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K Drafting- Covenants

[19] We agree with the lower courts that CBS's fourth cause of action, for breach of section 6.1 (f) of the purchase agreement, was properly dismissed inasmuch as section 6.1 (f) was a condition to closing, not a representation or warranty, and was waived by CBS.

[20] The order of the Appellate Division should be modified, with costs to the appellant, by denying the motion to dismiss the third cause of action for breach of warranty and the order should be otherwise affirmed.

[21] [The dissent of Justice Bellacosa is omitted].

Case Note

As *CBS v. Ziff-Davis* shows, then, there is at least one very sound reason to negotiate for representations and warranties from sellers, lessors, licensors, and the like. Assuming that one is in a jurisdiction following this case, which appears to be the majority role, even if a plaintiff knew that a statement was not true— which is fatal to its misrepresentation claim— it may still recover for breach of warranty. Similarly, breach of warranty is grounded in strict liability, so failure to prove scienter, which may be required for a misrepresentation claim sounding in tort is no obstacle to a breach of warranty suit.

3. Covenants.

A covenant is a promise to act or not to act in the future. BLACK'S LAW DICTIONARY 419 (9th ed. 2009). It is essentially a single contractual duty within a document. Breach of a covenant will support an action for damages or specific performance sounding in contract (or tort under the theory of promissory fraud), and the cause of action is generally ripe at the time the covenant was to be performed. However, doctrines such as anticipatory repudiation, impossibility, prospective inability to perform, and voluntary disablement may accelerate the accrual of the cause of action.

Covenants are generally drafted in the form of a "shall clause," an active voice statement that identifies the party making the promise and states that promise directly. For example: Seller shall indemnify and defend Buyer from all adverse claims to title.

Test all of your covenants for the active voice, asking: "do they clearly state *who* is to do *what* to or for *whom*, *when*, and in what *manner*, *quality*, or *quantity*?"

A final consideration when drafting covenants, similar to the decisions faced when drafting representations and warranties, is: What degree of performance will be required. Some covenants are unqualified and provide that a party shall do something, period. Other times they are drafted in terms of best efforts, commercially reasonable efforts, or reasonable efforts. When drafting or reviewing covenants, consider whether language qualifying the obligation is appropriate and

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506), the dissent obviously misses the point of our decision. We do not hold that no reliance is required, but that the required reliance is established if, as here, the express warranties are bargained-for terms of the seller.

whether it really adds any certainty by reference to an objective measurement or statement.

A duty to use best or reasonable efforts to obtain that result usually arises in one of three ways in contracts cases. First, the contract itself may specifically require that the promisor put forth his or her "best efforts." Second, the contract might expressly or implicitly specify a result, and this may be interpreted as imposing a duty of best efforts. Finally, a court may impose a duty of best efforts based simply on the facts and circumstances surrounding a contract. Either of these last two theories explains the result in that staple of first year law school contract law classes, *Wood v. Lucy, Lady Duff-Gordon*, 222 N.Y. 88, 118 N.E. 214 (1917), in which Justice Cardozo implied a duty to use reasonable efforts into a distribution and marketing arrangement in order to hold a fashion designer to the contract rather than allowing her to escape her implied obligations to the man she had hired so that she could market her designs through Sears-Robuck.

There appears to be no firm rule as to what constitutes adequate or sufficient best efforts. In general, each case turns on its particular facts. Some cases suggest that best efforts requires the same amount of effort under a contract as that expended under other, similar contracts where the quality of effort has not been questioned. Others imply that the promisor should merely avoid manifestly harmful conduct. The duty to act reasonably, like a duty to employ best efforts or to act in good faith, is not reducible to a fixed formula—unless the contract itself provides the formula or an objective measure.

A duty of best efforts is separate and distinct from the duty of good faith. Good faith is a standard with a moral component that has honesty and fairness at its core and that is imposed on every party to a contract. Best or reasonable efforts is a standard that focuses on diligence in performance or attempted performance. One method to address the uncertainty of best or reasonable efforts clauses is to provide for a specific dollar limit on expenses to be incurred on account of specific best effort covenants or for all similar covenants together.

Parties in preliminary negotiations, either oral or written, may intend to bind themselves to negotiate further in good faith. Some may even promise to use their best efforts to do so. Doing so can elevate what may have been an unenforceable agreement to agree into an enforceable agreement to negotiate in good faith, which is a somewhat vague, and thus troublesome, duty. *See, e.g., Cable & Computer Technology Inc. v Lockheed Sanders, Inc.,* 214 F.3d 1030 (9th Cir. 2000). Take care to avoid this trap.

4. The UCC Approach.

In a sale of goods contract covered by the Uniform Commercial Code, however, any "affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise."[14] This approach blurs the distinction between classic definitions and distinctions between representations, warranties, covenants, and even conditions. These UCC warranties also survive the closing of the sale.

[14]U.C.C. § 2–313.

5. General Rules and Techniques: Typical Representations & Warranties.

Each of the general rules regarding representations, warranties, covenants, and conditions can be altered by language of the contract itself, so none can be drafted or interpreted in a vacuum.

Typical representations and warranties include (i) the party is duly organized, in good standing, and authorized to enter in the transaction, (ii) the transaction is not a breach of any other agreement and does not violate the law, (iii) a seller or lessor has good title to all assets being sold or leased, and those assets are free of liens and encumbrances, and (iv) all material facts have been disclosed. Each is often phrased as "except as disclosed on schedule *X* to this agreement, [representation or warranty]." As noted above, this structure makes the provision more than just a representation or warranty—it becomes a due diligence tool that shifts the burden of finding and discussing exceptions to the statement to the representing and warranting party. Representations and warranties of this type are often combined with a covenant to defend against claims that are adverse to any of the representations and warranties and an indemnity against losses caused by inaccurate representations or warranties.

That combination of provisions resembles "deal insurance" in that one party makes a representation and warranty and then agrees to indemnify and defend the other party from claims that render the representation or warranty incorrect. Remember, however, that insurance is only as good as the insurer when the claim is made. Do not take too much comfort in unsecured, unregulated insurance-like provisions—circumstances change and parties die, are dissolved, and become insolvent or judgment-proof. Due to the use of blanket and purchase money security interests to support business financing, the sale and securitization of rights to payments and payment streams, and the use of limited liability entities to separate assets and retained earnings from liability-creating operations, many, if not most, businesses are judgment-proof beyond whatever insurance coverage they have. This does not mean clients should not contract with these businesses, just that counsel must focus on ensuring that their clients understand the risks involved and whether there is a creditworthy payor or other source of funds to look to if a representation, warranty, or other provision is incorrect or breached.

As discussed above, an important method of reducing the scope of a representation or warranty, and any covenant or indemnity linked to it, is a knowledge limitation. In light of the prior paragraph, it bears revisiting. For example, "the representations and warranties of section *X* below are limited to facts of which *a, b,* or *c* [people] have actual knowledge on the date of this agreement." This is a fair limitation, as long as the appropriate persons are specified: those who would naturally have the knowledge sought. Do not stop at the senior executive level—as knowledge there is generalized—but delve down to cover the knowledge of middle management and even the operations level of a business, as appropriate.