

# Purchase and Sale Agreement Representations: Who Bears the Risk of Change?

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**One concept that has broad implications in a purchase and sale transaction is to what extent a particular representation made upon execution of the purchase and sale agreement needs to similarly be accurate at the closing as a condition precedent to buyer's obligation to consummate closing. This concept largely rests upon the fundamental question of who should bear the risk of a change in circumstances or facts occurring after the execution of the purchase and sale agreement — seller or buyer? The author of this article addresses the question.**

It is customarily the case that the representations and warranties made by a seller in a real estate purchase and sale agreement are often the source of extensive negotiation and attention between the seller and the buyer. The veracity of these representations and warranties are intended to largely serve two legal purposes. First, the untruth of a particular representation that arises between the execution of the purchase and sale agreement and the closing may result in the failure to be satisfied of a condition precedent to closing and thus give rise to a buyer's right to elect not to consummate the transaction. Often, the parties will provide in the purchase and sale agreement that such right will only arise in the event of a "material" breach of a representation - which may be defined by a monetary threshold associated with the applicable breach and may be

determined on an individual or aggregate basis. Second, the breach of a representation which is discovered after closing may give rise to a post-closing claim by the buyer against the seller for damages.

## Pre-closing and Post-closing Breaches

Due to the consequences associated with pre-closing and post-closing breaches of a seller's representation, the extent of seller's representations and the circumstances in which a buyer may assert pre-closing or post-closing remedies are invariably the topic of extensive discussions during the on-going course of negotiations. This is compounded by the basic premise that the representations and warranties are one of the few provisions which the parties will agree will "survive closing," thus ex-

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posing the seller to post-closing liabilities and allowing for post-closing recoveries for a buyer in the event of a breach.

A buyer's ability to assert, after closing, a claim against a seller for a breach of a seller representation is customarily negotiated to be qualified by a survival deadline (i.e. a deadline for the buyer to assert such breach), limitations and thresholds for minimum recovery (i.e. the "floor") and maximum recovery (i.e. the "cap"), as well as the requirement that the buyer lacked "knowledge" of the underlying breach prior to closing. This "knowledge" requirement is often referred to as the "anti-sandbagging" provision. This nomenclature is derived from the premise that if a buyer obtains knowledge prior to closing of a breach of a seller's representation, then the buyer should be compelled to exercise its pre-closing remedies rather than "sandbag" the seller with a claim for damages after closing. The concept primarily benefits a seller and often results in a buyer's sole remedy, for such a breach, being either to waive the applicable breach and consummate closing or to elect not to close the transaction and to receive a refund of its contract deposit. A highly negotiated point will likely be whether buyer's "knowledge" of such a breach is based upon the buyer's actual knowledge, some form of imputed knowledge or, in some cases, based upon a more precisely defined concept of "knowledge" (e.g. the buyer is charged with the knowledge of anything contained in certain specified diligence materials made available to the buyer prior to closing).

### **Who Should Bear the Risk of Change?**

One particular concept that has broad implications in a purchase and sale transaction, is to what extent a particular representation made upon execution of the purchase and sale agree-

ment needs to similarly be accurate at the closing as a condition precedent to buyer's obligation to consummate closing. This concept largely rests upon the fundamental question of who should bear the risk of a change in circumstances or facts occurring after the execution of the purchase and sale agreement—seller or buyer?

The representations set forth in a customary real estate purchase and sale agreement can generally be bifurcated into two broad groups—entity-level representations and property-level representations. Entity-level representations are generally found in most contracts — real estate and otherwise. These include customary representations governing such matters as due formation, authorization, no conflict, litigation, Patriot Act compliance, bankruptcy/insolvency, ERISA and brokerage matters. The nature and import of these representations often result in sellers and buyers agreeing that such representations must be accurate both upon execution of the purchase and sale agreement and at the closing.

The issue becomes apparent with respect to property-level representations, since by the very nature of these representations a change in facts and circumstances may likely arise between execution of the purchase and sale agreement and closing and thus begs the question as to what extent a change should give rise to any remedy or relief available to a buyer. For example, with respect to a seller representation that no lease default exists, how should the purchase and sale agreement address the situation where a lease default arises prior to closing? In many instances, it is prudent to scrutinize each of these property-level representations on a case-by-case basis to determine who should bear the risk of a potential change. Tak-

ing the example of a lease default, the parties may agree that seller's representation regarding tenant lease defaults needs to only be accurate as of the date of execution of the purchase and sale agreement while seller's representation regarding landlord lease defaults must also be accurate as of the closing date. This rationale is founded upon the premise that a landlord lease default is largely a condition that is within a landlord's control, and thus, seller should bear the risk of a change.

In certain unique instances, the existence of a tenant lease default (or another particular representation) may have profound implications on the real estate that may engender a buyer insisting that seller bear the risk of a tenant default occurring prior to closing. With respect to tenant leasing matters, this is generally the case with respect to a master lease, ground lease or other leases deemed material and fundamental to the transaction, including with respect to one or more major tenants. Nonetheless, a seller needs to remain acutely sensitive to the ramifications of assuming the risk that a tenant lease default gives rise to the buyer's right to elect not to consummate the transaction.

It is important to be cognizant, even if the parties agree that a particular seller representation need only be accurate as of the date of execution of the purchase and sale agreement, that a sophisticated buyer will still require that the seller inform the buyer at closing whether or not the facts underlying such representations have changed. For example, the purchase and sale agreement may contain a representation as to a rent arrearage schedule that is

required to only be accurate as of the date of execution of the purchase and sale agreement. However, it will be important to the buyer to know what the existing arrearages are as of the closing date, recognizing that changes occurring in the arrearages schedule will not give rise to buyer's right to allege the failure of a condition precedent.

The determination of who should bear the risk of a change in facts underlying a particular seller representation often hinges upon whether or not the seller has control over the underlying condition or if the importance of the underlying condition is fundamental to the buyer's decision to purchase the real estate. To the extent that a seller has the ability to impact and control the matter, the buyer will likely insist that the seller bear the risk of any change occurring prior to closing. Similarly, the existence or non-existence of a particular condition may be fundamental to the transaction—for example, a buyer which is acquiring real estate for redevelopment purposes would not want to take the risk of an adverse zoning or land use matter that arises prior to closing.

### **Conclusion**

The ultimate scope and extent of seller's representations, the limitations on a buyer's ability to exercise a remedy under the purchase and sale agreement and the risk of a change in facts blend important legal and business considerations that should be given careful thought and discussion. In many respects, the negotiated outcome of these concepts and the related provisions contained in the purchase and sale agreement should be of paramount import to both a seller and a buyer.