Use of Special Covenants, Representations, Warranties & Indemnification Provisions in Commercial Real Estate Agreements

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USE OF SPECIAL COVENANTS, REPRESENTATIONS, WARRANTIES AND INDEMNIFICATION PROVISIONS IN COMMERCIAL REAL ESTATE AGREEMENTS

I. INTRODUCTION

The purpose of this presentation is to briefly discuss the use of special covenants, representations, warranties and indemnifications in a typical commercial real estate purchase agreement. Sometimes these provisions are appropriate; sometimes they are not. Buyers and Sellers can easily confuse special covenants, representations, warranties and indemnification provisions; consequently, they are misused. The use of these provisions should be tailored to fit the transaction:

A. Undeveloped land;

B. Income producing property such as apartment buildings or shopping centers;

C. Improved property that is used in connection with a business such as a manufacturing or distribution center;

D. Property with existing improvements that will be rehabilitated for another purpose.

Each raises unique concerns and a "boilerplate" set of provisions will not always work.

II. SPECIAL COVENANTS

A. General - The entire purchase agreement is a covenant made by and between the parties. A covenant has been defined as follows:

> An agreement or promise of two or more parties that something is done, will be done, or will not be done. Shafer v. Board of Trustees of Sandy Hook Yacht Club Estates, Inc., 76 Wash. App. 267, 274, 883 P.2d 1387, 1392 (Wash. App. 1994).

B. "Special" covenants are included in the purchase agreement to address concerns of a party related to a particular transaction - Examples:

1. Seller's obligation to produce certain documentation prior to closing;
2. Seller's obligation to obtain a "no action" letter from the MPCA; or
3. Buyer's obligation to use its "best efforts" to obtain financing or re-zoning.

C. Remedies for Pre-Closing Breach of a Covenant

1. Seller breach:

a. Termination and earnest money returned;

b. Buyer's right to cure and deduct;

c. If appropriate, damages;

d. Specific performance; and

e. Delay closing if necessary.

2. Buyer breach:

a. If the breach is **failure to close**, (i) terminate and retain earnest money as liquidated damages - It is important that the Buyer be required to put up substantial earnest money to make this remedy effective, or (ii) **as an alternative**, in the right situation, specific performance; the right to seek specific performance against a nonperforming Buyer can be a hollow right unless the Buyer is a solvent.

b. **In addition to Section 2a above**, retain right to claim damages for breach of special covenant. Example - Buyer causes damage during physical inspection, Buyer does not close, but Buyer has caused damage to property. Seller should have right to recover damages for breach of special covenant in addition to retaining the earnest money.

D. Remedies for Post-Closing Breach of Covenant - Avoid any post-closing covenants if possible.

1. Damages;

2. If Seller obligation - The best protection for Buyer is to have part of the purchase price escrowed until Seller performs;

3. If Buyer obligation - Quantify the obligation, if possible, and try to get funds escrowed.

III. REPRESENTATIONS

A. Background. Why give any? Is there a duty to disclose? Is it wise to make representations?

1. Doctrine of Caveat Emptor

"Doctrine of caveat emptor" states that where parties deal at arm's length, and each exercises or relies on his own judgment, Buyer, having opportunity to do so, ought to inspect thing bought and learn whatever a fair examination will disclose and, if he neglects to avail himself of his opportunity and right to inspect, or if he makes an inspection but fails to note discoverable defects, he buys at his own risk, unless he exacts a warranty or can show fraud on part of Seller. Permian Bldg., Inc. v. Greenblatt, 442 S.W.2d 831, 835 (Tex. Civ. App. 1969).

2. Minnesota Case Law Concerning Representations

a. What is actionable?

(1) Fraudulent and negligent misrepresentation. In Minnesota, "an actionable misrepresentation requires proof either that the misrepresenter acted dishonestly or in bad faith, i.e. with fraudulent intent, or, alternatively, that the misrepresenter was negligent." Florenzano v. Olson, 387 N.W.2d 168, 173 (Minn. 1986)

(a) According to Florenzano, to recover in an action for fraudulent misrepresentation (paralleling Restatement (Second) of Torts § 526 (1977)), the misrepresenter must either know or believe the matter not to be as represented or be conscious of ignorance of truth, or realize that the information relied upon by the misrepresentee is not dependable. Id.

(b) By contrast, the Florenzano court stated that to prevail in an action for negligent misrepresentation, the misrepresentee must prove that the misrepresenter failed to discover or communicate certain information that an ordinary person in his position would have discovered or communicated. Id.

Under neither theory, however, is one held to warrant the truth of all statements made. A good faith, non-negligent mistake is not the basis of liability for misrepresentation in this state.

(2) Failure to Disclose. An actionable misrepresentation can include a failure to disclose, but **in Minnesota, the general rule is that one party to a transaction has no duty to disclose material facts to the other.** Hommerding v. Peterson, 376 N.W.2d 456, 459 (Minn. Ct. App. 1985). However, special circumstances may dictate otherwise. For example:

(a) One who speaks must say enough to prevent his words from misleading the other party. Id. (citing Newell v. Randall, 32 Minn. 171, 19 N.W. 972 (1884)).

(b) One who has special knowledge of material facts to which the other party does not have access may have a duty to disclose these facts to the other party. Id. (citing Marsh v. Webber, 13 Minn. 96, 109 (1868)).

(c) One who stands in a confidential or fiduciary relation to the other party to a transaction must disclose material facts. Id. (citing Wells-Dickey Trust Co. v. Lien, 164 Minn. 307, 204 N.W. 950 (1925); Klein v. First Edina Nat'l Bank, 293 Minn. 418, 421, 196 N.W.2d 619, 622 (1972) and Target Stores, Inc. v. Twin City Plaza Co., 277 Minn. 481, 498-99, 153 N.W.2d 832, 844 (1967)).

The Hommerding case involved the sufficiency of a water supply to residential property. In Hommerding, the court recognized that a Seller could have a duty to disclose latent or "hidden" defects (see, e.g., Restatement (Second) of Torts §551, cmt. 1, illus. 9 (1977)), but the court held that none of the above-referenced exceptions to the general rule applied. The Hommerding court held that the sufficiency of a water supply in a well is the kind of fact "open to discovery upon reasonable inquiry by the vendee." Id.

(3) Summary. In Minnesota, a Seller has no duty to make any representation or disclosures unless one of the exceptions referenced in Hommerding applies or if a statute obligates a Seller to make certain

disclosures or representations. If a Seller elects to make a representation that the Seller is under no duty to make, the Seller opens itself to liability for fraudulent or negligent misrepresentation under Florenzano.

b. What are the remedies for misrepresentation:

(1) If there is a misrepresentation, a purchase agreement can be rescinded. See, e.g. Brink v. Larson, 411 N.W.2d 585, 587 (Minn. Ct. App. 1987).

or

(2) Damages - but note the measure of damages can cause problems.

(a) The general measure of damages for misrepresentation is **"out of pocket" loss, i.e., the amount paid less the fair market value of the property received.** Lobe Enterprises v. Griffin Cos., Inc., 360 N.W.2d 371 (Minn. Ct. App. 1985). In Lobe, the Buyer of an apartment building brought an action for damages against the Seller, alleging the Seller misrepresented the age of the roof. The trial court held that the Seller had negligently misrepresented the age of the roof but that the Buyer was **not** entitled to damages because it failed to show the value of the building without the new roof, an essential element to recover damages under the "out of pocket" rule. The Buyer offered evidence that to repair the roof would cost approximately $5,000 and simply subtracted the cost of repair from the purchase price. However, the trial court ruled, and the appellate court affirmed, that proof as to the cost of repairs did not establish the market value of the property received. **"Repair costs do not accurately reflect [the] loss proximately arising from the misrepresentation."** Id. at 373.

(b) Another example of the "out of pocket" measure of damages is illustrated in the

unreported case of Hart v. Coldwell Banker Northwoods Realty, No. C9-97-1835, 1998 WL 313586 (Minn. Ct. App. 1998). In Hart, the Buyer of a home brought an action against the Seller alleging misrepresentation relating to the age of the home and the condition of various building systems. The trial court found for the Buyer and the jury awarded the Buyer $36,000 in damages. The jury's damage award was based on evidence presented by a real estate appraiser who arrived at the measure of damages by determining the costs to repair or replace the misrepresented systems. The Minnesota Court of Appeals, relying on Lobe, reversed and remanded the decision relating to the measure of damages to the trial court, because the evidence relating to the repair and replacement value was erroneously submitted to the jury for consideration. **"There was no showing that the property was not worth the purchase price even with the misrepresentations."** Id. at *2.

(c) Occasionally, the Minnesota courts over the years have deviated from the general rule, which has led to some confusion in the area of damages. For example, in Marion v. Miller, 237 Minn. 306, 55 N.W.2d 52 (Minn. 1952), the Minnesota Supreme Court reiterated the general rule; however, because neither party objected to jury instructions setting forth a different measure of damages–the "benefit of the bargain" rule–the alternative measure of damages became the "law of the case." Marion, 237 Minn. at 309, 55 N.W.2d at 55.

3. Statutory Concerns. In some circumstances Sellers are **required by statute** to make certain disclosures in a purchase agreement. Examples are as follows:

   a. If the property is subject to "extensive" hazardous substance contamination, the owner must file an affidavit in the county land records **before** a transfer. Minn. Stat. §115B.16, subd. 2 (1996);

b. Owner must file an affidavit in the county land records disclosing the existence of storage tanks prior to conveyance. Minn. Stat. §116.48, subd. 6 (1996);

c. Owner must disclose the existence of wells on property in connection with executing a purchase agreement. Minn. Stat. §103I.235 (1996);

d. Owner must disclose certain information concerning individual septic systems on the property in connection with executing a purchase agreement. Minn. Stat. §115.55, subd. 6 (1996).

e. Owners and landlords must disclose whether "target housing," which includes apartment buildings, was built before 1978 and the presence of any known lead-based paint and lead-based paint hazards. 24 CFR Part 35 and 40 CFR Part 745; 61 Fed. Reg. 9,064 (1996).

f. New statutory **residential** disclosure requirements. (S.F. No. 2697, 3rd Engrossment, 2001-2002 Leg., 82nd Sess. (MN 2001-2002). The proposed coding for the new law is Chapter 513, Minnesota Statutes, effective January, 2003). Question: Will this sort of disclosure be required by statute in commercial transactions in the future?

B. Parties to a purchase agreement should approach written representations with great care. From a practical point of view, a representation should be a statement concerning a past or current fact. It should **not** be a prediction, a wish, a guess or a guaranty. A statement about some **future** event is probably a covenant or a warranty.

C. Seller Concerns. From the Seller's standpoint, representations should be limited to those matters that the Buyer could **not discover in the exercise of due diligence**. When determining whether to give a representation requested by a Buyer, the Seller should consider the following:

1. Is the requested representation within the knowledge of Seller?

2. Should the representation be limited to the knowledge of a particular employee or officer of Seller who has a duty or obligation to know?

3. How much time, effort and cost will be required to ascertain the accuracy of the representation?

4. Is the requested representation really a substitute for Buyer's due diligence?

5. Is the representation relevant to the transaction?

6. What is the effect of making an incorrect representation if discovered prior to closing?

7. Is the representation continuing until closing?

8. Does the representation survive closing and, if so, for how long?

9. What are the consequences if a representation that survives closing is proven to be incorrect at a later date?

10. Is the requested representation TRUE?

D. Buyer's interest in Seller representations. Representations are important to a Buyer because they provide a checklist for negotiations, they enable a Buyer to discover potential problems early before spending a lot of money and because Seller representations ease a Buyer's due diligence burdens. A Buyer is entitled to rely on a Seller's representation and may not have an obligation to determine the veracity of the representation. Nevertheless, when requesting representations from a Seller, a Buyer should consider the following:

1. What representations are actually relevant to the particular transaction. It is better to end up with a few good representations than many that have no value?

2. If the Seller is an entity and wants to limit the representations to the knowledge of a particular person, is it the right person?

3. If the representation is limited to "knowledge," is it "actual" knowledge or "constructive" knowledge?

4. Does the agreement give the Buyer an effective remedy if it is later determined that the representation is not correct?

5. Is the representation continuing through closing?

6. Does the representation survive closing and, if so, for how long?

E. Buyer representations are usually limited, but a Seller should consider the following:

1. Proper formation and legal existence of Buyer;

2. Authority of Buyer and individual executing agreement on behalf of Buyer;

3. Involvement of real estate broker or agent for Buyer; and

4. In certain instances, representation about current ability to obtain financing for the purchase if there is a financing contingency.

F. Proof Problems: To prove misrepresentation, the injured party must prove the following, among others:

1. Representation must be untrue at the time made;

2. Representation must be material; and

3. There must be reliance.

Davis v. Re-Trac Manufacturing Corp., 276 Minn. 116, 117, 149 N.W.2d 37, 39 (1967).

G. If party discovers representation is untrue prior to closing:

1. Termination;

2. Refund earnest money;

3. Sue for actual damages, as if a covenant breach.

IV. WARRANTIES

A. General. In addition to the warranties of title (which are not addressed in this presentation), purchase agreements can contain specific warranties. As a matter of fact, it is not uncommon to see language such as

> **Seller covenants, represents and warrants as follows:...**

The distinction between a representation and a warranty is **not** always clear as evidenced by a review of Minnesota cases, but it is clear that the party giving a warranty has increased its potential liability, eased the burden of the party claiming a breach, and affected the measure of damages. In the case of Walter Dawgie Ski Corp. v. United States, 30 Fed. Cl. 115, 126 (1993), a warranty is described as follows:

> A warranty is an assurance by one party to an agreement of the existence of a fact upon which the other party may rely; it is intended precisely to relieve the promisee of any duty to ascertain the facts for himself. Thus, a warranty amounts to a promise to indemnify the promisee for any loss if the fact warranted proves untrue.

B. By their nature, warranties generally do, and are intended to, survive closing and thus create residual liability for the party giving the warranty.

An example of the problem is presented in Parkside Mobile Estates v. Lee, 270 N.W.2d 758 (Minn. 1978). The relevant language in the purchase agreement stated:

> 4. Warranties by Seller - Seller hereby warrants as follows: The present operation of Parkside Mobile Estates upon the Subject Lands complies in every respect with all applicable zoning, building, licensing, health and subdivision laws, ordinances and regulations of the City of Rochester, County of Olmsted and State of Minnesota *** If Buyer notifies Seller in writing of any violations of any of the foregoing, prior to the date of closing, Seller shall take the necessary steps to bring the operation of said Parkside Mobile Estates into compliance with the foregoing. If Seller is unable to do so prior to the date of closing, this agreement shall be voidable at the option of Buyer.
>
> 10. Survival of Warranties - All covenants and warranties contained herein shall survive the closing of this transaction.

At trial the jury found that there had been a breach of these warranties by the Seller. In short, the drinking water was unsafe and the City of Rochester required that the Buyer of the mobile home park connect the park to the City water supply. This cost the Buyers approximately $20,000.00, but the jury awarded the Buyers damages of only $3,250.00. The trial court granted Buyers' motion for a new trial on damages and Seller appealed. The Supreme Court agreed that there had been a breach of warranty and affirmed the lower court's decision to grant Buyer's motion for a new trial on the issue of damages because the evidence at trial was insufficient as to the **amount** of damages. As to the measure of damages the court stated in a footnote:

> The trial court ruled that the proper measure of damages is "the cost of curing the defect in the water supply, or the expenses incurred in the hookup to the [municipal] water system. We concur. The cost to cure would not involve substantial economic waste so as to require damages to be measured by the diminution involved caused by the breach. Parkside Mobile Estates v. Lee, 270 N.W.2d 758, 762 (1978).

C. For an excellent discussion about the differences between a representation and a warranty review the case of Olson v. Kyllonen, No. C0-00-1623, 2001 WL 379045 (Minn. Ct. App. 2001) which is an unreported case. In Kyllonen the Court of Appeals reversed the trial court on the basis that the trial court had treated a representation as if it were a warranty. The language in the residential purchase agreement in question:

> Seller has/has not had a wet basement and has/has not had roof, wall or ceiling damage caused by water or ice buildup.

The Defendant Seller had circled "has not" as to whether there had been roof, wall or ceiling damage caused by water or ice buildup. The Plaintiff Buyers had the home inspected in January of 1999, but the inspector was unable to inspect the roof. The parties closed on March 22, 1999. In April 1999 after the snow and ice melted the plaintiff observed some roof problems. The estimate to replace the roof was $7,795. The Buyer sued the Seller in Conciliation Court and obtained a judgment for $7,530. The case was removed to District Court and the Judge in District Court, after taking testimony, found that there was roof damage and that the Seller had a duty to disclose the actual condition of the roof. There apparently was no finding as to the cause of the damage and there was no evidence as to the Seller's actual knowledge as to the condition of the roof. The Sellers appealed on the basis that the trial court erred in holding him liable for misrepresentation. The Court of Appeals went into an excellent and brief discussion of misrepresentation by deceit, reckless misrepresentation and negligent misrepresentation. The Court of Appeals decided that at best, the claim against the Seller would be for negligent misrepresentation. It further found that there was no evidence and no finding on the issue of whether the Seller exercised reasonable care. Therefore, the Court of Appeals found that the trial court's decision could not rest on negligent misrepresentation and concluded that what the trial court erroneously construed the statement at issue to be a warranty. Id. 1998 WL 379045 at 4. In other words, the trial court determined that the representation as to the roof constituted a warranty. The Court of Appeals concluded that the purchase agreement was clear that certain statements were representations and other statements were warranties. The statement as to roof was a representation and the evidence was not presented showing that the plaintiff had made out a case of misrepresentation.

V. INDEMNIFICATION

A. General. Sellers and Buyers sometimes "indemnify" each other. This is a natural result of purchase agreements containing special covenants, representations and warranties. The Minnesota Court of Appeals, in the case of Blomgren v. Marshall Management Services, 483 N.W.2d 504, 506 (Minn. Ct. App. 1992), describes indemnity as follows:

> Indemnity does not require common liability. Indemnity instead arises out of a contractual relationship, either express or implied by law, which "requires one party to reimburse the other entirely." Hendrickson, 258 Minn. 368, 371, 104 N.W.2d 843, 847. A claimant may recover indemnity:

(1) Where the one seeking indemnity has only a derivative or vicarious liability for damage caused by the one sought to be charged.

(2) Where the one seeking indemnity has incurred liability by action at the direction, in the interest of, and in reliance upon the one sought to be charged.

(3) Where the one seeking indemnity has incurred liability because of a breach of duty owed to him by the one sought to be charged.

* * * * *

(5) Where there is an express contract between the parties containing an explicit undertaking to reimburse for liability of the character involved.

Hendrickson, 258 Minn. at 372-73, 104 N.W.2d at 848; see also Tolbert, 255 N.W.2d at 366-368.

B. Indemnification provisions can cover two distinctly different concerns.

1. Third Party Claims. One party indemnifies the other as to claims made by third parties with the Seller generally indemnifying as to any claims that arise from events prior to closing and the Buyer generally indemnifying as to events that arise after closing.

2. Claims for Breaches of Covenants, Representations or Warranties. These usually relate to contract or tort claims that a party might have without specific indemnification language.

C. Survival. By its nature, an indemnification provision should survive closing. The discussions during negotiations should be about:

1. Length of time that the indemnification provision is in effect;

2. Whether there is a "de minimis" provision before the indemnification goes into effect;

3. Whether there is a maximum on any claim;

4. How the claim is made;

5. What are the obligations of the indemnifying party once a claim is made (payment of fees, etc.);

6. When does the legal action have to be commenced;