K Drafting- Representations & Warranties

Chapter 7

REPRESENTATIONS, WARRANTIES, COVENANTS, GUARANTIES, INDEMNITIES

Contracts frequently use representations, warranties, covenants, releases, guaranties, and indemnities. As you learned in Chapter 1, contracts themselves are risk-shifting devices, and representations, warranties, covenants, releases, guaranties, and indemnities are the main moving parts that make them so. Each is a different type of provision, and it is important to select the proper type to generate the proper legal effect. Perhaps more than any other set of provisions, those described in this chapter highlight the litigation or default planning aspects of transactional practice and contract drafting. Each of these provisions gives rise to a particular set of causes of action in the event of breach or error.

In particular, representations, warranties, covenants, guaranties, and indemnities are interrelated and reinforce each other. A represented fact will induce a party to enter into negotiation and documentation of a transaction. If a representation is false, a misrepresentation action will support rescission or damages. That representation will likely also be a warranty that survives closing, which would then provide a breach of warranty action that can support an award of damages. A covenant may be used to produce a duty on the part of the warranting party to make the facts as they were warranted. Finally, to the extent that the non-warranting party has been damaged by the breached or incorrect warranty, an indemnity or a guaranty can create a route for damage recovery.

Unlike the way you were probably taught to analyze a set of facts for tort, contract, or property claims—element by element, starting with duty and concluding with damages or other remedies—when thinking as a drafter, you should approach the problem from the desired *remedy* first. For example, if certain facts are misstated, what remedy do you want? Possibilities include pre-closing rescission, post-closing rescission, or consequential or liquidated damages from the other party or from a credit-worthy third party. Then draft the type of provision that will produce a cause of action for your client that is ripe when needed, lies against the appropriate defendant, and provides the desired remedy.

A. General Rules for Representations, Warranties, and Covenants.

1. Representations.

Classically, a representation is a statement of presently existing facts that is intended to induce reliance and action by a party, such as entering into a contract. BLACK'S LAW DICTIONARY 1415 (9th ed. 2010). Statements about future conditions do not qualify as representations because no one can know the future. An incorrect representation will support an action for rescission or damages sounding in contract, and tort, if fraud is present. Tort claims for fraudulent misrepresentation require a showing of (a) scienter (knowledge of falsity or conscious ignorance of

its truth or lack thereof), (b) intent to induce reliance, and (c) reasonable or justifiable reliance.

A party that discovers a misrepresentation pre-closing can either seek to rescind the contract and receive restitution for any funds expended in reliance on the misrepresentation or can elect to affirm the contract and seek damages. The rescission remedy is not available for breach of a warranty, which is why representations are so important in transactional practice in which many months of due diligence may take place between signing the documents and the closing of the deal. If due diligence uncovers unsatisfactory information, rescission provides a party like a buyer with a way out of the deal.

Unless otherwise specified, the representation speaks as of the execution of the document in which it is contained. The cause of action is, therefore, generally ripe as of that time, which may be pre-closing. Pre-closing representations may terminate at closing by operation of law unless the contract specifies that they survive the closing. Check governing law in your jurisdiction on this point and, best of all, address the matter specifically in the contract with survival and no-merger clauses. A survival clause specifies that the representation in the agreement survives the closing. A no-merger clause is one that defeats the common law doctrine of merger in a real estate transaction, whereby the land sale contract's provisions are said to merge into the deed, thereby being destroyed and replaced by the common law covenants of seizen, right to convey, against encumbrances, general warranty, quiet enjoyment, and further assurances in the case of a general warranty deed, or nothing at all if a quitclaim deed is used.

Representations are meant to give one party some reassurance that the other party's statements of fact are true. In this sense, they shift the risk that a stated fact is untrue to the representing party. Typical subjects for representations include the accuracy of financial statements, due formation of a business entity, and compliance with laws, and the existence or non-existence of adverse claims, breached or defaulted contracts, liens, encumbrances, and legal actions.

Representations are also used to shift the burden and cost of investigation and disclosure in the due diligence process. For example, assume that your client wishes to purchase a business but wants to know if there are any claims or lawsuits against the business. You and your client could search relevant court records, perhaps nationwide. You could also dig through all of the business records looking for evidence of claims. These are burdensome and expensive activities. Alternatively, you could insert a representation and warranty into the purchase agreement in which the seller states that, except as disclosed on an attached schedule, no claims or lawsuits have been asserted against the company. This sort of blanket statement is known as a flat or unqualified representation. It shifts the burden of investigation and disclosure back to where it belongs, on the seller, which is the entity that is the least cost provider of the information.

Typically, the seller's counsel would respond with the suggestion that the representation be qualified, often by narrowing it to relate to claims or lawsuits of a certain type or over a certain size—a "materiality threshold"—or known to certain specific individuals—a "knowledge limitation." Depending on the circumstances, this may be acceptable to your client. If so, make sure that either limitation is not overbroad. Materiality thresholds should be set at levels that sound appropriate alarms, but filter out the noise generated by immaterial claims. Knowledge limitations should specify persons who are likely to know the *details* involved; rarely will it be sufficient to

limit knowledge to that of the uppermost tier of management. In this way, the burden of necessary investigation and disclosure can appropriately be shifted to the sellers. The Question and Clauses for Consideration section of this chapter and the contracts in the appendices, particularly Appendix 2, provide additional examples of this technique.

The inclusion of a knowledge qualifier has the effect of shifting the representations from those based on the existence of the facts themselves to ones based on *awareness* of the facts. A party may justify its need to include a knowledge qualifier by arguing that it should not be required to make an assertion that it does not know to be the truth. If a party has incomplete knowledge or if the truth of a fact is fairly immaterial and difficult or costly to obtain, a knowledge qualifier may be appropriate. On the other hand, if the statement of fact is based upon something within the party's control or is one that the other party wishes to rely upon in deciding whether to proceed with the transaction, a knowledge limitation is inappropriate.

Representations are generally drafted in the form:

> *[Buyer, Seller, other defined term] represents [representation carefully stated as to scope and substance].*

Representations should almost always be drafted in the present or past tense, not the future tense, to prevent them from being interpreted as covenants.

A representation is often combined with a warranty, in which case the form is:

> *[Buyer, Seller, other defined term] represents and warrants [representation and warranty carefully stated as to scope and substance].*

This combination ensures that a cause of action will lie post-closing if the representation has terminated as of closing but the warranty survives or as part of an overall "belt and suspenders" approach. Consider the following case, which illustrates the due diligence process, the use of covenants to require disclosure of information, and misrepresentation liability when a represented fact turns out to be incorrect.

Linden Partners v. Wilshire Linden Assocs.
Court of Appeal of California

62 Cal. App. 4th 508; 73 Cal. Rptr. 2d 708 (1998)

FACTS AND PROCEDURAL BACKGROUND

[1] On June 7, 1989, plaintiffs agreed to buy and defendants agreed to sell a medical office building in Beverly Hills, known as the Wilshire-Linden Building. An agreement was signed on that date. The initial purchase price was $22.2 million. Escrow was opened on June 13, 1989, and after several negotiated extensions, closed on October 27, 1989.

[75] In sum: The trial court adequately instructed the jury on the causality of damages and committed no error in refusing defendants' special instructions Nos. 16 and 17.

[76] A final word in regard to causality. The first trial judge ruled on motion for summary adjudication that defendants had a duty to deliver an estoppel certificate which correctly stated Leumi's then current monthly rental. This court has approved that ruling. The jury found by substantial evidence that when defendants put into escrow an estoppel certificate which incorrectly stated Leumi's rent, defendants therewith breached the contract.

[77] That breach was, of course, only a partial breach because defendants had otherwise performed faithfully under the contract over the course of several months. It is the opinion of this court, however, that such breach was material, (Rest.2d Contracts, § 241) thus giving plaintiffs the right to seek damages. Any nonperformance of a duty under a contract when performance is due is a breach. This includes defective performance as well as an absence of performance; defective performance can be inadvertent as well as intentional, and the duty can be imposed by the court as well as by a promise stated in the agreement.

[78] Defendants having breached their agreement with plaintiffs, the ultimate question which must be addressed is: Was the breach a substantial factor in causing plaintiffs to be damaged? The answer is that such breach was unequivocally and unassailably a substantial factor in causing plaintiffs to be damaged.

* * * *

[79] The judgment is affirmed.

2. Warranties.

Classically, a warranty is a statement made about certain facts whereby the warrantor promises to ensure that those facts are as stated. BLACK'S LAW DICTIONARY 1725 (9th ed. 2009). A breached or incorrect warranty will support an action for damages sounding in contract that, in a non-Commercial Code context, may not survive the closing absent the presence of the survival and anti-merger clauses discussed earlier in this chapter. Because the law is not uniform with regard to survival, explicitly addressing the issue in the contract is the best practice.

Warranties are generally drafted in the form:

> *[Buyer, Seller, other defined term] warrants that [warranted facts carefully stated as to scope and substance].*

Like representations, warranties should almost always be drafted in the present or past tense, not the future tense, to prevent them from being interpreted as covenants.

Consider the following case discussing the purpose and effect of warranties accompanied by a survival clause.

[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.