To the Best of Whose Knowledge?

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INTRODUCTION

Representations and warranties serve three distinct but overlapping purposes in a transactional document. First, they are a mechanism for obtaining disclosure from the representing party. Second, they provide a mechanism for terminating the agreement prior to closing if they prove false. Finally, they affect the parties' rights of indemnification from each other in the case of a false representation or a breach of warranty.

It is a rare transactional negotiation that does not include some debate over whether a representation or warranty should be "clean" or "unqualified" as opposed to "qualified." One way to qualify the representation is with a disclosure schedule, *e.g.*, "Except as described on schedule 1.17, the seller represents that . . . ." Another way to qualify the representation is with a materiality threshold sometimes referred to as a "basket," *e.g.*, "Seller knows of no claims against itself or the assets to be sold under this agreement except for claims that, as asserted by the claimant, are in an amount less than $5,000 each." These approaches can, of course, be combined.

This article examines yet another form of qualifier—the knowledge qualifier. A knowledge qualifier is usually framed either in the form of "to Seller's knowledge" or "to the knowledge of [names of specific persons within representing entity]". This article first explores the distinctions between clean and knowledge-based representations, followed by the desirability of defining "knowledge" and the issues to take into consideration when doing so. Then the article turns to authorities that have defined "knowledge" when the parties have failed to do so. Many of the judicial opinions in this area are very fact specific and, presumably for that reason, are unpublished. Although they may not be cited, they should not be ignored because they do provide helpful interpretive guidance.

CLEAN AND KNOWLEDGE-BASED REPRESENTATIONS AND WARRANTIES

When an unqualified representation or warranty is given, the seller (or, *e.g.*, a lessor or licensor) who makes the representation or warranty takes on the risk of unknown conditions. In contrast, when a knowledge qualifier is used, the seller is not exposed to liability for things unknown and the risk of those facts and events is allocated to the buyer (or lessee or licensee).

Sellers often take the position that they cannot provide unqualified representations with respect to matters that they claim are beyond their control. For example, sellers generally resist providing unqualified representations concerning environmental matters (*e.g.*, "no hazardous wastes have been disposed of and there have never been any underground storage tanks at the subject property") at a facility owned by multiple industrial companies in the years before the seller's occupancy. By resisting, the seller is focusing on its own knowledge and its belief that it cannot make such an unqualified statement beyond its actual knowledge.

If, however, representations and warranties are viewed as risk allocation devices, the actual knowledge of the seller is somewhat irrelevant. Representations and warranties in a business contract are not the

same as statements made in an affidavit under penalty of perjury. By asking for an unqualified statement, the buyer is in effect asking that the risk that the statement is untrue be placed on the seller. The buyer really does not care whether the seller knows enough to make the statement responsibly based on its own knowledge. The buyer requests an unqualified statement more from a desire to have a source of recovery should the statement prove false. In this way, the statement looks more like an indemnity—not a traditional indemnity limited to damages to third parties, but a global indemnity covering damages both to third parties and to the buyer. See *DCV Holdings, Inc. v ConAgra, Inc.* (Del 2005) 889 A2d 954, 962 (using term "indemnify" to characterize liability under a breached representation and warranty). See, *e.g.*, *LWB Lido Partners LLC v Marvin Eng'g Co.* (2004) 2004 CA Unpub Lexis 3230 ("to the best of [its] knowledge after reasonable inquiry" representation and warranty breached due to actual knowledge of contrary fact); *Lockshaw v Rohr, Inc.* (2002) 2002 CA Unpub Lexis 11294 (breach of best-of-knowledge warranty in case where buyer—not seller—was accused of fraud and misrepresentation).

In such cases, directly requesting an indemnity, backed up by sufficient support in the form of held-back funds, a letter of credit, or third party guaranty, would be a more straightforward manner of addressing the issue. But it would also highlight the risk-shifting function in a way that could make it unacceptable to the other party. By couching the matter in the form of a representation, it may be more palatable, although recovery for breach will be less straightforward—a damaged party would be required to prove who knew what when, rather than proceeding directly to a claim for damages under an indemnity.

Alternative formulations of the knowledge qualifier include "to the best of the seller's knowledge" and similar qualifications. It is not entirely clear whether this is meant to imply an absence of knowledge after a reasonable inquiry or a shrug of the shoulders that disavows responsibility beyond what is at the time actually known to the seller. The latter suggests that willful or at least actual blindness will protect the party from liability. Compare *Committee on Negotiated Acquisitions, Model Asset Purchase Agreement with Commentary* (ABA Section of Business Law 2001) 28 (defining "knowledge" to include a deemed "reasonably comprehensive investigation regarding the accuracy of the representations and warranties" in any corporate agreement) with *Conner v Hardee's Food Sys.* (6th Cir 2003) 65 Fed Appx 19 ("in the absence of actual knowledge that a particular statement is false, statements disclosed with the qualifier 'to the best of one's knowledge' cannot give rise to a misrepresentation claim") (applying Tennessee law).

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In an unpublished opinion, the Superior Court of Delaware examined the issue, finding that "best knowledge" warranties "reflect the parties' mutual understanding that the warrantor will not bear the risk of defects which may exist unknown to the warrantor. In a sense, then, the 'best knowledge' language marks a shift in the risk of loss resulting from unknown (as opposed to unknowable) defects from warrantor to warrantee. *Price Automotive Group v Dannemann* (Del Super 2002) 2002 Del Super Lexis 252, *7 (collecting insurance contract cases to this effect and constructing rule of general applicability from them). Put differently, a "best knowledge" qualifier will allow a mistake defense to be presented, while an unqualified representation will not. *Interim Healthcare, Inc. v Sherion Corp.* (Del Ch 2003) 2003 WL 22902879 (unpublished opinion).

DEFINING "KNOWLEDGE"

As commentators as far back as Blackstone realized, a corporation or other non-individual legal entity is like a river—it remains the same although its water and other constituent parts are constantly changing. So, what then is the company's "knowledge" when it comes time to wrangle over whether a representation or warranty with a knowledge qualifier was breached? Is it the sum total of all the knowledge of all the people employed by the company, plus all materials in its files?

As with most other questions of interpretation, these are best avoided by careful drafting. Although one cannot foresee all the problems that may arise between the parties, interpretation of "knowledge" is an issue that should be recognized the minute that the qualifier is requested. The definition should explicitly state that knowledge refers to what is known to specific employees or agents, and if possible, after they have reviewed relevant records. This type of definition forces the qualifier to shift the cost of due diligence effectively to the seller when it makes the representation, rather than allowing the qualifier to serve as a shrug of the shoulders accompanied by a vague corporate mumble of "I didn't know."

Identifying the appropriate people whose knowledge to include is critical. It is highly unlikely that the CEO of a nationwide retail chain knows about specific slip-and-fall claims at particular company stores or about the history of hazardous materials storage at a particular warehouse. Naming the individuals at the appropriate level of management responsibility, and perhaps their immediate predecessors, is essential.

For drafting ease, a separate schedule listing names and the files or other documents required to be reviewed prior to making the warranty should be used. See, *e.g.*, *Grupo Condumex v SPX Corp.* (ND Ohio 2001) 163 F Supp 2d 857, 864 n4. The goal here is to present a road map for discovery of undisputed facts that will support a motion for summary judgment in an action on the warranty, if a lawsuit is ever brought. But see Committee on Negotiated Acquisitions, Model Asset Purchase Agreement with Commentary (ABA Section of Business Law 2001) 29 (definition of knowledge for both individuals and entities contains subjective standards such as "prudent individual" and "reasonably comprehensive investigation").

IF NOT DEFINED, WHAT IS "KNOWLEDGE"

If the documents do not define "knowledge," the search for its meaning becomes contextual. Courts will generally not require the seller to admit to an actual, subjective belief in a statement's falsity; it is enough that the seller is shown to be familiar with, and aware of, information that is contrary to the statement. *Lambert v Weyerhaeuser Co. (In re Paragon Trade Brands, Inc.)* (Bankr D Ga 2002) 324 BR 797, 817. See, *e.g.*, *Campell v McClure* (1986) 182 CA3d 806, 811, 227 CR 450 (seller had knowledge that income and expense statements in sales brochure did not match income tax returns). Recent decisions tend to take a strict imputation approach; see *American Transtech Inc. v U.S. Trust Corp.* (SD NY 1996) 933 F Supp 1193, 1199 (imputing knowledge of agent to corporate party to agreement). Sometimes the knowledge of individuals in supervisory roles is the cutoff point for imputing knowledge to a corporation (see *McNees v Cedar Springs Stamping Co.* (Mich Ct App 1996) 219 Mich App 217), but this is not an established rule (see *Trane Co. v Gilbert* (1968) 267 CA2d 720, 724, 73 CR 279 (imputing all agents' knowledge to company, and that of all subagents if agents were authorized to employ a subagent)).

Further, when "knowledge" is not defined, the inquiry can become a fact-intensive search with an outcome that will hinge on the titles and corporate affiliations of the individuals charged with that knowledge. The degree of privity between the individual involved and the party making the representation will need to be examined, which may preclude summary judgment and require the time and expense of trial. See, *e.g.*, *Dow Chemical Co. v MG Indus., Inc.* (Del Super 2003) 2003 Del Super Lexis 4 (unpublished opinion).

CONCLUSION

Knowledge qualifiers have important effects on the scope of representations and warranties. But these effects are often different than what counsel might predict. Rather than proposing or accepting such a qualifier with little thought as a routine matter, thinking through the ramifications of the decision is important. When a knowledge qualifier is proposed, it is best to specify whose knowledge, as of when, and whether that knowledge is to be based on some factual due diligence. To facilitate enforcement, keep it simple: Give the litigator a road map for discovering who knew what when, and what that means.

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