Risk Allocation in Commercial Contracts:
Everything You Really Need to Know About Representations and Warranties, Indemnities and Liability Caps

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Agenda

• Representations and Warranties
• Indemnities
• Liability Caps
• Q&A
• What are representations and warranties?
  – Statements of fact that each party to a contract makes to the other party, “representing and warranting” that certain facts are true.
  – Distinct from covenants, which are promises to perform obligations.
Representations and Warranties – Overview

• What’s at issue:
  – Allocation of risk
  – Driving disclosure
  – Remedies (claims and indemnification)
  – The ability to terminate between signing and closing

• In negotiations, ask:
  – Who is in a better position to have the relevant information?
  – Who should take the risk that the rep is inaccurate?

• Who is giving reps?
  – The respective leverage of the counterparties plays a role
  – Typically a counterparty who is paying money gives only limited reps, although in an ongoing relationship that balance may shift
  – Reps are more balanced where equity is being used as consideration
Representations and Warranties – Customary

- Customary in most commercial agreements:
  - Organization and good standing
  - Enforceability, power and authority
  - Due authorization, execution and delivery
  - Governmental consents and filings
  - Absence of conflicts with other instruments, laws and organizational documents
Representations and Warranties – Negotiated

- Other reps are tailored to the specific agreement. Examples include:
  - Capitalization
  - Intellectual property
  - Environmental matters
  - Compliance with law
  - Tax compliance
  - Insurance
  - Financial information
  - Assets and properties
  - Material contracts
  - Data privacy
  - No MAE
  - Employee benefits
  - Litigation
  - Absence of certain changes
  - Employees / labor disputes
  - FCPA
  - Related party transactions
  - No brokers
  - Full disclosure
Representations and Warranties – Disclaimer

• Disclaimer of warranties / No implied warranties
  – It is also standard to explicitly disclaim any reps/warranties made outside of the Agreement
  – “Except for the representations and warranties set forth in Article 2, Seller disclaims any warranty of any other kind, including any warranty that the goods are merchantable or fit for a particular purpose.”
  – Typically also disclaim infringement of third-party IP rights
Representations and Warranties – Drafting Considerations

• Stronger formulations:
  – Clean reps without qualifiers or exceptions
  – “The Company is and has been in compliance with all laws…”
  – “There is no lawsuit pending that will, or could reasonably be expected to have an adverse effect on the Company…”
Representations and Warranties – Drafting Considerations

• Materiality
  – “The Company believes in good faith that any 409A Plan complies in all material respects, in both form and operation, with the requirements of Section 409A of the Code and the guidance thereunder”
  – In lieu of materiality qualifiers in the reps, the issue of materiality can be addressed via remedies (e.g., only material breaches give rise to liability)
Representations and Warranties – Drafting Considerations

• Knowledge
  – Whose knowledge?
  – Burden to investigate?
    • is it actual knowledge as of the date the rep is given? Or does the party giving
      the representations have a duty to investigate the accuracy of the rep?
  – “The Company is and has been, to the knowledge of the Company, in compliance in all material respects…”
  – “There is no claim, action, suit, proceeding, arbitration, complaint, charge or investigation pending or to the Company’s knowledge, currently threatened [in writing]…”
Representations and Warranties – Drafting Considerations

• Disclosure Schedule
  – Sets forth exceptions to the representations
  – Requires “self-diligence” by the party giving the representation
Representations and Warranties – Other Considerations

• Other considerations
  – Reps are a snapshot in time. Consider whether they should be brought down to a later date.
  – Survival period
    • For purchase agreements and similar transactions, without an explicit survival clause, there is a risk that reps terminate at closing
    • For ongoing commercial agreements consider in relation to term and termination
Indemnities

- Allocates risk between two parties by requiring one party to pay for the expenses/losses incurred by others
- Often bundled with duty to defend
- No standard indemnity provision that suits all purposes
- Should be considered in conjunction with other risk allocation and dispute resolution mechanisms
Indemnification – Basic Formulation

• “Each party (the “Indemnifying Party”) shall indemnify and hold harmless the other party (the “Indemnified Party”) from and against all losses, damages, penalties, disbursements, costs and expenses incurred by the Indemnified Party as a result of any breach by the Indemnifying Party of any of its representations or covenants under this Agreement.”
Indemnities – Considerations

• Who is indemnified
  – Generally indemnification is mutual, although one party may be much more likely to make a claim for indemnification, and exactly what will be indemnified for will vary between the parties
  – Party, its officers, employees and agents
  – Affiliates
  – (sub)licensees?

• What losses are indemnified for
  – Include third party claims only?
  – Damages? Costs and expenses? Reasonable attorneys’ fees?
Indemnities – Considerations

• Claims subject to indemnification
  – Breach of any obligation, rep or warranty under the agreement
  – [Gross] negligence or willful misconduct
  – Personal injury?
  – IP?
  – Other specifically-identified risks
Indemnities – Considerations

- **Carve-outs**
  - “except in the case of clauses (i) through (iii), to the extent arising from or occurring as a result of (1) the breach by Company of any obligation . . . .”
  - Consider whether to expressly allocate comparative fault for relevant carve outs, e.g., “to the extent of their respective liability.”
Indemnities – Considerations

- Drafting considerations when modulating scope – affirmative grants and carve-outs
  - Allocation mechanism
  - Deal with gaps or “I don’t know what it is but I know what it isn’t”
Indemnities – Examples

• Modulating Scope
  – “Company indemnifies . . . . the exploitation of any Company Product . . . . including claims arising from or occurring as a result of an allegation that such exploitation violates or diminishes the intellectual property rights of a third party [solely] to the extent such claim arises from to use or incorporation of Company Core Technology . . . .”
  – “. . . including claims arising from or occurring as a result of an allegation that such exploitation violates or diminishes the intellectual property rights of a third party . . . . except to the extent such third party claim arises from the use or incorporation of ClientCorp’s Technology Platform . . . .”
Indemnities – Examples

- **CRO Master Agreement**
  - Company shall indemnify, defend and hold harmless CRO and its employees, officers, directors, agents and representatives (collectively, the “CRO Indemnitees”) from and against any and all direct or indirect liability, damage, loss, cost or expense (including reasonable attorneys’ fees and disbursements) (collectively, “Losses”) in connection with any claims made or suits brought by a third party against a CRO Indemnitee to the extent such claims allege bodily injury or death caused by the administration of a Study Drug under a Task Order in accordance with the provisions of this Agreement, such Task Order, the applicable Protocol and all written instructions of Company concerning the Study Drug or a Study, except to the extent that such Claims arise from: (i) the breach by any CRO Indemnitee of the terms of this Agreement, the applicable Task Order, the applicable Protocol or any written instructions of Company concerning the Study Drug or a Study; (ii) the violation by any CRO Indemnitee of any Applicable Laws; or (iii) the negligence, recklessness or willful misconduct of any CRO Indemnitee.
  - CRO shall indemnify, defend and hold harmless Company, its Affiliates and its and their respective employees, officers, directors, agents and representatives (collectively, the “Company Indemnitees”) from and against any and all Losses in connection with any claims made or suits brought against a Company Indemnitee resulting from or arising out of (i) the breach by any CRO Indemnitee of the terms of this Agreement, the applicable Task Order, the applicable Protocol or any written instructions of Company concerning the Study Drug or a Study; (ii) the violation by any CRO Indemnitee of any Applicable Laws; or (iii) the negligence, recklessness or willful misconduct of any CRO Indemnitee.
Indemnities – Examples

• Manufacturing Agreement
  – Upon the terms and subject to the conditions of this Article X, Manufacturer shall defend, indemnify and hold harmless Company, its Affiliates, and their respective officers, directors, employees and agents (collectively, “Company Indemnitees,” and, together with the Manufacturer Indemnitees, the “Indemnitees”), from and against any and all liabilities, damages, losses, costs, expenses (including reasonable attorneys’ fees and other expenses of litigation and arbitration), claims, demands, suits, penalties, judgments or administrative and judicial orders (collectively, “Losses”) relating to any Proceeding to the extent arising out of or resulting from (i) any negligent act or omission or willful misconduct of Manufacturer, its Affiliates, its contract manufacturers or raw material suppliers, or any of their respective officers, directors, employees or agents in connection with the performance of this Agreement; (ii) any breach by Manufacturer or its Affiliates of any of its representations, warranties, covenants or obligations contained in this Agreement; (iii) any failure by Manufacturer, its Affiliates, its contract manufacturers or raw material suppliers, or any of their respective officers, directors, employees or agents to comply with any Applicable Laws regarding the manufacture or supply of the Products; or (iv) any act or omission of any Secondary Supplier of Products designated by Manufacturer in accordance with Article X of this Agreement; in each case ((i) through (iv)), except for those Losses for which Company has an obligation to indemnify a Manufacturer Indemnitee pursuant to Article X, as to which Losses each Party shall indemnify the other to the extent of their respective liability for such Losses.
Indemnities – Procedural Considerations

• Notice

• Control of Defense
  – Choice of counsel subject to any approval rights, i.e., “reasonably acceptable to the Indemnified Party”
  – Costs & attorneys’ fees in the event it is determined indemnifying party is not obligated to indemnify?
  – Consequences for failure to defend?

• Right to Participate in Defense
Indemnities – Procedural Considerations

• Cooperation
  – Records, access to employees
  – Costs?

• Expense/Cost Reimbursement Schedule

• Settlement
  – Subject to consent rights?
  – Restricted by types of claims, e.g., injunctive relief?
  – Restrictions on ability to impose adverse effects or admissions
Limitations of Liability – Exclusion of Consequential Damages

• NEITHER PARTY SHALL BE LIABLE TO THE OTHER IN RELATION TO THIS AGREEMENT FOR ANY INDIRECT, CONSEQUENTIAL OR SPECIAL DAMAGES, WHETHER LIABILITY IS ASSERTED IN CONTRACT, TORT (INCLUDING NEGLIGENCE AND STRICT LIABILITY) OR OTHERWISE, AND IRRESPECTIVE OF WHETHER SUCH PARTY HAS BEEN ADVISED OF, OR OTHERWISE MIGHT HAVE ANTICIPATED THE POSSIBILITY OF, SUCH DAMAGES.
Limitations of Liability – Considerations

• Distinction between what is direct and indirect is unpredictable in practice
  – Context/transaction specific
  – Incorporates elements of probability and directness/causality

• Example – Lost Profits from Collateral Transactions
  – CA cases involve crops, goods intended for resale, agreement creating exclusive sales agency
  – “The likelihood of lost profits from related or derivative transactions is so obvious in these situations that the breaching party must be deemed to have contemplated them at the inception of the contract”
Limitations of Liability – Considerations

• Tailor to the Transaction*
  – What are the damages likely at issue in the transaction
  – Parties will look for mutuality

• Examples
  – Incidental
  – Exemplary
  – Lost Profits
  – Diminution of Value
  – Loss of Goodwill
  – Lost Productivity
Limitations of Liability – Liability Caps

• Consider underlying damages law
  – Don’t ignore ramification of other “non-monetary” remedies (e.g., injunctive relief for breaches of confidentiality, etc)
  – Cal. Comm. Code s. 2719

• Fixed amount
  – Total of $X or multiple of amount under contract

• Time delimited
  – Payments made in X time
  – Damages accrued in X time
Exclusions for Limitations of Liability

• Conduct-based
  – Consider underlying state law. In California, cannot exempt liability for fraud, willful injury or violation of law* Cal. Civ. Code s. 1668

• Types of Claims (e.g., Confidentiality, IP)

• Relationship to indemnification
  – Damages subject to indemnification could constitute consequential damages
  – Make relationship to indemnification express

Resources

- National Venture Capital Association Model Legal Documents
- CEB Drafting Business Contracts: Principles, Techniques & Forms
- ABA Model Asset Purchase Agreement
- Working with Contracts by Charles M. Fox