

# The Sliding Scale of Representations and Warranties — Negotiating Representations and Warranties when Buying or Selling a Business (or Real Property)

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- Representations: In an acquisition setting, generally a representation is a statement made from a one party to the other as to some fact or circumstance which is influential in inducing the closing of the agreement.
- For example, "Seller *represents* that the Financial Statements provided to Buyer are accurate and complete in all respects."

## What is a Representation?

- Warranties: In an acquisition setting, generally a warranty is a stipulation to a fact or set of facts related to the subject matter of the agreement *and an agreement to make the recipient of the warranty whole if those facts turn out to be untrue.*
- For example, “Seller *warrants* that seller has good and marketable title to the assets and that there are no liens encumbering those assets.”

## What is a warranty?

- The terms are often used together in an acquisition agreement.
- *“Seller represents and warrants to the Buyer that the following statements are true and correct as of the effective date hereof and will be true and correct as of the Closing Date . . . .”*
- The distinction is made irrelevant because the consequences of a misrepresentation or breach of a warranty are negotiated as exclusive remedies in the purchase agreement.

**In practice, the distinction between representations and warranties fades in an acquisition setting.**

# A Hypothetical Sale:

The sale of South Texas Services, from Sam Local ("Seller"), to Oleo National, the multinational from Brazil (the "Buyer").

- Local, single business Seller
- \$30,000,000.00 sale price
- Sale of Stock in South Texas Services, Inc.
- Highly capitalized, multinational Buyer in Oleo

- When representing a seller, we frequently tell our clients that our goal is to help them receive as much money as possible, and to make sure they don't ever have to give any of that money back—or to at least try to ensure they only have to give back as little money as possible.
- *Only represent or warrant things that the Buyer cannot determine or discover on their own through due diligence.*

## **Start strong: Negotiating Position when Representing a SELLER**

- Representations serve several purposes for a Buyer, including: (a) assisting the Buyer to better understand the business and assets it is purchasing; (b) establishing that certain facts are true and accurate as presented by Seller or discovered by Buyer during the due diligence process; (c) to protect the Buyer in allowing it to terminate the agreement in the event of a misrepresentation or breach of a warranty; and (d) to allow the Buyer recourse after closing.
- A Buyer is at a significant disadvantage to a Seller in knowing specifics about the business and assets to be purchased. Sellers are in the best position to be knowledgeable about certain matters and therefore bear the economic risk of such matters not being as they seem or are expected.

**Start strong: Negotiating Position  
when Representing a BUYER**

- There is no “norm,” but the Buyer traditionally desires to circulate the first draft of the acquisition agreement. This also allows the Buyer to establish the tone as to (a) expectations regarding the sophistication of the agreement, and (b) the measure of representations and warranties you expect from a seller.
- If Seller’s counsel initiates the first draft of the acquisition agreement, they will likely include only minimal representations and warranties and will have “anchored” the negotiation from that “low” place from a Buyer’s perspective.

**Which party commences the drafting?**

- Title to assets or property
- Authority and capitalization of entity
- Condition of assets or improvements
- Assignable contracts are in full force and effect
- Financial statements are true and correct
- Litigation
- Taxes
- Solvency
- Authority and capitalization of seller
- Litigation
- No environmental matters
- Leases are in full force and effect
- No condemnation

## **Common Representations in a Business or Real Property Acquisition**

## **BUYER'S INITIAL DRAFT:**

**When are the representations being made and tested? On the effective date? From time to time during the pendency of the agreement? Again at closing?**

**Representations and Warranties of Seller:** Except as expressly set forth otherwise herein, Seller represents and warrants to Buyer that as of the Effective date and through and on the Closing Date the following:

## BUYER'S INITIAL DRAFT

### DEAL IN "ABSOLUTES" (and Seller's beware of absolutes)!

**Contracts:** All Contracts to which Seller is a party are identified on Schedule 1.1 hereto. Except as expressly disclosed in Schedule 1.1, (i) no Contract has been breached by the other party . . . . (ii) Seller has performed all the obligations required to be performed by it under Contracts and is not in default . . . and no event or condition has occurred or arisen which with the passage of time or the giving of notice or both would result in a default . . . (iv) each Contract is legal, valid, binding, enforceable and in full force and effect and will continue as such following the consummation of the transactions contemplated hereby.

## BUYER'S DRAFT

**DEAL IN "ABSOLUTES" (and Seller's beware of absolutes)!**

**Condition of Real Property:** There are no defects in or unrepaired damage to the Property; all mechanical, electrical, plumbing, HVAC, elevator, access, security, fire protection, sanitary sewer, storm drainage and other systems and equipment serving Seller's Property are in good working order and condition; and the roof of the improvements is in sound condition without leaks or ponding.

## **BUYER'S INITIAL DRAFT:**

- **For what period after closing do the representations and warranties survive?**
- **Meaning, as the Buyer, how long do I have to sue the Seller?**
- **Meaning, as the Seller, how long do I have to look over my shoulder for a claim?**

*"All representations and warranties by Seller in this Agreement shall survive the closing of this transaction."*

## SELLER'S RESPONSE DRAFT

**When are the representations being made and tested? On the effective date? From time to time during the pendency of the agreement? Again at closing?**

**Representations and Warranties of Seller:** Except as expressly set forth otherwise herein, Seller represents and warrants to Buyer that as of the Effective date ~~and through and on the Closing Date~~hereof, the following:

# SELLER'S RESPONSE DRAFT

## MATERIALITY QUALIFIERS, MATERIAL ADVERSE EFFECT QUALIFIERS and KNOWLEDGE QUALIFIERS

“Material Contract,” means any Contracts (a) which involve any future payment or obligation to perform by Seller in excess of Fifty Thousand and No/100 Dollars (\$50,000) (unless such obligation may be avoided by cancellation or termination by Seller on less than sixty (60) days’ notice to the other party), (b) which involve any future payment to Seller in excess of Fifty Thousand and No/100 Dollars (\$50,000), or (c) for which the default thereunder by Seller would have a Material Adverse Effect on the business of Seller.

“Material Adverse Effect” means any state of facts, change, development, event, effect, circumstance, condition or occurrence that, individually or in the aggregate would have an adverse effect on the business, properties, assets liabilities, financial condition, or results of operations of Seller or its business and that would prevent or materially impair or delay the ability of Seller to perform its obligations hereunder.

“Seller’s Knowledge” means only to the actual knowledge, at the time in question, *without a duty to investigate*, of Sam Local the President of Seller.

# SELLER'S RESPONSE DRAFT

## MATERIALITY QUALIFIERS, MATERIAL ADVERSE EFFECT QUALIFIERS and KNOWLEDGE QUALIFIERS

**Contracts:** All Contracts to which Seller is a party are identified on Schedule 1.1 hereto. Except as ~~expressly~~ disclosed in Schedule 1.1, (i) ~~no contract~~ No Material Contract has, to Seller's Knowledge, been breached or canceled by the other party, and to Seller's Knowledge, there are no anticipated breaches by any other party ~~of~~ to any ~~such contract~~ Material Contract, (ii) Seller has performed all the obligations required to be performed by it under the Material Contracts, except to the extent the failure to perform such obligation will not have a Material Adverse Effect on the Business, and is not in default under or in breach of any Material Contract, and no event or condition has occurred or arisen which with the passage of time or the giving of notice or both would result in a default or breach thereunder, (iii) Seller has no present expectation or intention of not fully performing any obligation ~~pursuant to~~ under any Material Contract, and (iv) each Material Contract is ~~legal, valid,~~ binding, and enforceable and in full force and effect ~~and will continue as such following,~~ except to the ~~consummation of~~ extent the ~~transactions contemplated hereby~~ same is not binding and enforceable and in full force and effect only in part and the same shall not have a Material Adverse Effect on the business.

**Condition of Real Property:** ~~Intentionally deleted. There are no defects in or unrepaired damage to the Property; all mechanical, electrical, plumbing, HVAC, elevator, access, security, fire protection, sanitary sewer, storm drainage and other systems and equipment serving Seller's Property are in good working order and condition; and the roof of the improvements is in sound condition without leaks or ponding.~~

## **SELLER'S RESPONSE DRAFT**

- **For what period after closing do the representations and warranties survive?**
- **Meaning, as the Buyer, how long do I have to sue the Seller?**
- **Meaning, as the Seller, how long do I have to look over my shoulder for a claim?**

All representations and warranties by Seller in this Agreement shall survive the closing of this transaction for six (6) months only.

## **BUYER'S RESPONSE DRAFT:**

**When are the representations being made and tested? On the effective date? From time to time during the pendency of the agreement? Again at closing?**

**Representations and Warranties of Seller:** Except as expressly set forth otherwise herein, Seller represents and warrants to Buyer that as of the Effective date ~~hereof~~ and again on the Closing Date, the following:

# BUYER'S RESPONSE DRAFT:

## MATERIALITY QUALIFIERS, MATERIAL ADVERSE EFFECT QUALIFIERS and KNOWLEDGE QUALIFIERS

“Material Contract,” means any Contracts (a) which involve any future payment or obligation to perform by Seller in excess of ~~Fifty~~Five Thousand and No/100 Dollars (\$~~50~~5,000) (unless such obligation may be avoided by cancellation or termination by Seller on less than sixty (60) days’ notice to the other party), (b) which involve any future payment to Seller in excess of ~~Twenty~~Five Thousand and No/100 Dollars (\$~~50~~5,000), ~~or (c) for which the default thereunder by Seller would have a Material Adverse Effect on the business of Seller.~~

“Material Adverse Effect” means any state of facts, change, development, event, effect, circumstance, condition or occurrence that, individually or in the aggregate would have an adverse effect on the business, properties, assets liabilities, financial condition, or results of operations of Seller or its business and that would prevent or materially impair or delay the ability of Seller to perform its obligations hereunder; provided that the parties agree that any such result, consequence, condition or matter having a value or adverse impact in excess of Ten Thousand and No1/00 Dollars (\$10,000) shall be deemed to constitute a Material Adverse Effect.

“Seller’s Knowledge” means only to the actual knowledge, at the time in question, ~~without a~~with an affirmative duty to investigate; (which implies that the relevant parties are qualified to and have engaged in all investigation reasonably necessary to make any relevant representation or warranty). of Sam Local the President of Seller; and John Knowitall the Chief Operating Officer of Seller.

# BUYER'S RESPONSE DRAFT:

## MATERIALITY QUALIFIERS, MATERIAL ADVERSE EFFECT QUALIFIERS and KNOWLEDGE QUALIFIERS

**Contracts:** All Contracts to which Seller is a party are identified on Schedule 1.1 hereto. Except as disclosed in Schedule 1.1, (i) No Material Contract has, ~~to Seller's Knowledge~~, been breached or canceled by the other party, and to Seller's Knowledge, there are no anticipated breaches by any other party to any Material Contract, (ii) Seller has performed all the obligations required to be performed by it under the Material Contracts, ~~except to the extent the failure to perform such obligation will not have a Material Adverse Effect on the Business~~, and is not in default under or in breach of any Material Contract, and no event or condition has occurred or arisen which with the passage of time or the giving of notice or both would result in a default or breach thereunder, (iii) Seller has no present expectation or intention of not fully performing any obligation under any Material Contract, and (iv) each Material Contract is binding and enforceable and in full force and effect, ~~except to the extent the same is not binding and enforceable and in full force and effect only in part and the same shall not have a Material Adverse Effect on the business~~.

~~—————**Condition of Real Property:** Intentionally deleted.~~

**Condition of Real Property:** To Seller's Knowledge: (a) there are no defects in or unrepaired damage to the Property; (b) all mechanical, electrical, plumbing, HVAC, elevator, access, security, fire protection, sanitary sewer, storm drainage and other systems and equipment serving Seller's Property are in good working order and condition; and (c) the roof of the improvements is in sound condition without leaks or ponding.

## BUYER'S RESPONSE DRAFT:

- For what period after closing do the representations and warranties survive?
- Meaning, as the Buyer, how long do I have to sue the Seller?
- Meaning, as the Seller, how long do I have to look over my shoulder for a claim?

Except as otherwise provided in Section 10 regarding Indemnification, all representations and warranties by Seller in this Agreement shall survive the closing of this transaction for ~~six (6) months only.~~ a period of eighteen (18) months, as to matters for which Purchaser has not provided written notice to Seller within such period of time, and will survive for three (3) years as to all matters specified in any such written notice to the extent that such matters are not resolved or made the subject of litigation instituted prior to the expiration of such three (3) year period.

# SELLER'S FINAL RESPONSE DRAFT:

## MATERIALITY QUALIFIERS, MATERIAL ADVERSE EFFECT QUALIFIERS and KNOWLEDGE QUALIFIERS

“Seller’s Knowledge” means only to the actual knowledge, at the time in question, ~~with an affirmative~~without a duty to investigate or inquire, ~~(which implies that the relevant parties are qualified to and have engaged in all investigation reasonably necessary to make any relevant representation or warranty)~~, of Sam Seller ~~and~~the President of the Seller entity, John Knowitall the Chief Operating Officer of Seller, and Sherry Smith the HR Director of the Seller entity.

## SELLER'S RESPONSE DRAFT:

- For what period after closing do the representations and warranties survive?
- Meaning, as the Buyer, how long do I have to sue the Seller?
- Meaning, as the Seller, how long do I have to look over my shoulder for a claim?

Except as otherwise provided in Section 10 regarding Indemnification, all representations and warranties by Seller in this Agreement shall survive the closing of this transaction for a period of one year ~~(1) eighteen (18) months, as to matters for which Purchaser has not provided written notice to Seller within such period of time, and will survive for three (3) years as to all matters specified in any such written notice to the extent that such matters are not resolved or made the subject of litigation instituted prior to the expiration of such three (3) year period.~~

- AS IS, WHERE IS Language
- “No Reliance” Language
- Disclaimer of Reliance on Information from Third Parties
- Acknowledgement of Physical Inspection
- Waiver of Claims Related to Disclaimed Matters

## **How to Further Limit the Effect of Representations and Warranties**

- As a Seller, limit your client's exposure as to the condition of assets, stock or real property with an **AS IS, WHERE IS** disclaimer.
- This has the effect of waiving and disclaiming implied warranties and limiting a seller's exposure for inaccurate representations or breaches of warranties expressly set forth in the agreement.
- Not that these provisions should be in bold and/or capital letters so that they are "conspicuous."

*AS A MATERIAL PART OF THE CONSIDERATION FOR THIS AGREEMENT, SELLER AND BUYER AGREE THAT EXCEPT FOR SELLER'S WRITTEN REPRESENTATIONS AND WARRANTIES EXPRESSLY SET OUT IN THIS AGREEMENT, SELLER IS CONVEYING THE PROPERTY TO BUYER "**AS IS**" "**WHERE IS,**" **AND WITH ALL FAULTS.** THIS PROVISION SHALL SURVIVE CLOSING AND SHALL NOT MERGE THEREIN.*

**AS IS, WHERE IS and WITH  
ALL FAULTS**

- If representing the seller, attempt to include a “no-reliance” statement.
- This is an acknowledgment by Buyer that it is not relying upon any representations or statements of seller (except as set forth in the agreement). The following is an example of a simple “no reliance” disclaimer:

*Other than the representations and warranties expressly set forth herein, Buyer specifically disclaims that it is relying upon or has relied upon any statements, representations or warranties that may have been made by any person, and acknowledges and agrees that the Seller has specifically disclaimed and does hereby specifically disclaim any such other representation or warranty made by any person.*

## **“No Reliance” Disclaimer**

- Request Buyer acknowledge that it is not relying on any written information or data provided thereto by Seller which was prepared by third parties, as Seller has made no independent investigation or verification of such information's accuracy.
- Request Buyer acknowledge that prior to closing it will have made its own physical inspection of the relevant assets or real property and will by closing is acknowledging it is satisfied as to the condition of the assets or real property.
- Request a statement from Buyer that it waives, releases and discharges any claim it might have with respect to any disclaimed matters or the condition of the assets or real property or defects related to the assets or real property.

**Additional Disclaimers to  
Request as Seller!**

- Indemnification in a negotiated acquisition are frequently the most heavily negotiated part of the agreement. Indemnification obligations expose the Seller to the risk of having to pay or return money to the buyer after the closing if the Seller has breached its warranties or made misrepresentations or for a variety of other occurrences, such as breaches of covenants.

## Indemnification

- Threshold's for indemnification obligations for the Seller
  - Look-Back for the benefit of the Buyer
- Cap's on indemnification obligations
  - Non-applicable to Fundamental Representations for the benefit of the Buyer
- Knowledge Matters Disclaimer
- Reduction of Indemnification Obligation Based on Insurance Recovery
- Reduction of Indemnification Obligation based on Tax Benefit Resulting from Occurance

## Special Indemnification Provisions

# Thresholds for Indemnification Liability

To further limit the consequence of my client's representations and warranties, include a provision which sets a minimum dollar amount of losses before an indemnification obligation can be triggered. This is frequently called a "threshold."

*"Buyer shall not be entitled to indemnification under this Section unless the losses associated with such indemnifiable claims in aggregate exceeds Fifty Thousand and No/100 Dollars (\$50,000.00) ("Buyer's Indemnification Threshold")."*

**NOTE: When representing a Buyer, include a “claw back,” or “look back,” if you agree to an indemnification Threshold.**

In the face of an indemnification threshold, as buyer’s counsel request the indemnification obligation “claw back” or “looks back” to include all indemnifiable dollars up to the Threshold amount in the event the threshold is reached (e.g., when the indemnifiable losses accrue to \$50,001, the entire \$50,001 amount is owed and not merely amounts over the threshold of \$50,000).

*“Once Buyer’s Indemnification Threshold is exceeded, the Buyer shall be entitled to indemnification for the entire amount of any such loss which exceeds Buyer’s indemnification threshold without deduction.”*

# Caps for Indemnification Liability

Further limit the consequence of a client's representations and warranties by including a provision which sets a maximum dollar amount for indemnification liability. This is frequently called a "Cap."

*After the Buyer's Indemnification Threshold has been cumulatively achieved, the aggregate indemnification liability of Seller to the Buyer under this Section shall not exceed Two Million and No/100 Dollars (\$2,000,000.00) (the "Cap").*

**NOTE: When representing a Buyer, be sure the indemnification “cap” does not apply to “FUNDAMENTAL REPRESENTATIONS.”**

Limit the application of the “cap” to “non-fundamental” representations. Insist that there should not be a cap on indemnification liability associated with fundamental representations such as, for example, (a) title to the assets, stock or real property being acquired, (b) whether taxes have been paid, (c) authority to enter into the transaction, (d) bankruptcy or solvency of seller, or (e) whether a broker has been engaged.

*“The indemnification Cap shall not apply to indemnification liability arising under the representations or warranties provided in Sections \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_ and \_\_\_\_\_ (“Fundamental Representations”).”*

# “Knowledge Matters” Limitation

In representing a Seller, include a provision which provides that if buyer is made aware of an inaccurate representation or breached warranty prior to closing and elects to close on the contemplated purchase anyway, the Seller shall have no liability for that matter.

*“Notwithstanding anything contained herein to the contrary, neither party shall have any indemnification obligation to the other party pursuant to this Section if the Closing takes place despite such other party having knowledge of any inaccurate representation or breached warranty or breach of any covenant contained in this Agreement by the breaching party as a result of the provision of written notice from the breaching party prior to Closing or otherwise.”*

# Reduction of Liability for Insurable Claims

When representing a Seller, if your client has significant bargaining power, include a reduction or limitation of indemnification liability for indemnifiable claims for which the Buyer is protected by insurance. So, by including such a provision the Buyer is agreeing that it will simply rely on its insurance, to the extent it can, and will not enforce an indemnification obligation against the Seller.

# Tax Benefit Limitation

As Seller's counsel, if your client has significant bargaining power, consider also requesting a reduction or limitation of indemnification liability which is based on taxable benefit received by the indemnified Buyer arising from the occurrence giving rise to or payment of any claim.

- Holdbacks of a portion of the purchase price;
- Escrow of a portion of the purchase price;
- Requiring the Seller, in an asset sale, to retain a portion of the purchase price for some period of time before distributing it or dissolving;
- Indemnification guarantees from the seller parties.

**A few tools for the Buyer to secure their right to recover and the accuracy of the representations and warranties.**