BY THE WAY, WHAT ABOUT THE POST-CLOSING CREDIT ENHANCEMENT?

By Frederick L. Klein and Kevin L. Shepherd[*†]

As counsel to seller, you have finally resolved the final language for the representations and warranties made by the seller in a purchase and sale agreement ("PSA") for a significant commercial real estate asset. You have also agreed on the date, after closing, before which the buyer must assert a claim for a breach of a seller representation or warranty; the amount of the floor and ceiling damage caps relating to the breach, and the scope of the seller indemnities in case of a breach of one or more seller representations or warranties. The parties have also agreed that the buyer cannot assert a claim after closing for breaches of any seller representation or warranty of which the buyer had knowledge before the closing. These negotiations were extensive and tedious, but you feel comfortable that seller's exposure is limited given the qualifications you were able to negotiate, the modest post-closing survival period, the "market" floor and ceiling damage caps, and the fact that the seller is a single purpose entity with no assets other than the property being sold and the proceeds of the sale.

You believe the document is complete and the parties are now in a position to sign and deliver the PSA and proceed to closing. When you contact buyer's counsel to work out the logistics for executing and delivering the PSA, buyer's counsel mentions that the PSA looks fine, but notes, somewhat nonchalantly, that the parties need to resolve one final issue. You are nonplussed. Buyer's counsel says the issue is the post-closing security, or "credit enhancement," for a breach of a seller representation or warranty that is discovered after closing. Buyer's counsel insists that buyer needs a cash escrow to be held in escrow for the duration of the survival period (and longer in case buyer asserts a claim during the survival period) to support seller's representations and warranties, especially because the seller will have promptly distributed all of the net sales proceeds, and thus, the seller will have no assets post-closing. You were hoping, perhaps naïvely, that this issue would not arise, but it has. How do you deal with it? Are there forms of security other than a cash escrow that could be used as the credit enhancement that will satisfy the buyer? Are there other creative alternatives? What is "market" in this area?

This article will discuss the types of credit enhancement, their relative pros and cons, and when and how to use them. The article will also propose language that may be used for the most frequently used types of credit enhancement.

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Why Bother?

Anecdotal information from experienced commercial real estate lawyers suggests that the likelihood that a buyer will actually seek recourse against a seller for a post-closing breach of a representation or warranty is low. Indeed, in the course of a commercial real estate lawyer's career, it may be unusual to encounter a situation where a buyer actually sues a seller for a post-closing breach of a representation or warranty (although claims for resolution of pro-rations arise with somewhat more frequency). If that anecdotal information is correct, then why do the parties spend so much time and effort negotiating the post-closing credit enhancement framework?

One practical reason may be the *in terrorem* effect of having cash (or its equivalent) at risk for a breach of a seller representation or warranty that first arises after closing. Seller expects to achieve a certain economic return for the sale of a commercial real estate asset, and the prospect of temporarily degrading that return by effectively reducing the net purchase price persuades sellers to ensure that their representations and warranties are accurate so that a post-closing claim does not arise. Seller is also interested, perhaps to a lesser extent, in preserving its marketplace reputation by avoiding allegations of post-closing breaches of representations and warranties. These allegations move swiftly through the commercial real estate industry, and can affect a sponsor's ability to raise capital from institutional investors. By the same token, buyers seek to ensure that the amount of the post-closing credit enhancement is sufficient to provide comfort that the seller is economically and reputationally motivated to ensure that its representations and warranties are accurate.

Types of Post-Closing Credit Enhancement

The types of post-closing credit enhancement span a considerable range of choices, but the bottom-line is liquidity. These choices are often dictated by relative bargaining strength, the type of transaction (e.g., fee conveyance versus entity interest transfer), the cost (e.g., letter of credit fees or insurance premiums), and nature and scope of the underlying seller representations and warranties. The choices include the following: (a) no post-closing credit enhancement; (b) seller's promise to maintain a certain post-closing net worth; (c) a guaranty from a creditworthy affiliate of seller; (d) an irrevocable letter of credit provided by seller; (e) a cash escrow held by a third party escrow agent, and (f) representations and warranties insurance ("RWI"). Variations or combinations of these basic choices are possible as well, but these generally represent the universe of possible post-closing credit enhancement devices. This article will discuss these choices in turn.

No Post-Closing Credit Enhancement

From a seller's perspective, the optimal choice is not to have any post-closing credit enhancement at all, even when the seller is a single-asset, special purpose entity. It is surprising (and yes, jarring) the number of times that buyer's counsel carefully

negotiates the contours and content of the seller representations and warranties, but neglects to negotiate any post-closing credit enhancement – at least during the initial round of comments. If a seller is successful in avoiding an obligation to provide some form of post-closing credit enhancement, the buyer may not be able to recover damages form a post-closing defaulting seller, particularly if that seller no longer has any assets. Of course, it's possible that the seller (especially a limited liability company) may have a statutory obligation to maintain a certain level of liquidity to address post-closing contingent claims, but a seller's failure to do so leaves a buyer with no practical and efficient legal remedy. Other remedies – such as tracing the proceeds or piercing the corporate veil – may involve significant hurdles and, hence, legal fees that could easily exceed the amount in dispute.

SELLER'S CONTRACTUAL PROMISE TO MAINTAIN POST-CLOSING NET WORTH

Moving up the scale from a seller having no post-closing credit enhancement obligation, the next choice is seller's express contractual obligation to maintain a specified post-closing net worth to support the possibility that buyer may successfully assert a claim for a breach of a seller representation or warranty after closing. A seller may not object to having this obligation so long as the net worth period coincides with the survival period under the PSA and seller is not obligated to provide buyer with on-going evidence that seller is maintaining the specified net worth. Variations on this theme may include an obligation by seller to maintain a separate account funded with the required net worth amount at a designated bank or other financial institution for the requisite time period, and perhaps for the seller to provide written evidence, such as a bank statement, proving the existence of the amount on deposit.

As a buyer, this choice is far from optimal. Buyer has no practical means to verify or confirm that seller is maintaining the required net worth absent an affirmative contractual obligation by seller to provide periodic bank statements or other written evidence confirming that seller is complying with its net worth maintenance requirement. If seller breaches a representation or warranty post-closing, buyer will then have to demand payment from seller up to the agreed upon damage cap (which presumably is equal to or less than the net worth maintenance amount). If seller refuses or fails to pay the amount in controversy, buyer will be forced to file suit against seller to enforce seller's contractual obligation. Such a suit will entail time, expense, and uncertainty.

Set forth below are examples of provisions where the seller is required to maintain a specific net worth for a specific time period and where the seller is obligated to maintain funds in an account at a bank or other financial institution in an amount equal to the damage cap. If the seller agrees to maintain such an account, the seller may require that any amount in the account in excess of a buyer's damage claim be released to seller at the end of the survival period.

Example of Seller Obligated to Maintain Certain Net Worth:

Notwithstanding any contrary provision in this Agreement, as a material inducement for Buyer to enter into this Agreement, during the Survival Period Seller covenants and agrees to maintain a tangible net worth in an amount equal to the Damage Cap; provided, however, that if Buyer files an action, suit, or proceeding prior to the Suit Deadline, Seller shall continue to maintain such tangible net worth until such time as the action, suit, or proceeding has been finally resolved as more fully provided in Section ____ above. Seller further covenants that it shall not dissolve or liquidate during the Survival Period and at all relevant times thereafter during the pendency of any such action, suit, or proceeding. This paragraph shall survive Closing.

Example of Seller's Obligation to Maintain Account at Bank:

During the Survival Period (and for so long thereafter as any written claim made by Buyer remains pending), Seller covenants and agrees to maintain its legal existence and retain or cause to be retained in a savings or deposit account at _________ or another federally insured, national banking association an amount equal to the Damage Cap. Such account shall be in the name of Seller and no other party, and at any time and from time to time, within five (5) days of a written request, Seller shall deliver to Buyer (which delivery may be effected by electronic mail) a copy of statement issued by the deposit bank confirming the amount on deposit. To the extent Buyer timely delivers a Notice of Breach to Seller during the Survival Period and the loss or damage resulting from the alleged breach or failure of a representation or warranty of Seller is less than the Damage Cap, at the end of the Survival Period Seller shall be entitled to withdraw from such account an amount equal to the difference between such loss or damage and the Damage Cap.

GUARANTY FROM A CREDITWORTHY AFFILIATE OF SELLER

A seller may propose that an affiliate guaranty seller's post-closing obligations in case of a breach of a seller representation or warranty. Before a buyer readily agrees to this proposal, a buyer should consider several factors. First, the buyer needs to ensure that the proposed guarantor has the financial ability to satisfy seller's post-closing obligations. Buyer thus needs to underwrite the creditworthiness of the proposed guarantor and, to that end, the buyer should request, and seller should provide, copies of audited financial statements and other information on the proposed guarantor. As part of the underwriting process, buyer should confirm, if the seller is an investment fund, that the fund is not intending to liquidate its portfolio before the survival period expires. Second, the buyer should evaluate any particular challenges it may encounter in seeking to enforce the guaranty. For instance, is the guarantor domiciled outside of the United States or in an inconvenient jurisdiction where obtaining or enforcing a judgment may be

difficult? Third, the parties will need to agree on the form of the guaranty, which may range from a single-sentence joinder provision or a full blown payment guaranty attached as an exhibit to the PSA. The buyer may strongly prefer a robust guaranty, but most sellers will attempt to get by with the bare minimum.

Set forth below is a form of guaranty that is contained in a joinder provision in a PSA. This form of guaranty results in a self-contained guaranty that makes it unnecessary for the guarantor to execute and deliver a separate guaranty agreement.

Guaranty via a PSA Provision and Related Joinder (simple)

PSA Provision

> Seller represents that Seller is indirectly owned or controlled by ___________, a _____________ ("**Guarantor**"), the ultimate recipient of all or a material portion of the proceeds from the Purchase Price. As such, Guarantor hereby guaranties the payment (and not just the collection) of Seller's obligations under the representations and warranties made by Seller in Section ___ and Seller's indemnification obligations under the Assignment and Assumption of Leases and Contracts to be delivered at Closing, such guaranty being limited by Seller's Damage Cap and being deemed given only to the extent of Seller's liability under this Agreement, as the same is so limited as set forth in Section ___ and this Section ___. Such guaranty shall survive Closing for the Survival Period with any Proceeding (as defined below) to be brought on or before expiration of the Survival Period. Seller acknowledges and agrees that the resolution of such Proceeding may not occur until after the expiration of the Survival Period and the Survival Period shall be deemed to be tolled with respect to (and only with respect to) any such Proceeding brought on or before the expiration of the Survival Period. Guarantor joins in the execution of this Agreement to acknowledge its guaranty of Seller's obligations hereunder as aforesaid and as limited hereby. If Buyer brings an action against Guarantor based on such guaranty (it being understood that Buyer shall not be obligated to first pursue a claim against Seller), Buyer acknowledges that Guarantor may assert any and all rights, defenses, and offsets that Seller may have against Buyer. For purposes of this provision, "**Proceeding**" means a legal proceeding by Buyer in a court of competent jurisdiction against Seller alleging that Seller was in breach of a representation or warranty contained in Section ___ as of the date made and that Purchaser has suffered damages as a result thereof thereon.

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Joinder

> _______________, a ____________, joins in the execution of this Agreement solely for the purpose of evidencing its guaranty of Seller's

obligations hereunder as set forth in and as limited by Sections ___ and ___ above [*these limitations include the Damage Cap and Survival Period*].

Guaranty via a PSA Joinder (detailed, with net worth maintenance)

_______________, a ____________ ("**Guarantor**"), by Guarantor's execution of this Joinder (this "**Guaranty**"), hereby irrevocably joins in execution of this Agreement (this Agreement, collectively with any amendments, modifications, supplements, or extensions of this Agreement consented to in writing by Guarantor entered into by Seller and Buyer, being herein referred to as the "**Purchase Agreement**") to guarantee absolutely and unconditionally to Buyer, its successors and assigns, the prompt payment and performance of all of Seller's representations and warranties set forth in Section __ of the Purchase Agreement (collectively, the "**Guaranteed Obligations**"), subject to any applicable limitations set forth in the Agreement (including, without limitation, to the extent applicable, Sections ____ and ___ [*these limitations include the Damage Cap and Survival Period*]). In the event of the failure of Seller to perform timely the Guaranteed Obligations, Guarantor shall make the payment or performance in question immediately upon notice of such failure, it being agreed that the guaranty of the Guaranteed Obligations set forth herein is a guaranty of payment and performance and not of collection. Guarantor is an affiliate of Seller, and Guarantor is executing this Guaranty to induce Buyer to enter into the Purchase Agreement, and therefore, Guarantor is receiving full and adequate consideration for the execution and delivery of this Guaranty. Guarantor hereby waives any and all suretyship defenses (other than full and timely payment and performance of the Guaranteed Obligations and any modification of the Purchase Agreement without Guarantor's written consent) with respect to the Purchase Agreement and this Guaranty. [*Guarantor shall maintain a tangible net worth of at least __________ Dollars ($________) for the duration of the Survival Period.*] This Guaranty shall be governed by and construed in accordance with the internal laws of the State/Commonwealth of ________, and not the laws pertaining to choice or conflict of laws of the State/Commonwealth of ________. Guarantor hereby irrevocably appoints ________________ as its agent for service of process, and agrees that Guarantor shall submit to the personal jurisdiction of the local and Federal courts of the State/Commonwealth of _____________ in connection with any action or proceeding to enforce the Guaranteed Obligations. The Guaranteed Obligations shall be binding on Guarantor and its successors, legal representatives and assigns. Notices to Guarantor shall be provided in the same means as specified in Section ___ of the Purchase Agreement, and shall be sent to _________. This Guaranty shall survive the Closing.

LETTER OF CREDIT PROVIDED BY SELLER

A seller that is reluctant to deliver a cash escrow or to offer a creditworthy affiliate as a guarantor may propose to deliver an irrevocable letter of credit in a specified amount for a specified time period. A chief attribute of a letter of credit is its liquidity. The seller may be willing to pay the letter of credit fees imposed by the issuing bank in lieu of allocating a portion of the purchase price to serve as the escrowed funds; or, alternatively, the parties may elect to share the letter of credit fees. The parties will need to decide whether the letter of credit itself will be held in escrow or whether it will be directly delivered to the purchaser for it to hold during the survival period. Because the issuing bank will often require the account party to deposit cash in an amount equal to the maximum amount of the letter of credit, in addition to an annual fee that could be as much as 1% of the face amount, this alternative poses the same issue to a seller as a cash escrow – the seller's investors will be forced to wait to receive all of the proceeds they are expecting.

Set forth below is representative language that may be included in a PSA obligating the seller to deliver a letter of credit into escrow. In some transactions, the seller may have the option to deliver a letter of credit or a cash escrow. The PSA will need to include the form of the letter of credit as well as the form of the escrow agreement. A seller would prefer that the letter of credit be held by an escrow agent (and not by the buyer) and, if it is so held, the parties will need to make sure that the beneficiary is the escrow agent (and not the buyer) so that the escrow agent can present a draw on the letter of credit when requested to do so. The escrow agreement will need to detail the draw conditions, which will include a requirement that the escrow agent present a draft for payment, in the absence of a post-closing claim, if the letter of credit is not timely renewed or if the issuing bank's credit rating falls below a specified level.

Letter of Credit Provision

> As collateral security for the Damage Cap, Seller shall deliver to Escrow Agent at Closing an unconditional and irrevocable sight draft letter of credit in an amount equal to the Damage Cap ("**Letter of Credit**"), which escrow shall be governed by the terms and conditions of an escrow agreement ("**Escrow Deposit Agreement**") among Seller, Buyer, and Escrow Agent. The Letter of Credit and Escrow Deposit Agreement shall be in form and substance reasonably acceptable to Seller and Buyer. The Letter of Credit shall (i) be issued by ______________ or other FDIC-insured financial institution reasonably satisfactory to Buyer; (ii) be an "evergreen" letter of credit that shall be renewed automatically unless the issuing bank gives Buyer and Escrow Agent at least sixty (60) days' notice prior to expiration; (iii) permit drafts to be presented in the ___________ metropolitan area, and (iv) be in a form satisfactory to Buyer. The Letter of Credit or Escrow Deposit Agreement shall survive Closing for the Survival Period with any action, suit, draw, or proceeding thereon to be brought on or before the Suit Deadline.

CASH ESCROW WITH A THIRD PARTY ESCROW AGENT

From a buyer's perspective where the focus is on liquidity, a cash escrow deposit is highly preferable – and perhaps the best alternative. Not surprisingly, a seller may take a dim view of being required to escrow a portion of the purchase price at the closing for some of the reasons noted above. As with a letter of credit, the seller, the buyer, and the escrow agent will need to enter into an escrow agreement that will govern the disposition of the cash escrow. Set forth below is an example of a PSA provision requiring a cash escrow:

> As collateral security for the Damage Cap, at Closing Seller shall deliver into escrow with Escrow Agent an amount in cash equal to the Damage Cap ("**Escrow Deposit**"), which escrow shall be governed by the terms and conditions of an escrow agreement ("**Escrow Deposit Agreement**") among Seller, Buyer, and Escrow Agent in the form of Exhibit __ attached hereto. The Escrow Deposit Agreement shall survive Closing for the Survival Period with any action, suit, draw, or proceeding thereon to be brought on or before the Suit Deadline.

REPRESENTATIONS AND WARRANTIES INSURANCE

The insurance industry has developed a product that will provide coverage in case of losses from a post-closing breach of a seller representation or warranty. Referred to as RWI, this product is increasingly used in merger and acquisition transactions, but it is also for the purchase and sale of commercial real estate. When a buyer is making a competitive bid to acquire an asset, its willingness to obtain RWI, rather than insist on a cash escrow or letter of credit to back up the seller's representations and warranties, can make the buyer's bid more attractive.

RWI basically allows a seller to avoid the need for a cash escrow, letter of credit, or guarantor. The insurer will underwrite its risks, and this insurance product generally entails a deductible (i.e., "retention") along with an initial premium payment. Because RWI presents significant benefits to both buyer and seller, the parties may decide to share the premium cost. The insurer typically structures the policy period so that it aligns with the survival period under the PSA. From a buyer's perspective, it may benefit from looking to the insurer for recovery and not to the seller, which may no longer have any assets. In the current insurance market, the cost of RWI insurance may be as much as 4% or 5% of the policy limit.

RWI typically takes the form of either a seller policy (referred to as a "sell side policy") or a buyer policy (referred to as a "buy side policy"). Under a sell side policy, the insurer will indemnify the seller from loss arising from a post-closing breach of a representation or warranty. Under a buy side policy, the insurer will pay the buyer for a loss arising from such a breach.

Even though several insurance companies offer this coverage, it is critical that the insurer be engaged as early as possible in the sale process, because the insurer will need to conduct its own due diligence, which may include one or more conversations with buyer's and seller's counsel. From a drafting standpoint, buyer's and seller's counsel must ensure that the policy coverage language and the PSA language regarding survival of representations match. The seller's counsel will want to take special care to ensure that the RWI carrier does not have the right to subrogate against the seller.

CAPS, FLOORS, AND RELATED MONETARY LIMITS

Although beyond the scope of this article, a few words are in order dealing with the damage cap and floor amounts and related monetary limits. Sellers do not want unlimited post-closing liability exposure to buyers. Sellers will insist on a monetary cap on their post-closing liability and, for good measure, will negotiate a floor beneath which they will not want to be bothered with claims from buyers. Buyers, viewing the situation from a much different vantage point, want to ensure that sellers are willing to stand behind their representations, warranties, and covenants.

If the parties agree on a floor amount, the buyer wants to ensure that the PSA clearly state that any claim in excess of that amount will allow the buyer to recover damages from the first dollar of the claim (and not amounts only in excess of the cap). For example, if the floor amount is $50,000 and buyer's damage claim is $75,000, buyer should be allowed to recover $75,000 from seller, not just the amount in excess of the floor amount (i.e., $25,000), so that the floor does not serve as a "deductible." Buyers should take care in expressly stating that the floor amount does not apply to seller indemnities for prorations and other "true-ups," broker indemnities, and others not related to a specific seller representation or warranty. Buyers often overlook this point, and controversy may arise when buyers demand payment on an indemnity that is less than the negotiated floor amount.

Damage caps are often the subject of intense discussion. There is no magic in negotiating these caps, and they are nearly always driven by market forces and not from a prescriptive formula or grid that specifies the appropriate amounts. Market forces, however, are subject to interpretation and one's most recent experiences. For example, what is considered a "market" liability cap for the sale of an office building for $100 million? Experience suggests that the damage cap range is somewhere between 2% and 3.5% of the purchase price. Obviously, each deal is unique and the ultimate damage cap may fall outside this range.

CONCLUSION

Negotiating the scope of seller representations and warranties, along with the attendant survival period and damage floor and cap amounts, should not blind a buyer to the need to have contractual protection that will actually support a buyer's post-closing claim for damages arising from a breach of a seller representation or warranty. Sellers need to protect their interests from burdensome post-closing obligations, and they should

avail themselves of options designed to minimize that burden while still affording protection to buyers.