# Special Contract Issues In A Real Estate Portfolio Transaction

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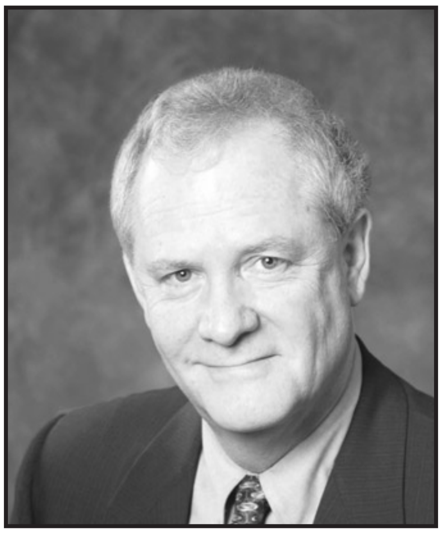

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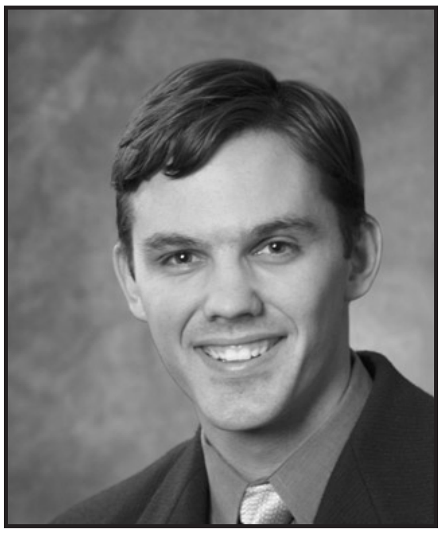

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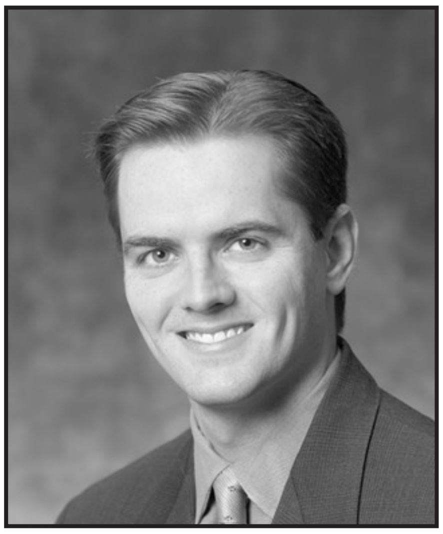

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Certain terms of a contract may differ significantly if a sale involves a portfolio of assets rather than a single property. The issues raised for portfolio transactions are often times the most heavily (and heatedly) negotiated because of the competing disposition and acquisition strategies of the seller and buyer, and the differing viewpoints of the seller and buyer. Understanding these differences is important to successfully negotiating a contract that achieves the client's goals and expectations.

The sale of a portfolio of properties is driven by a number of unique issues that are absent in the sale of a single real estate asset. These issues arise in part because the seller's underlying portfolio disposition strategy may include a desire to dispose of lesser-performing properties by also selling better-performing properties as a value enhancement. Should the buyer have an opportunity to exclude these lesser-performing properties from the portfolio – due to casualty, condemnation, due diligence concerns, inability to get necessary consents or other contingencies – and take only the better-performing, more attractive properties, the seller will have failed to achieve this important goal. On the other hand, the buyer likely has a competing strategy of avoiding the obligation to acquire the lesser-performing properties if highly performing assets are excluded from the transaction. Also, the seller may view the portfolio of properties as an aggregate business unit that is being transferred off its balance sheet; any erosion of the unit makes the transaction less attractive to the seller. However, the buyer typically views the portfolio as the purchase of individual assets, each separate and distinct, rather than as an aggregate business unit. It is this tension, created by the seller's all-or-nothing approach and the buyer's aversion to problematic properties, that drive the unique issues and additional negotiations that arise in a portfolio contract.

**The Problem Of Cherry-Picking**

The seller typically views the portfolio of properties as a package deal and does not want the buyer to cherry-pick for the best values, leaving the rest behind. Conversely, the buyer will almost certainly want the right to exclude a property from the transaction if it discovers material problems with the particular property, and will not want to proceed with the acquisition if too many (or even one) of the attractive properties are excluded.

*Due Diligence Period.* In both single-asset and portfolio transactions, the buyer will typically have a due diligence period commencing after the execution of the contract. For single-asset transactions, the buyer may terminate the transaction prior to the end of the due diligence period, normally at its sole discretion, if the buyer is not satisfied with the results of its due diligence. In a portfolio transaction, to avoid cherry-picking, the seller will not want to give the buyer discretion to exclude individual properties during the due diligence period. Rather, the seller will usually require the deal to be all-or-nothing; the buyer must accept or reject the whole package after the due diligence period. As an alternative, the parties may be able to agree on an exclusive list of reasons why the buyer would have the right to exclude a property from the transaction during the due diligence period (such as environmental, engineering or title defects) with a significant and reasonably verifiable materiality hurdle.

*Post-Due Diligence Period.* The seller will want to limit the buyer's right to exclude a property from the transaction due to the occurrence after the due diligence period of certain events such as casualty, condemnation, failure to obtain a necessary consent not required to be obtained during the due diligence period, or the discovery of a new title defect. In a single-asset transaction, the buyer will typically have the right to terminate the transaction only if the event giving rise to such termination right has a material adverse effect on the property. This is usually the case in a portfolio transaction as well. The concept of material adverse effect may be stated in terms of a minimum dollar threshold of damages (either expressly stated or stated in terms of a percentage of the purchase price) that must occur prior to the buyer having a right to exclude the property from the transaction. The seller may want to state expressly that the adverse effect must be material to the portfolio taken as a whole, rather than material to an individual property, although the buyer may be reluctant to accept such a limitation. Also, in a portfolio transaction, the seller may be able to increase these dollar thresholds to levels that are higher than that which is typical in a single-asset transaction because in such a context, the single-asset-level thresholds may not be high enough to be material.

*Termination of Portfolio Transaction.* Notwithstanding any rights the buyer may have during or subsequent to the due diligence period to exclude a property from the transaction, both seller and buyer will want the right to terminate the entire portfolio transaction if too many properties (or perhaps certain properties) are dropped from the deal. The mutual termination option may be triggered by the purchase price falling below a certain amount, by the number of properties being sold falling below a certain number, or, in some circumstances, if certain designated properties are excluded from the transaction.

**Default And Remedies**

*Termination Rights.* A single-asset contract and a portfolio contract should not be substantively different as to the seller's representations, warranties and operating covenants. However, in a single-asset sale, a breach by the seller of a representation, warranty or operating covenant normally will not be considered a default unless the breach is material to the property. In a portfolio transaction, the seller may attempt to provide that a seller's breach will not be considered a default unless the aggregate of all breaches for all properties has a material adverse effect as to the portfolio taken as a whole. In such an event, the seller also may want to limit the buyer's remedy to excluding only a sufficient number of the properties that are subject to a breach, as that will reduce the aggregate effects of all the breaches to a level below the materiality threshold. The buyer will want a breach by the seller of a representation, warranty or operating covenant to be a default if the breach has a material adverse effect on the affected property, without regard to its effect on the portfolio as a whole, giving the buyer the right to exclude the property from the transaction. One compromise the parties may reach is requiring a breach by the seller of a representation, warranty or covenant to have a material adverse effect on the entire portfolio for the buyer to have any termination rights, but allowing the buyer to terminate a property if a casualty, condemnation, failure of a necessary consent or new title defect has a material adverse effect as to that property.

*Unilateral Termination Option.* If enough properties are excluded from a portfolio transaction, the parties will usually have a termination option giving each of them the right to terminate the entire transaction. However, if properties are excluded because of a seller breach, the buyer may want the termination option to be exercisable only by the buyer in order to prevent the seller from effectively obtaining the right to abandon the transaction as a result of its own breach.

*Baskets and Caps.* In both a single-asset and a portfolio transaction, the seller may seek a basket (floor) that must be exceeded before the buyer can bring a claim after closing for breaches of any representations, warranties and covenants of the seller that survive the closing, and a cap (ceiling) limiting the total amount of all claims. The cap will likely be a stated percentage of the purchase price in both a single-asset and a portfolio transaction. The basket concept, however, may differ significantly between the two transactions. In a single-property deal, the basket will typically be a stated dollar amount or percentage of the purchase price. In a portfolio transaction, the parties must decide if there will be one basket for the entire portfolio or a series of baskets for the individual properties within the portfolio. The seller will want the basket to be based on the portfolio purchase price, making it more difficult for claims to be brought unless the aggregate of all claims are material in relation to the transaction taken as a whole. The buyer will want a basket for each separate property, as each claim represents a loss to the buyer that may be material to the affected property and would exceed a basket for such individual property, but may not be material to the transaction taken as a whole and would not exceed an aggregate basket applicable to the entire portfolio.

**Conclusion**

The parties to a portfolio transaction will likely spend a good portion of the time they negotiate the contract addressing the issues mentioned above. These issues are among the most important, and the most likely to differ from transaction to transaction. The nature of the transaction may largely determine the outcome of the issues; however, to achieve the client's disposition or acquisition goals, it is vital for the parties to understand these differences and the advantages and disadvantages of each of them.

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