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PURCHASE AND SALE AGREEMENTS IN TROUBLED ECONOMIC TIMES

REPRESENTATIONS AND WARRANTIES IN PURCHASE AND SALE AGREEMENTS

The issue of representations and warranties is often one of the most hotly negotiated in purchase and sale agreements for real estate in general and shopping centers in particular. The objectives of the parties are totally at variance. The focus of this presentation is on the seller's representations and warranties. The cautious buyer will, nevertheless, seek a set of representations and warranties as comprehensive as it can obtain. These negotiations should not be deemed an academic exercise.

REPRESENTATIONS & WARRANTIES

A. Identity of Maker and Scope of Knowledge

A threshold issue is the identity of the person making the representations and warranties. The seller's orientation is to have any representations and warranties made by the smallest number of people, one if possible. The buyer wants the representations and warranties to come from the seller itself so it includes the actual and constructive knowledge of any and all of seller's personnel. The usual resolution is a compromise that limits the maker to the people most closely involved with the operation of the property.

B. General Subject Matter

Ordinarily, a seller will be amenable to making representations and warranties regarding its organization, good standing and authorization to enter into the transaction.

i. Outstanding Contracts.
The custom is to attach a schedule of existing contracts to the purchase agreement. The seller then warrants that there are no others and that the seller is not in default. Note that this representation is limited to the knowledge of the seller.

ii. Leases/Tenants/Rent Roll.
A rent roll is ordinarily attached as a Schedule to the contract of sale. The seller will ordinarily represent that it properly identifies each existing lease and tenant and that the tenants are not in default except as may be disclosed.

iii. Litigation.
The ordinary procedure is to attach a schedule of any pending legal matters to the contract of sale. In Transaction 1, the seller represented that there was no pending action or to its knowledge threatened action except as disclosed and affecting the real property or relating to the ownership management or operation

thereof. However, there is a further representation that the seller had not received service of process claiming more than $10,000 in damages. Thus, presumably if lawsuits seeking less in damages had actually been served, the seller would not have been obligated to disclose it.

iv. Compliance with Laws.

Buyers seek a representation and warranty that the property is full compliance with all laws. Often, however, the seller insists on limiting its representation to the fact that it has not received any notice or allegation that there have been any such violations.

v. Environmental.

It is almost a universal custom for the buyer to obtain at least a Phase 1 environmental study as part of its due diligence. However, the complexity of environmental issues and the potential exposure are such that buyers uniformly seek some additional comfort from the seller. In Transaction 1, specific reference is made to the environmental reports previously obtained (presumably when the seller acquired the property) as well as to environmental reports obtained by the buyer in connection with the transaction. The representations and warranties exclude any matters disclosed in such reports. The seller was required to represent that to its knowledge, it had not generated or handled hazardous materials and has no knowledge of any such materials being on the property and has not released any such materials into the environment. The seller was also required to represent that it had not received any communication from any environmental enforcement agency.

INDEMNIFICATION/LIABILITY FOR BREACH

The subject of who is responsible for a breach, to what extent, and for how long is ordinarily a hotly contested subject. In such cases, indemnification is essentially a mechanism for loss shifting and allocation of defense obligations between the parties. A buyer will seek to contractually impose financial responsibility upon the seller for any breach of the seller's representations, warranties, and covenants set forth in a purchase agreement, along with other specifically delineated responsibilities. Concomitantly, a seller will seek to limit its obligations pertaining to indemnification under a purchase agreement.

A. Limitations

i. Caps

When establishing indemnification provisions, a cap is often set on the total actual dollar amount of seller's liability (generally, a percentage of the purchase price). There is sometimes a general cap on maximum liability limits and then different caps are applied to different types of claims. One aspect of the debate that

	may arise is the determination of what is "customary" in the market for the particular sale of property. **ii. Baskets** Another heavily negotiated area involving limitations is that of "baskets." Baskets set a threshold level of damages that must be met before a seller is required to indemnify a buyer for breach. There are three general types of baskets: **a. Deductible --** where the seller is not required to indemnify the buyer for any losses until the aggregate amount of losses exceeds a certain amount (the deductible), at which point the seller will only be responsible for losses exceeding the deductible; **b. First Dollar** – where the seller is not required to indemnify the buyer for any losses until the aggregate amount of losses exceeds a certain threshold amount, at which point the seller will be responsible for the aggregate amount of all losses; and **c. Combination** – where the seller is not required to indemnify the buyer for any losses until the aggregate amount of losses exceeds a certain threshold amount, at which point the seller will only be responsible for losses exceeding a set deductible amount. **iii. Additional Considerations** The seller should also attempt to limit indemnification for the buyer's consequential or liquidated damages and should request a reduction in any claim for insurance proceeds the buyer receives that are related to a claim and for any tax benefit received by the buyer. **B. Manner of Securing Obligations** It is imperative to take the financial strength of the indemnifying party into consideration when evaluating the manner in which the seller's indemnification obligations will be secured. It is up to the buyer to conduct thorough due diligence of the seller's financial viability when evaluating the transaction. That being said, a wise indemnified party will not just rely upon the indemnifying party's financial wherewithal, but will generally adopt more secure methods of securing indemnification obligations from indemnifying parties. These considerations are of particular importance when the property being transferred is the seller's sole asset. Once the proceeds of sale have been disbursed to seller's owners, it will be almost impossible for the buyer to find assets to satisfy any post closing seller liability. Thus, the negotiation of indemnification obligations inevitably leads to a determination of the manner in which such obligations are secured.

	Obligations can be secured in various ways: **i. Escrow/Holdback** Maintaining a portion of the purchase price in an escrow account with a third party or holding the funds until certain conditions are not met or time periods are reached can help a buyer ensure that funds are available, should indemnification be necessary. **ii. Letters of Credit** Often a seller will attempt to negotiate for a letter of credit to secure its indemnification obligations. Sellers prefer letters of credit because the seller will not have to sacrifice the corresponding portion of the purchase price, and will, as a result, have that cash available for other purposes. Letters of credit also can be beneficial to buyers, in that a letter of credit may secure the indemnifying party's obligations by placing the risk on a depository institution, rather than on the indemnifying party itself. Reliance on letters of credit, however, is not entirely devoid of risk – a letter of credit is likely only good if the institution that issues it is solvent when the letter is called upon. First and foremost, it must be recognized that letters of credit (whether backed by a contingent obligation to the issuer or by cash collateral) are not generally covered by FDIC deposit insurance. It is well established that a standby letter of credit backed by a contingent promissory note is not an insured deposit. Second, should a bank-issuer of a letter of credit fail, the beneficiary may find itself in a precarious position with regard to the collectability of its security deposit. Typically, the FDIC is appointed receiver of an insolvent bank. Under such circumstances, it is the FDIC's position that, as of the date it enters into receivership, as long as no default has occurred under the letter of credit and the beneficiary has not yet made presentment to the issuer for payment, the obligation under the letter of credit is contingent in nature and may, therefore, be repudiated as a burdensome contract. Because of the aforementioned reasons, it is important for any indemnified party to carefully monitor the stability and solvency of any proposed issuer of a letter of credit. An indemnified party should also require the following provisions in the purchase agreement to protect its interests with regard to any letter of credit obtained by the indemnifying party to secure its indemnification obligations: • Establishing a solvency and ratings requirement for issuers of letters of credit; • Providing that, upon any change in an issuer's

solvency or downgrade below the required rating, an issued letter of credit must be substituted or replaced by an equivalent letter of credit issued by an institution meeting the stated requirements;

- Providing that, should the indemnifying party fail to replace the letter of credit with an equivalent letter of credit from a creditworthy issuer within a specified time period, then such action should be considered an event of default and the indemnified party should be permitted to draw on the original letter of credit;

- The "right to draw" provision should also apply if a letter of credit is due to expire and has not been renewed or replaced within a similar specified time period; and

- Finally, the purchase agreement should be drafted so that the indemnified party may take immediate and decisive action should the issuer fail to meet the stated standards. In the instance that an issuing institution fails, the ability of the indemnified to draw upon the letter of credit prior to an issuer entering into receivership with the FDIC is of utmost importance.

WHAT'S NOT IN THE CONTRACT – GOOD FAITH AND FAIR DEALING

In contrast to the topics discussed above (i.e., representations, warranties and indemnification rights), the concept of good faith and fair dealing is seldom contemplated by the parties before entering into an agreement for the purchase and sale of real property. Most overlook the possibility that the duty could give rise to contractual obligations even before the execution of a final agreement or otherwise underestimate its scope. Given today's climate of economic uncertainty, the doctrine of good faith and fair dealing becomes increasingly relevant. In such times, parties often resort to litigation to enforce a good deal, break a bad deal or interpret an ambiguous deal. The concept is amorphous and, consequently, quite unpredictable. Often, the implied covenant becomes an offensive, defensive or interpretive (gap-filling) tool used by parties and courts to achieve their respective purposes.

We will first address the manner in which lawmakers and courts have defined (or more accurately, failed to define) the duty of good faith and fair dealing. Next, the focus will be on the role of the duty of good faith and fair dealing in the context of the purchase and sale of real property. Finally, we will explore other discrete issues raised by the duty, such as the ability to disclaim the duty and the remedies available in the event of a breach.

A. The Applicability of the Concept of Good Faith and Fair Dealing and Its "Definition."

The duty of good faith and fair dealing has become a widely accepted principle. Indeed, the duty is imposed in all contracts falling within the ambit of the Uniform Commercial Code ("UCC"), where the doctrine first emerged. Since then, the doctrine has been adopted by the Restatement of Contracts and the majority of jurisdictions. There are, however, a few notable exceptions, where the doctrine is either not recognized or only recognized in a limited form.

Notwithstanding its pervasiveness, to date, the concept of good faith and fair dealing has escaped a fixed (and workable) definition. The definition varies from legal source to legal source and from jurisdiction to jurisdiction. The first iteration appeared in the UCC. UCC § 1- 304 imposes the obligation, stating that "[e]very contract or duty within [the UCC] imposes an obligation of good faith in its performance or enforcement." "Good faith" is only defined as "honesty in fact in the conduct or transaction concerned." UCC § 1-201(19).

The Restatement (Second) of Contracts makes no meaningful attempt to further define the concept. Like the UCC, the Restatement "imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."

Many judicial attempts at interpreting the doctrine have also emphasized notions of fulfilling an agreed upon purpose and satisfying the justified expectations of the parties. The duty has been defined by courts by focusing on the other party's right to receive the benefit of the bargain. Viewed through this lens, the duty imposes an obligation on the parties to refrain from intentionally or purposefully doing anything to frustrate or injure the other party's right to receive the fruits of the contract.

B. Considerations in the Purchase and Sale Context.

i. Triggering the Duty of Good Faith and Fair Dealing.

The ordinary purchase and sale transaction involves extensive negotiations before the consummation of what the parties intend to be a final agreement. In this context, the duty of good faith and fair dealing can become a trap for the unwary. Even at the infant stages of contract formation, parties can potentially and unknowingly subject themselves to the obligations imposed by the duty of good faith and fair dealing, such as negotiating in good faith to reach a final agreement.

Particularly problematic are interim documents, executed by the parties, such as letters of intent, memoranda of understanding, term sheets and agreements in principle. Depending on the language used in these agreements, courts can, and have, imposed liability under these documents. Unless carefully and unambiguously drafted, the duty of good faith and fair dealing can transform interim documents into legally binding agreements to negotiate in good faith to reach a final agreement.

To avoid this problem, an interim document should contain more than a statement that it is not intended to be a binding agreement. The document should include express language that it will not bind the parties to further negotiations and that parties may unilaterally terminate negotiations at any time.

ii. Between the Execution of the Purchase Agreement and Closing: Contingencies.

The duty of good faith and fair dealing is also applicable to the period after the execution of the purchase and sale agreement but before the closing. In many instances, the contractual obligations of the parties are subject to the satisfaction of conditions identified and negotiated by the parties. The parties are required to take certain steps to satisfy these conditions. During this period, the parties must be mindful of the standards imposed by the duty of good faith and fair dealing.

In this context, the duty of good faith and fair dealing requires that the parties refrain from any actions that could be construed as frustrating the other party's fulfillment of the relevant condition. Unless the parties' responsibilities in fulfilling the contingencies are clearly set forth, the duty of good faith and fair dealing could trap the buyer and seller into obligations that were not originally contemplated when the condition was considered.

Where conditions precedent are implicated, buyers and sellers should be careful to state explicitly how and when the duty is triggered. Failure to do so could lead to an unintentional breach of the duty of good faith and fair dealing leading to contract damages, specific performance, or, in the case of Huber, rescission. 949 P.2d at 797-98.

iii. The Interplay Between the Duty of Good Faith and Fair Dealing and Other Contractual Protections

Finally, the duty of good faith and fair dealing often intersects with other contractual obligations such as warranties, representations and indemnification obligations. These situations can also implicate another real property principle, caveat emptor. Despite its general abrogation in the context of residential property, the doctrine of caveat emptor often persists in the commercial context.

Of course, savvy buyers and sellers, which are often found in commercial transactions, contract for potential remedies with respect to disclosures, such as warranties and indemnification obligations16, largely eroding the principle of caveat emptor. However, the duty of good faith and fair dealing, where applicable, might revive the doctrine by providing an additional contractual remedy, which is often coupled with tort claims such as misrepresentation and fraud.

C. Other General Characteristics of the Duty of Good Faith and Fair Dealing.

The duty of good faith and fair dealing has been described as "implied" or "constructive." As a general rule, the obligations imposed by the duty cannot be contractually disclaimed by the parties. This is true even in the face of an express contractual provision evidencing a clear intention to disclaim all express and implied warranties generally or the covenant of good faith and fair dealing specifically.

The duty of good faith and fair dealing is an implied contractual obligation. Therefore, it should come as no surprise that the damages available for the breach of the duty of good faith and fair dealing are those normally available for any other breach. Like other contract actions, the appropriate remedy depends on the circumstances. A non-breaching party can recover typical breach of contract damages. In the purchase and sale context involving real property, specific performance is often a potential remedy.

D. Conclusion

The implied covenant of faith and fair dealing is pervasive. Nearly every jurisdiction recognizes some form of the implied covenant and iterations of the doctrine can also be found in major statutory schemes (such as the UCC) and influential pronouncements of law (such as the Restatement). Furthermore, it is well settled that the doctrine is applicable to every contractual provision and cannot be disclaimed. Notwithstanding its ubiquity, parties often fail to consider the implications of the doctrine. Given the covenant's pervasiveness and impermeability, spotting potential issues becomes critical. These characteristics, coupled with its definitional uncertainty, often create a course that is difficult to predict and negotiate.

In the context of the purchase and sale of commercial property, the duty can give rise to contractual obligations that are not contemplated by the parties when the deal is made. Because of the prevalence of the practice of entering into preliminary or interim understandings, it is important to be mindful of the obligation to negotiate in good faith, which obligation can arise even before the parties intend to form a binding agreement. Such liabilities are often predicated on the duty of good faith and fair dealing. Once a contract is formed, other considerations arise from common practices in purchase and sale agreements. The faithful performance of contingencies should be considered before attempting to enforce or "walk away" from a deal based on the failure to satisfy the contingency. Finally, the covenant of good faith and fair dealing is often coupled with other principles relevant in the context of purchase and sales agreements. In light of these issues, consideration of the doctrine should be given by all parties throughout the entire process of purchasing and selling commercial property.