

Post-Closing Apportionments: The Escalation Trap

Lee A. Kuntz*

In sale transactions involving commercial real property, the provisions that relate to closing and post-closing apportionments involve several conflicting objectives of the parties, primarily the seller's desire for finality to its obligations and the purchaser's desire to have the seller retain liability for those items that accrued prior to the sale. The conflicting objectives present especially challenging issues in the area of operating expense escalation and pass-thru charges, where the amounts involved will generally not be ascertainable until after the end of the then current year and the amounts actually payable by the tenants until some time thereafter. This article analyzes these issues.

LEASE PROVISIONS

Escalation charges² are, of course, governed by the terms of the particular leases of space at the property. The applicable provisions vary widely. As a general matter, operating cost escalation is an annual charge based upon the operating expenses incurred in a particular year (the "Operating Year").³ Such operating expenses are to be determined by the landlord in the first part of the succeeding year, with the escalation amount to then be billed to the tenants.⁴ Tenants are then required to pay the amount due to the landlord, less any estimated payments made during the Operating Year, as discussed below. Generally tenants have a relatively short period of time within which they may challenge the landlord's escalation statement for the Operating Year, though major tenants can negotiate quite extended periods (often a year or more)⁵. Leases vary widely as to the mechanism by which challenges by tenants to escalation statements are resolved, but obviously the period within which the final amount of escalation charges is fixed will be prolonged by a challenge.

Escalation provisions also generally require that a tenant pay monthly estimated escalation charges during the Operating Year based upon a

* Lee A. Kuntz is a partner of Shearman & Sterling LLP and head of its Property Practice Group.

preliminary budget prepared by the landlord. Those monthly payments are subject to the year-end escalation statement and a true-up in the following year. The landlord's estimate is generally not subject to challenge by the tenants, although, for major tenants, there may be a cap to the amount of increase from the prior Operating Year, and there may be some interest or other adjustment factor if the estimates are substantially above the year-end final amounts.

Two other provisions of the lease become relevant on a sale. The first is the so-called "landlord for the time being clause", which generally provides that the term "landlord" means the particular person or entity that is the landlord under the lease at the particular time, and that, from and after the transfer of the lease, the transferor is relieved of any further obligations or liabilities under the lease.⁶ The second is the estoppel certificate provision, which generally provides that, upon request, the tenant will deliver an estoppel certificate to the landlord and a prospective purchaser. The form of estoppel will, in one manner or another, address the date to which additional rent (e.g., escalation charges) has been paid and whether there is any existing dispute with respect thereto.

CONTRACT OF SALE PROVISIONS

The starting point is, of course, the apportionment provision. Generally, this provides, as relevant, for escalation charges to be apportioned just as fixed rent is apportioned; but, in recognition that the current year's escalation charges are estimates, provision is made for a true-up in the following year when the actual amount of operating expenses for the year of sale is known, and the escalation charges for the Operating Year can be computed. The true-up is usually done in conjunction with the preparation of the year-end escalation statement for the tenants. Often the contract provides for a resolution mechanism should the seller and the buyer disagree as to the amount of operating expenses, the escalation charges or the particular apportionment between the two parties. This process is independent of the actual billing of the annual escalation charge to the tenants and, of course, is not binding upon the tenants, though it is binding upon the parties.

Most contracts of sale also have two other provisions directly bearing on the apportionment issue. The first is a contractual statute of limitation on claims by the buyer against the seller. The scope of such provisions varies broadly, ranging from claims arising from factual representations and warranties relating to the property to essentially all claims under the contract. Thus, such provisions may be broad enough in scope to cover

post-closing apportionment claims. The time period within which claims must be asserted runs from the closing and generally falls within the range of 6 to 12 months. The second provision is a floor and ceiling on the amount of claims. The floor is intended to prevent claims which in the aggregate and in the context of the deal are not material; the ceiling is intended to limit all post-closing claims against the seller.⁷ Generally, the scope of applicability of the floor and ceiling provision correlates with the scope of the contractual statute of limitation provision.

As it became common for commercial properties to be owned by single purpose vehicles, the stated purpose of the ceiling was to permit the seller to make appropriate distributions of the net sales proceeds and complete liquidation in an orderly fashion. Without such a ceiling, the seller might have to maintain its existence for the applicable legal statute of limitations for claims under a contract or risk a claim against its investors.⁸ Moreover, the contractual statute of limitation provision obviously provides, within the scope of its application, a shorter period within which the seller must be concerned about maintaining the financial resources to satisfy claims of the buyer under the contract.

In addition, in the assignment of leases delivered by the seller to the buyer, the seller generally retains liability for, and indemnifies the buyer against, lease claims arising before the transfer date, and the buyer assumes liability for, and indemnifies the seller against, lease claims arising from and after the transfer date. In addition, there may be a more general cross-indemnity in the contract of sale itself.

INTERPLAY OF AGREEMENTS

In the case of most of the items apportioned at closing, the time when the item arose or accrued and the amount to be apportioned are either reasonably determinable at closing or within a short period of time thereafter. For example, with rare exception, the amount of fixed rent payable under a lease and the date to which it has been paid are not only easily determinable but are also confirmed in the tenants' estoppels. Likewise, most amounts due under service contracts are determinable based upon the billing under the contract and can be confirmed by estoppel letters from the vendors. Moreover, the point in time when the charge arose is usually clear. Utility charges may not be as precisely determinable as it may not be possible to have all of the relevant utility companies read meters or provide a change-over billing for the closing date. However, the amounts for the period including the closing date can generally be obtained from the utility companies within 30 days after closing and can

then be finally apportioned. However, annual operating expenses, and the escalation charges based thereon, are not finally determined until after the Operating Year in which the closing occurs, often three or more months after the end of such Operating Year. Moreover, the determination of the aggregate escalation charges for the tenants can be complex, as the relevant lease provisions differ, often substantially.

The determination of operating expenses for the Operating Year in which the closing occurred is just the first step in the process. Independently of such determination, the escalation charges must be determined, escalation statements must be sent to the tenants and any tenant challenges to such statements must be resolved. That process generally extends well beyond the period fixed between the seller and the buyer for the final apportionment.

THE ISSUE

The core issue is which party will be responsible if a tenant successfully challenges an escalation statement. In the first instance, and assuming there is no other claim between the seller and the buyer, the total disputed escalation amounts may well be below the floor for claims in the contract and, if not part of the final apportionment (likely the case), may well not be recoupable by the buyer from the seller. The same would be true for a very large claim that exceeded the ceiling, but, given the nature of escalation charges, that should be a remote circumstance.

More vexing is the timing issue. It is quite likely that a tenant's claim will not be raised until after the cut-off date for claims against the seller under the contract of sale. Assuming a broad contractual statute of limitation provision, the buyer is time-barred from bring a direct claim against the seller under the contract. However, the claim likely arose, at least in part, because of an overbilling or incorrect billing by the seller of estimated escalation charges. Thus, cannot the buyer resist the tenant claim on the basis that it was not the landlord at the time or, alternatively, that the tenant is barred by its estoppel certificate? Also, cannot the buyer look to the provisions of the assignment of leases and claim that the seller retained this liability as it arose before the date of transfer and, indeed, indemnified the buyer against such claim? The answer, of course, depends upon when the claim arose – upon the billing of the estimated escalation charges or upon the final billing of escalation charges for the Operating Year in which the closing occurred.

Based upon the customary lease provisions, by far the most likely answer is that claims in respect of incorrect escalation charges do not arise

until the annual escalation statement is rendered to the tenant with the actual bill for the Operating Year's escalation charge and the tenant challenges the bill. This conclusion is readily apparent from the basic lease terms. The estimated charges are just that – estimates, and not only are subject to year-end adjustment but also are subject to challenge by the tenants. Also, the escalation rent obligation is generally phrased in terms of an annual obligation to pay based upon the operating expenses for the Operating Year as, in the first instance, determined by the landlord in the annual escalation statement. Thus, the tenant does not have a choate claim against the landlord until the annual billing is made. The landlord at the time the claim can be made is, of course, the buyer. Based upon the same reasoning, the tenant is not barred by its estoppel certificate because at the time issued the tenant did not have a claim against the landlord.

DISCUSSION

The foregoing is not the rational result, as the final apportionment is supposed to provide a process whereby the parties true-up their closing apportionments. Without an accurate adjustment for escalation charges, the seller is unjustly enriched, more likely than not based upon incorrect estimated escalation charges generated by the seller or its managing agent. This enrichment is exacerbated when the closing is in the latter part of the year.

A simple solution is, of course, to provide that claims in respect of the operating expense/escalation charge apportionments are not time barred. However, such a provision is not often acceptable to sellers, particularly as it may postpone for a considerable period of time distributions to its investors and liquidation of the seller. It would also require that credit for post-closing claims remain in place. An alternative solution, somewhat within the control of the buyer, is to attempt to have the tenants respond more promptly to the annual escalation statement so as to flush out any claims within the contractual period of limitations. Whether the tenants will cooperate and whether for the longer term it is in the buyer's best interest to have tenants focused on challenging annual escalation statements are two problems with this approach. A landlord could, of course, seek to address the issue by requiring shorter periods for tenant challenges in respect of escalation charges for a year of sale; however, this is not only off-market but also not in the best interest of the landlord, who will be the seller when the issue arises.

If the sale closes very late in the year (say, December), a buyer might seek to have the seller retain full responsibility for escalation charges. Thus,

the buyer would seek to limit the operating expense apportionment to just the portion not covered by escalation charges (not as simple a concept as it sounds, as the escalation chargeable under each lease may vary) and leave the seller with the benefit of all escalation rent and the burden of all other operating expenses. This may, of course, leave the seller with a long tail obligation, as the seller would not be fully relieved of liability to the buyer until the period of challenge under each lease had run or the seller had otherwise settled with each tenant. Moreover, the buyer is only contractually relieved of liability as between it and the seller. A tenant that was not satisfied by the seller could assert its claim against the buyer, which is, as discussed above, the landlord when the claim becomes choate.

If the purchase closes early enough in the year, the buyer has an opportunity to review carefully the operating expenses it is actually incurring and, if appropriate, make adjustments to the estimated escalation charges to the tenants. Such adjustments could reduce the risk of overbillings that might be challenged by the tenants and that might not have been correctly apportioned with the seller. However, many times the escalation challenge by a tenant does not solely relate to overbilling of an expense but rather to a different interpretation of a particular provision of the escalation clause of its lease. Those instances are harder to catch and correct.

As a practical matter, the buyer should carefully review prior recent escalation statements and tenant claims in respect thereof and compare such escalation statements with the escalation statement for the current Operating Year.⁹ By focused due diligence on this issue, the buyer may be able to determine to some degree the likely extent of successful challenges by the tenants for escalation charges in respect of the year of sale. If there is a discernable risk, that risk can be addressed more specifically in the negotiations with the seller.

NOTES

¹ Real estate ad valorem taxes and similar taxes are not included in this discussion, though under certain circumstances they might raise similar issues.

² For leases that have a so-called “gross” rent, such charges are based upon increases in operating costs over a base amount. For leases that have a so-called “net” rent, the charges are based upon the full operating costs and thus are often called “pass-thru” charges. For convenience all such charges are referred to as escalation charges.

³ For example the newly issued form of Office Lease prepared by The Committee on Real Property of the Association of the Bar of the City of New York (the “Office Lease Form”) provides in Section 7.2: “If Expenses for any calendar year . . . exceeds Expenses for the Expense Base Year, Tenant shall pay to Landlord Tenant’s Expense Payment within 15 days following Tenant’s receipt of the Expense Statement for that calendar year.”

⁴ The Office Lease Form further provides in Section 7.2: “Landlord shall, within 120 days following the end of each calendar year, deliver to Tenant an Expense Statement for that calendar year.”

⁵ The Office Lease Form provides in Section 7.5: “An Expense Statement shall be binding and conclusive on Tenant unless Tenant, within 180 days following Tenant’s receipt of that Expense Statement gives notice to Landlord disputing its accuracy. . . .”

⁶ The Office Lease Form provides in Section 23.5: “In the event of a transfer. . . of the Building (a) the transferor. . . shall be. . . relieved of all obligations and liabilities of Landlord under this lease accruing after the effective date of the transfer”

⁷ At common law a seller’s obligations under a contract of sale merged into the deed, so, absent fraud, there were essentially no post-closing liabilities to the buyer. Parties are able to, and typically do, contract around this limitation. The scope of these provisions varies, with perhaps the principal point of contention being whether the floor and ceiling apply just to claims arising from breaches of representations and warranties or apply more broadly to breaches of covenants and to post-closing financial adjustments. For purposes of this discussion, a broad floor and ceiling limitation is assumed.

⁸ The buyer generally obtains some credit assurance (a deposit, letter of credit or guarantee) to cover the claims up to the ceiling.

⁹ The buyer should also carefully review the escalation provisions of the leases, including the time periods for tenant challenges and whether tenants may use contingent fee arrangements with professionals it may select to review the landlord’s escalation statements, as such arrangements seem to increase the risk of aggressive challenges.