

COMMERCIAL AGREEMENTS: REPRESENTATIONS AND WARRANTIES AND INDEMNIFICATION

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Amit is a shareholder in Stradling's corporate and securities law and technology transactions practices.

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Introduction

- What Are Representations and Warranties?
- What Is A Duty To Indemnify?
- Limitation of Liability Clauses and Indemnity
- Special Issues with Indemnity and Limitations on Liability

Representations and Warranties

- General definition of a “Representation” – factual statement at a particular time intended to induce reliance
- General definition of a “Warranty” – promise about a factual statement into the future, may imply a right to indemnity if untrue
- As a practical matter, use both terms together
 - avoids ambiguity

Representations and Warranties: General Purpose and Examples

- Similar Purpose – Allocate costs or apportion risk for certain adverse situations
- Typical Representations and Warranties In Commercial and Licensing Agreements
 - Company has authority to enter into agreement
 - Company is corporation in good standing
 - Company's products or services do not infringe third party IP rights

What Is Indemnification?

- General Definition – The obligation of one party to pay for the losses or expenses suffered or incurred by another party.
- Indemnitor – The party who has to pay for the losses and the expenses incurred.
- Indemnatee -The party who suffered the losses or incurred the expenses.

Indemnification:

General Purpose and Examples

- Typical Indemnity Scope In Commercial and Licensing Agreements
 - Breach of reps and warranties
 - Third Party IP Infringement claims
 - Breaches or violations of law
 - Grossly negligent or willful misconduct

Indemnification:

General Purpose and Examples

- In mergers and acquisitions, indemnification might involve, in addition to indemnity for third-party claims:
 - Indemnification for “diminution in value”
 - Baskets
 - Tipping
 - Non-Tipping
 - De Minimis Exclusion

Real World Example

- Factual Scenario: Licensor licenses software for distribution by Licensee with hardware
- Infringement Risk: Licensee is concerned that Licensee will be infringing third party IP rights by distributing Licensor's software
- Allocating Risk
 - Representations and Warranties
 - Indemnity

Allocating IP Infringement Risk: Representations and Warranties

- Representation and Warranty that:
 - Licenser has all permissions necessary to grant Licenses
 - Licensee's exercise of rights will not infringe third party IP rights
 - [Cuts both ways?]

Allocating IP Infringement Risk: Indemnity

- Indemnity Scope:
 - Licensors will indemnify Licensees against claims that Licensee's exercise of rights will infringe third party IP rights
 - Note: Discussion of indemnity language will come later

Infringement Rep/Warr Breach vs Indemnity

- Representation and warranty breach means all remedies available for contract breach
 - Damages Resulting From Breach
 - Termination For Breach
 - Cannot terminate agreement if licensed software breaches third party IP rights, without an IP representation
- Representation and Warranty breach can occur before specific claim brought
 - Leverage to terminate and sue for damages before a claim is made
- Indemnity generally includes defense against specific claims (depending on the jurisdiction and the specific language)
 - If limited to third party claims, no rights arise until a claim is actually made
 - But, unless a contrary intention appears, the indemnitee is not entitled to recover without payment (California Civil Code Section 2778(2))
 - “Payable as incurred and on demand”

Parsing and Analyzing Indemnity Language – Basic Provision

“Licensor agrees to indemnify Licensee from and against any and all claims, counterclaims, suits, demands, actions, causes of action, damages, penalties, injuries, setoffs, liens, attachments, judgments, debts, costs or expenses of every character whatsoever arising out of a breach of any of the representations, warranties or covenants made by Licensor in this Agreement.”

Negotiation Points in Indemnity

- “Defend” AND “Indemnify”?
- What is the defense procedure?
- Who is indemnified?
- Which claims trigger the indemnity?
- What is being “indemnified”?

“Defend” vs. “Indemnify”

- “Licensor agrees to **defend**, indemnify and **hold harmless** Licensee”
- Benefits of indemnity (if in California or when drafted properly from indemnified party’s standpoint) are coverage for losses PLUS defense
- The defense may be the more valuable part of the indemnity
- Even baseless patent infringement suit can cost \$100,000+ easily to knock out at summary judgment phase
- California has specific statute regarding interpretation of indemnity clauses (California Civil Code Section 2778)
 - In California, “indemnify” includes “defense”
 - Most states (e.g., NY), a duty to indemnify does NOT include a duty to defend

Defense Procedures - Notice

- “Promptly after receipt by an Indemnatee of notice of the assertion of a Claim, such Indemnatee shall give notice to the Licensor of the Claim, provided that the failure to notify the Licensor will not relieve the Licensor of any liability that it may have to any Indemnatee, **unless** the defense of such Claim is prejudiced by the failure to give such notice.”
 - “Promptly after receipt by an Indemnatee of notice of the assertion of a Claim, such Indemnatee shall give notice to the Licensor of the Claim, provided that the failure to notify the Licensor will not relieve the Licensor of any liability that it may have to any Indemnatee, **except to the extent that** the defense of such Claim is prejudiced by the failure to give such notice.”

Defense Procedures – Admission of Indemnification Obligation

- Typically, the Indemnifying Party controls the litigation. But, it may be required to admit liability first.
 - “Until the Licensors acknowledges in writing its obligation to indemnify the Indemnitee and assumes control of the defense of a Claim, the Indemnitee has the right to defend the Claim (at the Licensors’ expense, should the Claim ultimately be determined to be indemnifiable), with counsel of its choosing.”

Defense Procedures – Conflicts

- In certain situations (e.g., conflicts of interest), the Indemnified Party may need to control the litigation (or at least have a right to appear with separate counsel).
 - “If (A) a Claim is primarily for non-monetary damages against an Indemnitee or seeks an injunction or other equitable relief that, if granted, would reasonably be expected to materially adversely affect Licensee or (B) Licensee determines in good faith that an actual or potential conflict of interest makes representation of the Parties by the same counsel inappropriate, then in each case Licensee may, upon written notice to Licensor, assume the exclusive right to defend, compromise and settle such Claim.”
- Should specify who selects the defense lawyer.
- Should specify who has the right to settle the Claim.

Who is Indemnified?

- **“Licensee and its officers, directors, [managers, members,] [constituent partners,] [stockholders,] employees, agents, control persons, subsidiaries, permitted successors and permitted assigns (collectively, the “Indemnitees”)”**
- Because these third parties can be indemnitees, ensure that any “no third party beneficiaries” clause carves out indemnity rights
 - **“Except as set forth in Section __ with respect to the rights of the Indemnitees, nothing expressed or referred to in this Agreement will be construed to give any Person other than the parties to this Agreement any legal or equitable right, remedy or claim under or with respect to this Agreement or any provision of this Agreement.”**

What Is “Indemnified”?

- “all **third party** claims, counterclaims, suits, demands, actions, causes of action, **damages, losses**, penalties, injuries, setoffs, liens, attachments, judgments, debts, costs, expenses (including without limitation **attorneys' fees** and expenses) **or other liabilities** of every character whatsoever (each, a “Claim”)”
- Damages/Losses vs Liabilities
 - Damages/Losses – Indemnified Party hasn't suffered damage until they have to pay
 - Liabilities - Indemnified Party can become liable before they have to pay

Relative Fault of the Parties

- “**to the extent** arising out of a breach of any of the representations, warranties or covenants made by Licensor in this Agreement”
- The added language allocates risk based on whose fault it is.
 - If the Claim arises 10% from a warranty breach, then the Indemnifying Party shouldn't be liable for 100% of the loss.
- An alternative approach: “arising **primarily** out of...”
 - Avoids scenario where both parties have to simultaneously indemnify/defend each other

Which Claims Trigger Indemnity?

- Example from licensing:
 - Claims brought alleging that Licensee's exercise of rights caused third party infringement claim to be brought against Licensee
 - Indemnifying Party may seek carve-out for actions taken by Licensee that caused, accelerated or increased chances of Claim such as:
 - Certain combinations of software
 - Actions taken outside of exercising license rights such as modifications to software

Parsing and Analyzing Indemnity Language – Improved Language

“Licensor agrees to **defend, indemnify and hold harmless** Licensee **and its officers, directors, [managers, members,] [constituent partners,] [stockholders,] employees, agents, control persons, subsidiaries, permitted successors and permitted assigns** (collectively, the “Indemnitees”) from and against any and all **third party** claims, counterclaims, suits, demands, actions, causes of action, **damages, losses,** penalties, injuries, setoffs, liens, attachments, judgments, debts, costs, expenses (including without limitation **attorneys' fees and expenses) or other liabilities** of every character whatsoever (each, a “Claim”), **to the extent** arising out of a breach of any of the representations, warranties or covenants made by Licensor in this Agreement.”

Special Issues With Indemnity and Limitation of Liability – Part 1

- Standard Examples of Limitation of Liability
 - No liability for special, incidental and consequential damages (claims based)
 - No liability above certain amount (financial)

Special Issues With Indemnity and Limitation of Liability – Part 2

- Claims based limitations (no liability for special, consequential, incidental damages)
 - Indemnified Party should carve out indemnity to avoid Indemnifying Party from claiming that defending a Claim not needed because the Claim is for damages that are “consequential”
 - Drafting pitfall: Some language carves out indemnity by literally using the word “indemnity” – instead carve out all actions in the indemnity section so someone doesn’t argue that the “defense” is not carved out

Special Issues With Indemnity and Limitation of Liability – Part 3

- Financial based limitations (no liability for amounts exceeding an amount)
 - If Indemnified Party does not negotiate a carve out for indemnity obligations, do defense costs count towards cap? What about damages?
 - Parties can negotiate the caps to apply even to the indemnity obligations but needs to be addressed explicitly

Summary

- Representations and Warranties
 - Immediate claim for damages from breach
 - Right to termination or other rights arising from any contract breach
- Indemnity/Defense of Third Party Claims
 - No rights arise until Claim made
 - No termination rights until Claim made
- Language of Indemnity is very important, don't gloss over it!