



Zoning Contingencies in Real Estate Contracts

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In the wake of the recession, the marketplace is still in the process of clearing properties that were zoned with an expectation of a development that never came. As the economic environment for real estate transactions improves, the land use entitlements associated with real property will continue to play an important role in the negotiation of a purchase contract, both from the perspective of the buyer and the seller.

Whether the transaction involves raw land or a site primed for redevelopment, the provisions concerning permitting and zoning are critical in allocating risk between the contract parties. Buyers and sellers should consider the following issues when drafting contract language governing zoning contingencies and related provisions.

A Buyer's Diligence Must Include Zoning

A prospective buyer of a property needs to ask several questions when agreeing to purchase real property: What is the owner allowed to do with the property? What is the owner *not* allowed to do with the property? What *must* an owner do with the property? The buyer should have an inspection period that affords the buyer an opportunity to answer these questions, as well as provisions that obligate the seller to provide documentation regarding any outstanding proffers or other restrictions that may impact the property.

A zoning conformance letter from the local jurisdiction can provide some assurance that a use is permitted and describe any associated conditions for such use. The due diligence period should contemplate sufficient time to request these letters from the jurisdiction. However, securing a letter should not end the inquiry. For example, if the property is subject to proffers made in connection with an earlier rezoning, these obligations will not always appear in a title report. Further, undisclosed cash proffer obligations may have an impact on the economics of the transaction. A buyer may attempt to draft contingency provisions in the contract that allow any cash proffers not disclosed by the seller prior to ratification to be offset against the purchase price. Otherwise, the buyer's only remedy would be to terminate the contract.

Define the Scope of the Contemplated Approvals

The relationship between a buyer and a seller can become more complicated in the event that a buyer determines that the current zoning of a property is not suitable for its proposed development. The parties may negotiate a contract contingency that allows the buyer to pursue certain entitlements from the locality that would permit the buyer's proposed

use. Doing so raises a number of issues for both the buyer and the seller.

From the seller's perspective, a zoning contingency should be drafted carefully to narrow the scope of potential changes that a buyer can make to the property's zoning. For example, the adoption of a zoning map amendment, which generally includes proffered conditions by the applicant, would bind the seller and any successive purchaser in the event that the buyer does not close on the purchase of the property. On the other hand, if the buyer's desired use can be achieved with a special use permit or special exception from the board of zoning appeals, the seller does not bear as significant a risk. If the contract allows the buyer to pursue an outright rezoning of the property, the seller should ensure that this is the final contingency, and should offset this risk with additional deposits from the buyer when all other contingencies have been satisfied. The contract should also apportion liability for any roll-back taxes, which can be triggered by a rezoning of property in a land use tax abatement program.

Finally, the definitions of the approvals should be drafted carefully. Does the contingency cover site plans, which in many jurisdictions are a ministerial approval, or even building permits, certificates of occupancy, or environmental permits? The scope of this language will be important to both parties' understanding of what could allow the buyer to terminate the contract prior to closing.

Timing of the Zoning Approvals Period

Whether the buyer is entitled to pursue an amendment or a permit, both processes place the timeline of the transaction at the mercy of the local jurisdiction's administrative and legislative processes. Public hearings, which typically are held both at the planning commission and legislative body level, require thirty-day notice or more, prior to which there may be other deadlines as staff review the proposal and make a recommendation to the elected body. Both the buyer and the seller face a decision when negotiating the contract regarding how long they are willing to be locked into the transaction. The buyer may desire to have a longer approval period, in order to have sufficient time to secure the necessary entitlements. The seller may prefer a shorter approval period if it anticipates other likely suitors for the property. This poses some risk to the seller, as a short approval period may simply mean that the clock runs out on one buyer while sending the transaction back to square one when the next buyer comes along.

The contract language should also address appeals of any action by the jurisdiction. While the legislative body of the jurisdiction may deny an application, the applicant may still be entitled to an appeal. The buyer will want to preserve the right to appeal an action by that body that is adverse to its interest. Naturally, this further lengthens what in many cases is a particularly drawn out process, so the seller may wish to require additional fees or deposits.

Extension Periods and Deposits

Extension periods provide a method for both parties to mitigate the risk posed by a prolonged approval process. The buyer can receive more time if needed, but then pays for the privilege with additional deposits or non-refundable fees. Depending on the seller's leverage in the transaction, these extensions may obligate the buyer to pay a fee rather than a deposit, which would not be credited to the contract purchase price at closing. From the buyer's perspective, any payments made should be credited to the purchase price if it proceeds to closing, as, at that point, the risk to the seller has been mitigated. On the other hand, the seller continues to bear some risk that the market conditions changed in the buyer's favor between the time that the contract was ratified and the time the buyer closed on the purchase of the property. In some cases, the approval period could last for six months or longer. In cases where there is a perceived threat of market fluctuation, the seller has a particular interest in drafting a tight assignment provision that prevents the

buyer from ratifying the contract at a favorable price, then assigning its purchase rights to an unrelated party twelve months later when market conditions have changed.

Seller Cooperation and Prior Consent

During a zoning contingency period, the seller remains the owner of the property, but the buyer takes the lead in pursuing the approvals that it desires. The buyer should make sure to include further assurance provisions in the contract that obligate the seller to cooperate in any rezoning or permit applications. For its part, the seller should clarify that all costs related to such applications are borne solely by the buyer. If the contract covers a portion of property, with the residue to be retained by the seller and potentially sold to third parties, the buyer may desire to obligate the seller to make reasonable efforts to secure agreements with adjacent purchasers to share in the cost of common improvements, such as access roads or stormwater facilities.

Because aspects of rezoning will affect the property whether or not the buyer proceeds to closing, the seller should insist upon the right of prior consent for any actions by the buyer that would create an obligation for the seller or otherwise encumber the property. In particular, any proffered terms or payments should require prior approval by the seller, as they will run with the property upon adoption by the jurisdiction.

A final concern is what happens if the contingency expires and the seller desires to continue the approval process in order to make the property more attractive for a successor purchaser. The contract should afford the seller the option to require the buyer to assign any permits or other applications that may be pending with the local jurisdiction in the event that the buyer terminates the contract or defaults.

Conclusion

When contemplating the acquisition or sale of property, both the buyer and the seller should anticipate the course of any entitlement approval process, should any be necessary, and provide means for offsetting the risk to both parties. The buyer should ensure that it has sufficient time to procure the approvals needed, while reducing any downside risk in the way of deposits or non-refundable fees. For its part, the seller should ensure that any changes made to the zoning of the property are made only with sufficient security for the risk that the buyer fails to close. With proper forethought and investigation into land use matters, buyers and sellers can avoid being shackled to a contract that turns out to be a vastly different deal than the one they bargained for.

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