recent sale transaction I handled evolved from the outright sale of this 90 percent leased investment property to a joint venture. The would-be buyer lost one of its equity investors and could not close; and the purchase and sale agreement was rescinded. The out of town owner/seller knew that the property needed help. It needed better management, oversight of renovation, and by consolidation of two burdensome mortgages. The mutually beneficial solution became clear: a joint venture evolved where the buyer invested some cash, but most of the equity came from the seller, allowing for a reconstituted ownership entity, bringing its owner on site management and financing expertise to the tired but still valuable property.

The broker had, of course, worked hard to take the deal to the contract stage. As contingencies fell (unfortunately not all of them), and as the broker drew closer to his payday – the deal failed, and the buyer walked away. To his credit, the broker "hung in there" and helped the parties reach agreement on the basic terms of a joint venture. Then it happened. The seller and buyer re-examined the commission agreement and obligation. Here are the many issues the broker suddenly faced:

1. The exclusive listing term had long since expired, and the term was never extended.

2. The post term protection period required negotiations – and the broker saw little need to register the contract buyer – after all, the deal was under contract.

The broker got past these issues, because the seller and buyer recognized the broker's continued role in the deal, and the broker's new listing agreement will have post expiration protection for as long as negotiations with a procured buyer continue, extending as long as the property is under contract. The new form of listing agreement will also provide that if a buyer signs a contract, that such prospect need not be named in the post term registration letter.

This takes us to that next hurdle: how much commission is due on the new JV deal, and in this new scenario, who pays the fee? Let's look a bit more closely at how the deal (and the fee) changed. The old deal was a sale of $70,000,000, and the commission rate was negotiated between the seller and the broker, based upon the sale price. The new deal looked something like this:

a. New property value of $74,000,000 because the seller had new offers, and leveraged those offers in negotiating his new deal with the old buyer.

b. There was debt on the property of $50,000,000 (to be refinanced after the JV was formed, but temporarily assumed by the JV).

c. Seller "sold" or conveyed to the new investor, $6,000,000 of equity, which would allow the seller to take some cash from the initial JV formation;

d. After formation, the JV investor would contribute another $4,000.000 of cash to address the defeasance fee and other refinancing expenses.

When the dust settled on the deal, our seller "sold" $10,000,000 of equity, and retained a 90 percent interest in the new JV. How is the commission to be computed, and in the absence of explicit language in a listing agreement, what is appropriate?

One approach is to simply apply the old commission rate to the value of what was sold, that is, $10,000,000, resulting in a dramatic reduction from that original sale commission by almost 85 percent of the fee. Another approach is to apply the commission rate to the new value of the property, which even if increased to show the equity sold ($74,000,000 x ($10,000,000/$74,000,000) still results in a dramatic reduction of the fee.

The buyer brings more to the table than its cash, including management expertise, and gets a two year management contract on the asset with the JV; and a construction management contract for the planned renovation of the property with the JV; and the seller receives the benefit of each part of the plan i.e. value from refinancing, new debt, lower interest rate and cost, and better return on investment. Seller also derives benefit from "owner's eyes" in management and construction management. If the property increases in value over the next few years, after Seller's preferred return, the Buyer's share of the profits on resale doubles from 5 percent to 10 percent. Arguably, its broker has brought value to the seller – but how much benefit, and when?

In this scenario, how would your own listing agreement protect you? Was the possibility of a JV overlooked (no deed, no closing, therefore no commission)? Is your fee based on the amount of "new money" meaning the reduced fee in our example? Was the fee a fixed amount or a minimum amount if the property is essentially taken off the market, i.e. as liquidated damages? Could this merit a full fee because the property was removed from the market? Might the fee be computed on the value added, meaning future value at time of resale? You procured a buyer who invested cash, brought management expertise, construction oversight, refinancing expertise, perhaps leading to significant profit – for both your seller and the buyer.

As much as I worry about deferred commissions, could an agreement be made that the commission should be based on the "ultimate" closing, the value created from the JV the broker procured?

Consider the following language which a well prepared broker might use:

"If Owner is a partnership, corporation, limited liability company, or other business entity (collectively "Ownership Entity") and an interest is the Ownership Entity is transferred, whether by merger, outright sale, or through recapitalization of the Ownership Entity, in lieu of a sale of the Property, and applicable law does not prohibit the payment of a commission in connection with such sale or transfer, the commission shall be calculated on the fair market value of the Property rather than the gross sale price, multiplied by the percentage of interest so transferred and shall be paid at the time of the transfer.

Add the following:

"In the event that Owner forms a joint venture, Owner shall pay Broker a commission on the value of the portion of the property or the entity which owns the property sold or contributed to the new venture; "and as a result of the new venture, if the Property is sold thereafter within ______ years, Owner shall pay broker a deferred commission computed as __ percent of the profit realized, computed as the difference between the gross sale price and the value of the joint venture initially stipulated."

This seems fair, Seller gets new management, new debt with better terms, buyer gets an extra "bonus" share of sale proceeds – and the broker who put it all together for the parties, gets some extra commission. Perhaps some inclusive language in the listing agreement could cause such a scenario.

You probably can't predict how every deal would take shape, but you should try and cover your right to commission for value added. The challenge is computing that value and getting your client to recognize and reward your own contribution. ■