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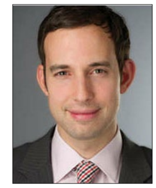
Portfolio PSA Considerations

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Acquisitions and dispositions of portfolios of real estate assets present certain challenges and complexities that are not present in a transaction involving a single asset. For example, will the deal be an "all-or-nothing" transaction such that the buyer has to close on all assets and cannot decline to close on assets plagued by serious defects without terminating the entire transaction? Will all assets in the portfolio close at the same time, or will the closings be held in phases over time? Any approach to addressing these questions creates additional issues, and there are a number of factors to consider in negotiating the sale of a real estate portfolio.

Sellers of portfolios typically desire all-or-nothing deals (i.e., the buyer either buys all assets or none of them). Sellers often structure portfolio sales to couple less desirable assets with premium assets for the primary purpose of facilitating disposition of the less desirable assets that would be more difficult to sell on a stand-alone basis.

If a buyer has the ability to exclude assets from the sale either pursuant to a due diligence termination right or on account of a problem with the asset (for example, a breach of a seller's representations and warranties, or the delivery of nonconforming or insufficient estoppels), sellers do not want to be left with the less desirable assets while being compelled to sell the premium assets.

In a portfolio deal, termination of the entire contract as the sole remedy for a material defect at a single property may not be an equitable (or even favorable) solution for either of the parties.

The buyer, on the other hand, is likely to want some flexibility to exclude assets; the buyer would not want to lose the benefit of its bargain to acquire the balance of the assets in the portfolio because of some defects in a handful of properties that were not disclosed at the time of the contract.

In a single-asset transaction, conditions such as material title defects, breaches of seller representations and warranties relating to the property, a material casualty or condemnation, or the failure of the seller to deliver required tenant estoppels, usually have a material impact on the value proposition for the buyer, and the buyer frequently has the right to terminate the agreement in any of these cases.

The larger the portfolio, the less likely that any of these issues pertaining to an individual asset will deprive the buyer of the benefit of its bargain. In a portfolio deal, termination of the entire contract as the sole remedy for a material defect at a single property may not be an equitable (or even favorable) solution for either of the parties. Either party may still want to proceed (and have the ability to

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force the other party to proceed) with the transaction.

Often, buyers and sellers resolve the natural tension between their respective incentives by creating limited exceptions to an all-or-nothing construct. Negotiation of these exceptions is a risk assessment, with the buyer determining whether the value of the overall portfolio on an aggregate basis will outweigh any issue it may be forced to accept at an individual site and the seller assessing its level of comfort with the risk of receiving a reduced purchase price and retaining rejected sites.

The parties may agree to grant the buyer limited "kickout rights," whereby the buyer may terminate the contract as to a limited number of assets, while the contract remains in full force and effect as to the balance of the assets. A buyer's kickout rights during a due diligence period in which it has a termination right may be different from its kickout rights for seller defaults or another failure of the buyer's closing conditions.

In a transaction where the buyer has a due diligence period and can terminate the agreement for any reason, the seller will usually limit the kickout rights during the diligence period (which may sometimes be exercised in a buyer's sole discretion regardless of whether there is a specific issue with the excluded property); those rights may be limited to a certain percentage of the portfolio (usually determined by value), and the kickout rights may be inapplicable to certain assets.

A seller may also insist on there being some objective diligence-related trigger for the kickout rights, such as a title defect or an environmental issue, rather than a determination by the buyer in its sole discretion. When a kickout right is limited to a maximum threshold, whether by number or value, the buyer may be able to designate properties above the threshold for removal from the transaction, but (unless the seller agrees to remove all of the properties so designated) the buyer will need to terminate the entire agreement or limit the designated properties to fall within the threshold.

Once the diligence period has lapsed, kickout rights arising from the seller's breaches, failures of conditions to closing, or a material casualty or condemnation may be more liberal, as there is a predicate to the termination right and cherry-picking is less of a concern.

Often, there are extrinsic considerations that the parties must take into account in structuring kickout rights, which require certain assets to be grouped for purposes of the kickout right. A group of assets within a portfolio may be pooled together to secure a single financing, and the seller may not be able to obtain a release of less than all of the properties securing that financing without repaying the entire financing; in that case, a buyer may only be permitted to kick out one of the pooled assets if the buyer kicks out all of the assets in the pool.

Similarly, a buyer's ability to exclude assets from the transaction may be constrained as a result of limitations imposed by its own financing sources. Another consideration is that the seller may, by virtue of the sale, be exiting a geographic market or a particular asset class, and may not be willing to be left with a single asset in that market or asset class (due to the loss of economies of scale, among other reasons).

Portfolio assets in that market or asset class may be linked for purposes of the kickout rights. Similarly, a buyer's ability to exercise its kickout rights may be limited in practice by similar concerns about acquiring less than a critical mass of assets in a given market or asset class.

Treatment of tenant estoppel requirements in a portfolio sale agreement can vary widely. Buyers will sometimes take the position that estoppel requirements (typically a minimum percentage of leasable area) should be met on an asset-by-asset basis, which would give the buyer more optionality and more comfort as to each asset it acquires.

A seller might counter that the buyer should be entitled to the required percentage of estoppels on an aggregate basis across the portfolio, so that excess estoppels from one property can be applied to a shortfall at another property, and that it should not matter to the buyer whether the estoppels are evenly distributed among the properties in the portfolio.

The parties may take a hybrid approach, where each property will have a minimum estoppel requirement, with a higher aggregate threshold for the entire portfolio. However, if the buyer is financing the assets in separate pools, the buyer may need to negotiate a separate threshold for each pool being financed in order to satisfy the lender's estoppel requirements.

Also, if the portfolio is being closed in phases, the parties must agree how the aggregate estoppel threshold needs to be satisfied at each closing, and whether estoppels in excess of the required threshold at an earlier closing should carry forward to satisfy any shortfall at a subsequent closing.

Another complexity with portfolio transactions is that, while the parties may intend to consummate the closing for all assets together, commercial realities may require the transaction to close in phases. For example, the transfers of some of the assets may require regulatory approvals with an uncertain timeline.

Similarly, for assets with assumable financing, the buyer will need to go through through a lender approval process with limited control of the timing. Also, satisfaction of the conditions to the buyer's obligation to close (such as receipt of tenant estoppels or clearance of title issues) may prove more difficult for certain assets.

With a large portfolio of assets, it is a virtual certainty that some assets will lag. While the parties could choose to wait until all assets are ready to close at once, often neither the buyer nor the seller will want to defer the entire closing until those assets can be included. A seller desiring an all-or-nothing transaction has to compromise that goal to the extent that the transaction closes in phases.

Once the first group of assets is conveyed, those assets will not be recovered if the buyer subsequently defaults at future closings, and the seller loses a lot of leverage to deal with a buyer default. A seller can ameliorate that risk by backloading the contract deposit. Once multiple closings are contemplated, the parties have to determine how the deposit will be allocated.

While a buyer would argue that the deposit should be applied pro rata based on the value of the assets at each closing so that the seller has a ratable amount of security for each closing, sellers typically require that the deposit (or a substantial portion of the deposit) roll forward to be applied to the last closing to enhance the seller's security for a buyer default.

Phased closings and kickout rights affect many of the other commercial terms in the contract. For example, parties will often allocate or resize the amount of any basket, cap or holdback escrow applicable to breaches of the seller's representations and warranties, and any threshold for termination based on casualty or condemnation events. An allocation of the purchase price among the assets becomes necessary.

In an all-or-nothing deal that is consummated in a single closing, other than for transfer tax purposes, there may be no need for the seller and buyer to agree on an allocation of the purchase price among the assets in the portfolio. If the portfolio closes in phases or the buyer has the right to exclude specific assets, the parties need to agree on an allocation to allow for the phased closing or exclusion of assets.

The buyer and seller may have different views of the relative valuation of each of the assets. If the allocation differs from the fair market value of the respective assets, then a buyer with kickout rights may be able to game the system by removing assets whose allocations exceed their respective market values.

The foregoing is meant to highlight some of the complications involved in purchases and sales of portfolios of real estate assets. The parties will need to consider carefully issues like these in structuring and negotiating such transactions.

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