Nonbinding opinion

By Tina L. Stark

Another view on reps and warranties

Editor's note: This column is written in response to the feature article by Kenneth A. Adams in the November-December 2005 issue of BLT: "A lesson in drafting contracts: What's up with 'representations and warranties'?"

A lawyer drafting a business contract has multiple responsibilities, but two of the most important are to protect her client against risks and to secure those advantages that are reasonable and appropriate. Having a client receive both "representations and warranties" will generally help you fulfill these responsibilities.

To understand the benefits of a client receiving both representations and warranties, some background is necessary. This column will address issues relating to representations and warranties as they arise in the common law, not in the context of the Uniform Commercial Code. Common law representations and warranties appear in many agreements, including acquisition, loan, publishing, joint venture, and employment agreements.

We will begin with representations. They are statements of present or past fact. For example, "The financial statements fairly present the financial condition of the seller." Future "facts" cannot generally form the basis of representations because no one can know the future. At best, someone can have an opinion.

If a representation is intentionally false, a plaintiff can make a common law claim of deceit (a tort) and allege fraudulent misrepresentation. Among the elements of this cause of action are:

- scienter (knowledge or conscious ignorance of the statement's falsity);
- an intent to induce reliance; and
- justifiable reliance.

Reps and warranties are not inextricably linked.

If a plaintiff cannot prove the defendant's scienter, or if the plaintiff knew that the statement was false so that she could not have justifiably relied on its truthfulness, the plaintiff's cause of action for fraudulent misrepresentation will fail.

Remedies are a critical factor in the mix when assessing the relative benefits of representations and warranties. Generally, a plaintiff injured by a fraudulent misrepresentation has a choice of remedies. She may rescind the contract and obtain restitutionary recovery, or she may affirm the contract and sue for damages. The ability to rescind — to unwind a closed transaction — is a remedy not available to a plaintiff suing for a breach of warranty, and therefore is a benefit of including representations in a contract. A second benefit is that the plaintiff may be able to obtain punitive damages under special circumstances.

Some states use the "out-of-pocket" measure of damages for fraudulent misrepresentations. This limits the plaintiff's damages to the amount paid for the item ($1,000) minus what the item was actually worth ($200) (damages = $800). The alternative measure of damages is the "benefit of the bargain," the measure of damages generally associated with contracts. In this case, the injured party's damages are equal to the value of the item as it was represented to be ($1,200) minus what the item was actually worth ($200) (damages = $1,000). The importance of these different measures of damages will become clear after the discussion of warranties.

Now, let's turn to warranties. In the past 15 years, courts have been struggling anew with the meaning and implications of a common law *warranty* — a promise that a fact is true. The seminal case was *CBS Inc. v. Ziff-Davis Publishing Co.*, 75 N.Y.2d 496 (1990). In that case, Ziff-Davis "represented and warranted" the financial condition of the division it was selling to CBS. CBS, however, as part of its due diligence, sent in its own accountants to review the division's financial statements. They reported that the financial condition

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was not as represented and warranted. The parties closed anyway, and then CBS sued.

In New York's highest court, the issue was whether CBS had a cause of action for breach of warranty. Ziff-Davis argued that CBS did not because it had known about the problems with the financial statements and had not justifiably relied on the warranties. Stated differently, Ziff-Davis argued that the standards for a cause of action for a fraudulent misrepresentation and a breach of warranty both required justifiable reliance on the truthfulness of the statement. Ziff-Davis lost.

According to the New York court, a warranty is a promise of indemnity if a statement of fact is false. A promisee does *not* have to believe that the statement is true. Indeed, the warranty's purpose is to relieve a promisee from the obligation of determining a fact's truthfulness.

Since the *CBS* case was decided, the majority of states have followed New York.

The meaning of *warranty* is critical to plaintiffs whose defendants made both representations and warranties. As we have seen, a plaintiff's fraudulent misrepresentation claim will fail if she knew the statement was false. But, if a plaintiff's jurisdiction follows the CBS/Ziff-Davis rule, the plaintiff may sue for breach of warranty on the same statement and recover despite knowledge of the falsity of the statement, subject to some limitations. This is a substantial business and legal reason for a party to receive both representations and warranties.

Not surprisingly, other consequences flow from coupling representations and warranties:

- A plaintiff may be able to win a breach of warranty claim when it would have lost a claim for fraudulent misrepresentation because it could not prove scienter.
- Recovery for a breach of warranty may be greater than recovery for fraud. Breach of warranty is a contract breach and its measure of damages is the benefit of the bargain. As noted, in some states, the measure of damages for fraud is out-of-pocket damages, which may be less.

Representations and warranties are not inextricably linked. Some parties, as a matter of principle, refuse to take fraud risk (read punitive damages), and will not make representations, only warranties. A more sophisticated version of this issue can arise in acquisitions. Occasionally, a buyer will ask a seller to represent as a fact something that the seller knows is not true or does not know whether it is true. Technically, doing so is fraud. A buyer nonetheless defends its request by telling the seller, "It's just risk allocation." In other words, even if the statement is not true, it represents the business deal.

A seller often accedes to this request on the theory that it is not fraud because it has "worked it out" with the buyer. This is cold comfort when the buyer sues for fraud, "forgetting" that it was "just risk allocation" and "forgetting" that the seller explained the situation's actual status. As an alternative, the seller can merely "warrant" the statement. In that case, the seller makes no representation that can be the basis of a fraudulent misrepresentation, and the warranty is the promise of indemnity, precisely the risk allocation the buyer sought.

Representations and warranties are important — but different — tools for the contract drafter. But receiving both of them from the other side usually — but not always — provides a client with the best protection.