



Litigating Indemnities and Reps and Warranties: What You Thought You Negotiated May Mean Something Else

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Representations, Warranties, and Covenants

- Representations are statements of past or existing facts which induce a party to enter into a contract
- Warranties are promises that existing or future facts are or will be true
- Covenants are promises to do something

Warranties vs Representations

“Although a court may treat a misrepresentation as an implied warranty, in general a warranty differs from a representation in four principal ways: (1) a warranty is **conclusively presumed to be material**; (2) a warranty must be **strictly complied with**, while substantial truth is the only requirement for a representation; (3) a warranty is an **essential part of the contract**, while a representation is usually only a collateral inducement; (4) an express warranty is **usually written on the face of the contract**, while a representation may be written or oral.”

-- Black's Law Dictionary (9th ed. 2009)

Core Reps and Warranties

- Corporate organization; good standing
- Authority
- No conflicts
- Title to stock or assets
- Capitalization
- Subsidiaries

Other Reps and Warranties

- Financial statements
- No undisclosed liabilities
- Intellectual property
- Condition and sufficiency of assets
- Material contracts
- Environmental matters
- Tax matters
- Employees
- Real estate

Claims for Breach of Reps and Warranties – a few issues

- Relevant in acquisition of private companies
- What the claim is called may matter:
 - Warranties breached at time of sale; breach of contract may occur later, which affects the running of limitations and notice periods
 - But proving breach of warranty may be easier to prove, as it requires proof of damages only, not reliance
 - Contractual limitations may apply to some claims and not others
- Anti-sandbagging provisions
- “Merger” clauses and “non-reliance” provisions
- Survival of reps and warranties

Contract Interpretation Principles

- Agreements are construed in accordance with the parties' intent
- Contract is unambiguous if the language used has a definite and precise meaning as to when there is no reasonable basis for a different of opinion

Contract Interpretation Principles

- Typically, a contract is construed as it would be understood by an objective, reasonable third-party
- A court looks to the objective meaning of a contract term as defined in the agreement
- A contract is not ambiguous simply because the parties disagree as to the proper interpretation
- Parol evidence may not be used to vary the terms of an unambiguous agreement

Contract Interpretation Principles

- With respect to contracts negotiated between sophisticated, commercial entities, courts will be extremely reluctant to interpret an agreement using extrinsic and parol evidence
- If an agreement on its face is reasonably susceptible to only one meaning, a court is not free to modify the agreement to reflect its notion of fairness and equity. *In re New York Skyline*, 471 D.R. 69 S.D.N.Y. 2012

Contract Interpretation Principles

- The rules of contract construction require a court to adopt an interpretation which gives meaning to every provision of the contract. *Westminster Security v. Detrocom Energy*, 2012 WL 147917 (2nd Cir. 2012)
- Contract interpretation “that has the effect of rendering at least one clause superfluous or meaningless is not preferred and will be avoided if possible.” *Shaw Group v. Triple Fine*, 322 F3d 115, 124 (2nd Cir. 2003)

Contract Interpretation Principles

- Think through defined terms
- Consider litigation risks as well as transactional risks
- Address disagreements prior to document execution and closing

Contract Interpretation Principles

- Secret nicotine research facilities and \$323MM scam
 - Confirm accuracy of reps & warranties
 - To the best knowledge defined as actual knowledge

Indemnity: Definition

- The right to have someone else pay for your loss.
 - “Indemnification...places the entire burden of a loss upon the party ultimately liable or responsible for it, and by whom the loss should have been discharged initially.”
 - *Levy v. HLI Operating Co.*, 924 A.2d 210, 221 (Del. Ch. 2007)
 - “Indemnification is ‘[t]he right of one party to shift the entire loss to another’ and ‘may be based upon an express contract or an implied obligation.’”
 - *Genesee/Wyoming YMCA v. Bovis Lend Lease LMB, Inc.*, 98 A.D.3d 1242, 1244 (N.Y. App. Div. 2012)

Various Kinds of Indemnity

- Statutory
- Implied or equitable
- Express (contractual)
 - Insurance

UCC Statutory Indemnity

- Commercial Code sec. 2312(3):
 - “Unless otherwise agreed a seller who is a merchant regularly doing business in goods of the kind warrants that the goods shall be delivered free of the rightful claim of any third person by way of infringement or the like but a **buyer who furnishes specifications to the seller must hold the seller harmless against any such claim which arises out of compliance with the specifications.**”

Limits on Indemnity

- Monetary limits in agreement (baskets and caps)
- Indemnitee's negligence:
 - “In order for a party to be entitled to indemnification for the results of its own negligence the contract language must be crystal clear or sufficiently unequivocal to show that the contracting party intended to indemnify the indemnitee for the indemnitee's own negligence.”
 - *Sweetman v. Strescon Indus., Inc.*, 389 A.2d 1319, 1321 (Del. Super. 1978)
- “Anti-reliance” provisions/fraud carve-outs – two sides of the same coin
- Time limitations and notice provisions

Fraud Carve-Outs

- Fraud exception to limits on indemnity/exclusive remedy provisions
 - Role of insurance
- Undefined fraud carve-outs may undermine waiver of reliance provisions, contractual caps on indemnification, and negotiated time limits for claims.
 - Proof of common law fraud may require less than intentional misstatements intended to defraud
 - Contractual claims can be converted to tort claims

Sample Language

- The Insurer, at its sole cost and expense, shall only be subrogated (with respect to the Seller Parties) to the Insureds' respective rights of recovery against the Seller and shall only be entitled to exercise rights acquired by assignment, or **to pursue claims in contribution against the Seller** (including, for the avoidance of doubt, the direct shareholder of Seller) **if and to the extent that payment made by the Insurer was directly attributable to Loss arising out of deliberate fraud by the entity against whom the Insurer exercises the rights** set forth in this Section 8.2, provided, however, that the deliberate fraud of any entity(ies) shall not be imputed to any other entity for purposes of the application of this Section.

Anti-Reliance Provisions and Extra-Contractual Fraud Claims

- **Delaware** – Public policy favors enforcement of contractual language disclaiming reliance on extra-contractual statements.
 - Language must add up to a “clear anti-reliance clause” to defeat extra-contractual fraud claim. See *Prairie Capital III, L.P. v. Double E; Abry Partners V, L.P. v. F & W Acq. LLC*
- **New York**– Similar to Delaware.
 - Explicit and specific disclaimer will defeat extra-contractual fraud claim. *Danann Realty Corp. v. Harris*, 5 N.Y.2d 317, 320 (1959); but “peculiar knowledge” exception could allow claim.
- **California** – Against public policy for a contract to exempt a party from responsibility for its own willful or negligent fraud.
 - Anti-reliance clauses not a bar to extra-contractual fraud claim, but may be used as evidence that reliance was unreasonable. *Hinesley v. Oakshade Town Ctr.*, 135 Cal. App. 4th 289 (2005).

Anti-Reliance Provisions and Extra-Contractual Fraud Claims

Sample provision:

In making its determination to proceed with the Transaction, the Buyer **has relied on . . . the representations and warranties** of the [Sellers] expressly and specifically set forth in this Agreement, including the Schedules. **Such representations and warranties by the [Sellers] constitute the sole and exclusive representations and warranties** of the [Sellers] to the Buyer in connection with the transaction, and the Buyer understands, acknowledges, and agrees that **all other representations and warranties** of any kind or nature express or implied (including, but not limited to, any relating to the future or historical financial condition, results of operations, assets or liabilities or prospects of [the portfolio company]) are **specifically disclaimed** by the [Sellers].

Prairie Capital

Limitations Periods and Notice Provisions

- Statute of limitations for breach of contract is 3 years in Delaware, 5 years in Missouri, and 6 years in New York
- Notice provisions can be as short as 18 months; failure to comply can preclude a claim
- Survival provisions can extend the limitations period

Limitations Periods and Notice Provisions (cont'd)

- Nice idea, but....
 - “Delayed Discovery” Rules – can vary by jurisdiction
 - Missouri rejects in favor of “middle of the road” “capable of ascertainment” test
 - When did the claim accrue?
 - Date of breach?
 - Date of injury?
 - Indemnification right can arise on date of breach or date of payment, depending on jurisdiction
 - Breach of warranty or breach of indemnity obligation?
 - Date when basket exceeded?
 - Sellers’ “obligation to indemnify and hold harmless . . . shall commence at such time that the aggregate amount of such Losses and Expenses equals or exceeds US \$600,000.”
 - No prejudice from delay/material compliance with terms of agreement
- Extension of statute of limitations may not be valid or may be limited in some jurisdictions

Third-Party Claims

- Settlements vs judgments
- Standards for settlements

Settling Third Party Claims

- “The Indemnified Party shall have the right in its sole discretion to conduct the defense of any Third-Party Claim; provided, however, that any settlement of any such Third-Party Claim shall be effected with the prior written consent of the [Shareholder Representative], which consent shall not be unreasonably withheld, conditioned or delayed, but if such consent is unreasonably withheld, conditioned or delayed then such consent shall not be required. Consent shall be deemed “unreasonably withheld” if the proposed settlement would satisfy the requirements of good faith as that term is used in California Code of Civil Procedure Section 877.6 and construed in relevant case law.”

Settling Third Party Claims

- Alternative language:
 - Consent shall be deemed “unreasonably withheld” if the proposed settlement would satisfy the requirements of good faith as that term is used in California Code of Civil Procedure Section 877.6 and cases interpreting it with respect to the burden of establishing that the settlement was not made in good faith and that its consent was not unreasonably withheld. Further, California Civil Code Section 2778 shall not apply to a determination of whether or not consent has been “unreasonably withheld.”



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