

How to determine price in real estate contracts – earn-out and clawback clauses



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In today's world, contractual provisions must be flexible. Transactions involving real estate often require special legal solutions. In particular, this flexibility should apply to the determination of the price in the contract or, more precisely, the possibility of increasing or decreasing the price after the conclusion of the contract.

Clauses ensuring price flexibility

Clauses that provide for price flexibility are often used in trading and include earn-out and clawback clauses.

Earn-out clauses are used to calculate the price in a sales contract and provide for an additional payment (price increase) to the seller should events that have been specified by the parties occur. Earn-out clauses divide the price into two parts:

- the amount which is known at the time of concluding the contract and, as a rule, is payable at that time; and
- the amount which is unknown at the time of concluding the contract and may never fall due as it is subject to the fulfilment of certain conditions. For example, this could be obtaining a building permit for a specific floor space or renting (commercialising) additional office space within a specific deadline.

On the one hand, earn-out clauses offer security to a seller by providing it with a chance to obtain a higher price when events which occur after the conclusion of the sales contract positively affect the real estate's value. On the other hand, such clauses offer security to the buyer, which, at the time of concluding the contract, pays the price that it considers adequate, bearing in mind the possibility that it will increase. The price determined in a standard way does not always reflect the real value of the real estate; sometimes the parties themselves do not have a full understanding of that value.

If the prerequisites for an additional payment do not occur, the price will not increase. It is usually the seller which has the full opportunity to act in order to obtain the additional payment (eg, it is the seller which conducts the administrative proceedings concerning the building permit or takes steps to find more tenants within a certain period and under certain rules).

However, clawback clauses allow the price to be reduced if it turns out that the value of the object of sale was overestimated in the sales contract. Therefore, this mechanism allows the price to be recalculated according to the rules set out in the contract.

Methods of determining price in sales contracts

Under Polish law, a sales price may be defined directly as a specific amount, but may also be determined by indicating the grounds for its determination (Article 536(2) of the Civil Code).

Both earn-out and clawback clauses are applied under Polish law. However, parties to a contract should ensure that the rules for increasing or reducing a sales price are set out in the contract in a precise manner, including how the price is to be calculated and the identification of events (and dates) which will result in a price change. Pursuant to Polish law:

Declaration of will should be interpreted in the way required due to the circumstances in which it was made, the rules of social coexistence and established customs. Contracts should rather be examined in terms of what the intention of the parties was and the purpose of the contract than rely on its literal wording.
(Articles 65(1) and (2) of the Civil Code.)

Thus, in the event of a dispute, the clauses discussed herein are subject to interpretation by a common court or arbitration tribunal. Materials pertaining to the settlement negotiation procedure (eg, emails and notes from meetings) are usually important for this interpretation, as well as witnesses' testimonies.

The parties should indicate in the contract when the payment should be made (by the seller or the buyer – depending on the mechanism implemented in the contract). This is crucial for determining the moment of maturity of the claim for payment.

There are no grounds for treating the incorporation of earn-out or clawback clauses in a property sales contract as a condition clause. This is important because, under Polish law, the ownership of real estate cannot be transferred under a condition or be subject to a time limit (Article 157(1) of the Civil Code). Therefore, if any of these clauses were to be regarded as a condition, they could not be incorporated in the agreement transferring the ownership of real estate or perpetual usufruct rights.

It also cannot be ruled out that a specific clause will, in certain situations, be considered invalid as being unlawful (in particular, as going beyond the principle of freedom of contract) or contrary to the principles of social coexistence. However, such situations are exceptional.

For further information on this topic please contact Barbara Jelonek-Jarco at Kubas Kos Galkowski by telephone (+48 22 206 83 00) or email (barbara.jelonek@kkg.pl). The Kubas Kos Galkowski website can be accessed at www.kkg.pl.

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Barbara Jelonek-Jarco