THE IMPACT OF THE PRINCES POINT LLC V. MUSS DEVELOPMENT LLC DECISION

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Sellers of U.S. commercial real estate typically agree to make a number of representations, warranties and covenants in the associated purchase and sale contract. The substance and breadth of those undertakings are usually heavily negotiated by sellers and buyers. This issue was recently highlighted in a decision earlier this year by the New York Appellate Division, First Department, in the case of Princes Point LLC v. Muss Development LLC.

Commercial real estate acquisitions in the U.S. are generally completed on an "as-is" basis premised on the deep-rooted real estate doctrine of caveat emptor (or buyer beware). Sellers as a result tend to resist and stridently argue against making any representation, warranty or covenant about the subject property or properties unless it is considered a material inducement to a buyer's entering into the contract or cannot otherwise be determined by a buyer through inspection and customary due diligence methods. The consequence of this is a limited set of seller representations, warranties and covenants in the contract, which are often weightily relied upon by the buyer in its ultimate decision to enter into the contract and proceed with the transaction.

If a representation and warranty made by the seller when the purchase and sale contract is signed is discovered to be materially false prior to the closing of the transaction, subject to the terms of the purchase and sale contract, the buyer might bring a legal action under common law against the seller seeking to rescind or void the contract on the grounds that the buyer would not have entered into the contract if the falsehood or misrepresentation was known by it at the time of contract execution.

However, buyers of New York commercial real estate and their advisors should take caution before bringing an action for rescission prior to the closing date as it might have the unintended and devastating effect of constituting an anticipatory breach by the buyer.

The New York Appellate Division, First Department, came to that conclusion earlier this year in Princes Point LLC v. Muss Development LLC. The case, however, is pending review by the Court of Appeals after the non-prevailing buyer's motion to New York's highest court to appeal the decision was recently granted.

Anticipatory breach, also known as repudiation or anticipatory repudiation, is a fundamental and long-standing principle of contract law. It is essentially a statement or an act by a party to a contract that indicates either that party's intent to breach or inability to perform a promise. Anticipatory breach occurs before performance under the contract is due, but is nonetheless deemed a breach as a matter of law.

Some jurisdictions implement different standards for determining when anticipatory breach has occurred. The "relaxed standard" under the Restatement (Second) of Contracts and the Uniform Commercial Code (UCC) requires that the statement or act be sufficiently positive to be reasonably interpreted to mean that the party will not or cannot perform. This differs from the "traditional standard," which requires that the statement or act be clear and unequivocal. New York has historically followed the traditional standard.

In any case, once a party has in effect indicated its intent to breach or inability to perform, an anticipatory breach is deemed to have occurred. The other party is then entitled to seek remedy or rescission. Since there are a multitude of ways in which a party could show intent to breach or inability to perform, whether a particular statement or act constitutes anticipatory breach is susceptible to uncertainty and dispute and therefore litigation. Until Princes Point, however, New York courts have never addressed whether a legal action for rescission can constitute anticipatory breach.

The facts of the Princes Point case are as follows. The subject property, a 23-acre site of waterfront land in Staten Island, had previously been listed as a hazardous waste site by the New York State Department of Environmental Conservation (DEC). In order to delist it, the seller performed work at the property that included building a revetment seawall along the shoreline. The seller achieved delisting in 2001.

In 2004, the seller agreed to sell the property to the buyer for a purchase price of approximately $36m with an initial non-refundable deposit of approximately $1.9m. As a condition to the buyer's obligation to close, the seller had to deliver the property fully entitled with all municipal approvals for development on the land obtained. If the municipal approvals had not been obtained by the closing date, either party could terminate, but the deposit would then be returned to the buyer. In the event the seller terminated, the buyer could waive the municipal approvals condition and close with a reduction in the purchase price. The contract also permitted extensions by the buyer of the outside closing date for up to six times, provided the buyer paid an additional deposit of $200,000 per extension.

The seller experienced difficulty obtaining the municipal approvals. In 2005, after the effects of Hurricane Katrina, the DEC inspected the revetment seawall and determined that it required further work before it would grant the municipal approvals. The seller notified the buyer that it could not obtain the municipal approvals by the outside closing date and intended to exercise its termination option, except that the seller would be willing to extend the outside closing date if the buyer agreed to the following:

(1) an increase in the purchase price to approximately $38m;
(2) an increase in the deposit to approximately $4m;
(3) the reimbursement of half the costs incurred by the seller thereafter to obtain the municipal approvals; and
(4) the waiver by the buyer of any legal action against the seller in the event the municipal approvals were not issued or the work needed to acquire them were not completed by the new outside closing date. The buyer agreed to the revised terms, and in 2006 the parties amended the contract accordingly.

The issues with the revetment seawall continued. Soon after the parties entered into the 2006 amendment, the DEC found material issues with the construction of the revetment seawall. The parties extended the outside closing date several more times. Prior to the new outside closing date and the completion by the seller of the additional revetment seawall work, the buyer brought suit.

The buyer's complaint alleged that the seller had induced the buyer into entering into the contract based on the seller's fraud and misrepresentation that the revetment seawall had been built in accordance with the DEC's specifications. The buyer also claimed that the seller failed to obtain the municipal approvals because the seller had deliberately and willfully failed to construct the revetment seawall in accordance with the DEC-approved design. The buyer therefore sought rescission of the 2006 amendment and specific performance of the 2004 purchase contract.

The seller counterclaimed, arguing that the

buyer breached the contract by bringing suit, which was a violation of the buyer's waiver to do so under the 2006 amendment. The buyer's claims were dismissed. The seller's counterclaims, on the other hand, were granted. The Supreme Court, New York County, found that the buyer anticipatorily breached the contract by commencing a rescission action prior to the closing of the transaction, thereby entitling the seller to terminate the contract and retain the full amount of the deposit and payment of significant fees.

The buyer appealed the Supreme Court's decision. The issue on appeal was whether the buyer anticipatorily breached by seeking rescission of the contract and, if so, whether the seller was then required to show that it was ready, willing and able to complete the sale in order to retain the deposit and other liquidated damages. The Appellate Division, First Department, affirmed the Supreme Court's decision.

The Appellate Division found that by seeking rescission the buyer evidenced its intent to declare the contract void and eliminate its duty to perform the contract. A rescission action, noted the court, unequivocally evinces the plaintiff's intent to disavow its contractual obligations, and therefore commencement of such an action before the date of performance constitutes an anticipatory breach. The Appellate Division also found that the seller was not required to show that it was ready, willing and able to complete the sale because the buyer's anticipatory breach relieved it of further contractual obligations.

The decision in Princes Point is noteworthy. The decision could have a chilling effect on real estate buyers seeking to challenge a contract prior to the closing date on the basis of fraud or misrepresentation. This is because buyers of real estate stand to lose their deposits, which in real estate acquisitions can represent a considerable percentage of the purchase price. The Princes Point buyer, for example, had deposited an amount representing approximately 10% of the purchase price.

The court in Princes Point distinguished an action for rescission from other cases involving plaintiffs seeking declaratory relief. Such other cases have held that actions seeking declaratory judgment as to a contract do not constitute anticipatory breach since declaratory judgment suits only serve to clarify the parties' rights. By contrast, the Appellate Division reasoned, in seeking rescission, the buyer sought to nullify the agreement entirely. As such, the Appellate Division found rescission suits to be "markedly different" from declaratory judgment suits, thereby constituting anticipatory breach. Thus, the use of declaratory judgment actions could be viewed as a safe harbor for real estate buyers in bringing claims prior to the closing date.

However, it is unclear based on the Princes Point decision whether a rescission claim will in all cases constitute repudiation. The particular facts in Princes Point seemed to have tipped the scales in favor of the seller. The Princes Point buyer waived all legal claims against the seller for failure to obtain the municipal approvals or complete the work needed to acquire them. The Princes Point buyer also agreed to a number of closing date extensions, even after the issues with the revetment seawall became well known.

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The Princes Point buyer could have waited until the new outside closing date to terminate and receive a return of its deposit or waive the condition and close with an abatement to the purchase price should the condition to deliver the property with all municipal approvals had not been satisfied (in lieu of bringing its recession claim in advance of the closing date essentially based on the same concerns). Neither the 2004 purchase contract nor the 2006 amendment contained any representation by the seller in respect of the revetment seawall, or for that matter any representation by the seller as to the physical condition of the property. The 2006 amendment increased the purchase price, increased the deposit and afforded the seller a reimbursement of half the costs incurred in obtaining the municipal approvals likely because both parties were aware of DEC's concerns and that additional work was required to the revetment seawall. These and others were damning facts to the Princes Point buyer's case.

New York follows the "traditional standard," requiring an unequivocal statement or act. While filing suit is suggestive of a refusal to perform, it seems premature to declare that it is in all cases sufficiently unequivocal to constitute repudiation. One could argue that until rescission is granted, barring other facts such as those in Princes Point, the buyer remains able to retract the suit, settle or in some other way perform under the contract.

Other jurisdictions support this view. In California, there is no implied repudiation unless the party actually puts it out of his or her power to perform. As an example of the California rule in practice, a trustee in a bankruptcy does not anticipatorily breach with respect to a promisee's claim if within a reasonable time the trustee elects to perform the contract, even though bankruptcy is presumably strongly suggestive of the promisor's inability to perform. Even the Restatement (Second) of Contracts, which endorses the "relaxed standard," provides that to constitute repudiation, a party's act must be both voluntary and affirmative, and must make it actually or apparently impossible for him or her to perform. This approach seems to thoughtfully balance the aim of protecting the rights of contracting parties and the desire promoted by the principle of anticipatory breach which is to settle disputes early.

The Princes Point holding and its forthcoming conclusion to be decided by the Court of Appeals should be closely studied because it could have a lasting impact in New York on both substantive law and commercial real estate transactions generally. Whether or not a suit for rescission constitutes an anticipatory breach is an interesting legal question, but it also raises important practical concerns as noted herein. As the Court of Appeals deliberates, these issues and others are likely being considered. Until such time there is more certainty with respect to this issue, buyers of New York commercial real estate should restrain from bringing an action for rescission prior to the closing date. Instead, buyers could elect to bring a declaratory judgment action prior to the closing without risking a finding of anticipatory breach.

Otherwise, if an earlier remedy is not necessary, buyers could allege at the closing that the seller failed to satisfy the customary closing condition that all representations and warranties made by the seller remain true and correct in all material respects. In any case, buyers should be ready at closing to perform their contractual obligations while they wait to see if the seller can perform its obligations and avoid taking any actions at or before the closing that would likely suggest an inability or unwillingness to do so ■

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