

# Translating the Business Deal into Contract Concepts: Part 1 (Representation and Warranties & Covenants and Rights)

## 3.1 INTRODUCTION

Before deal lawyers begin to draft, they learn the terms of the business deal. Those terms are the deal lawyer's facts. The lawyer must then find the contract concepts that best reflect the business deal and use those concepts as the basis of drafting the contract provisions. This skill is known as **translating the business deal into contract concepts**. It is the foundation of a deal lawyer's professional expertise and ability to problem solve. Without it, negotiating and drafting are abstractions. By learning this skill first, you will be able to layer knowledge of how to draft on top of a framework that has taught you what you are drafting.

This chapter and the next discuss the contract concepts in depth and demonstrate how they are used in a contract. This chapter deals with representations and warranties, then covenants and rights. Chapter 4 deals with conditions, discretionary authority, and declarations. As part of this discussion, you will learn not only the legal aspects of each contract concept, but also its business purpose. Chapter 4 ends with a chart that summarizes the material in these two chapters.

## 3.2 REPRESENTATIONS AND WARRANTIES

### 3.2.1 DEFINITIONS

Imagine that Sally Seller has listed her house for sale and that Bob Buyer is interested in purchasing it. But before Bob agrees to buy the house, he wants to learn more information about it. All that he knows now is that the house is a two-story Cape Cod painted brown. He asks Sally the following questions during a telephone call as he is out of town on business:

- When was the house built?
- How old is the roof?
- Do all the appliances work?
- Is the house wired for cable television and is the wiring functioning properly?
- Is there a swimming pool?
- Is there a swimming pool water heater? Does it use propane gas for fuel?

- How much propane gas is in the tank?
- What color are the living room walls, and when were they last painted?
- How big is the lot on which the house was built?

Sally responds to Bob by telling him the following:

- The house was built in 1953 along with other houses in the neighborhood.
- The roof is four years old.
- All the appliances are in excellent condition.
- The house is wired for cable television, and it is functioning properly.
- Yes, there is a swimming pool.
- Yes, there is a swimming pool water heater, and it uses propane gas for fuel.
- The tank is exactly one-half full with propane gas.
- The living room's walls are painted eggshell white and were painted one year ago. Sally mentions that she has been thinking of painting them a pale blue to coordinate with her furniture.
- The house was built on a one-acre lot.

After hearing Sally's responses, Bob decides that the house is perfect for him. He and Sally agree on a \$200,000 purchase price. Bob then calls his lawyer and asks her to draw up the contract and to include within it the information that Sally has just told him. He tells his lawyer that the answers were an important factor in his decision to buy the house.

How does the lawyer include the information in the contract? The answer is that she will use **representations and warranties**.

#### A representation

- is a statement of fact
- as of a moment in time
- intended to induce reliance.<sup>1</sup>

Assume that Sally and Bob sign a contract today for the sale of the house and that in the contract Sally tells Bob the following:

- The roof is four years old.

Sally's statement is a representation. She made that statement (*a statement*) today (*a moment in time*). (Had she made the statement a year ago, the roof would have been three years old, and if she were to make the statement in a year, it would be five years old.) In addition, she made the statement to convince Bob to purchase the house (*to induce reliance*).

The representation that the roof is four years old is a statement about a present fact. Sally also made representations with respect to facts concerning the past: *The house was built in 1953 along with other houses in the neighborhood*. Although a party can make representations with respect to present and past facts, they generally cannot do so with respect to future facts. Those are mere statements of opinion. Chapter 9 discusses this issue in more depth.

For Bob to have a cause of action for misrepresentation, he must actually have relied on Sally's statement, and that reliance must have been justifiable.<sup>2</sup> That is, Bob

1. See *Harold Cohn & Co, Inc., v. Harco Intl., LLC*, 804 A.2d 218, 223-224 (Conn. App. Ct. 2002).

2. See *S. Broad. Group, LLC v. Gem Broad., Inc.*, 145 F. Supp. 2d 1316, 1329-1330 (M.D. Fla. 2001), *aff'd*, 49 Fed. Appx. 288 (11th Cir. 2002) (table).

must not have known that Sally's statement was false. So, for example, if Bob purchases the house after his contractor tells him that the roof is much older than four years, Bob's reliance on Sally's representation that the roof is four years old is not justifiable. Accordingly, Bob would not have a cause of action with respect to a misrepresentation as to the roof's age. He would have a cause of action, however, for breach of a **warranty** of that same statement.<sup>3</sup>

A warranty differs from a representation.

**A warranty is a promise by the maker of a statement that the statement is true.**<sup>4</sup>

This promise will result in the maker of the statement paying damages to the statement's recipient if the statement was false and the recipient damaged. The warranty acts as an indemnity. It does not matter whether the recipient knew the statement was false.<sup>5</sup> The salient factor is the recipient's reliance on the promise of damages if the statement is false. Therefore, while Bob would not have a cause of action for a misrepresentation with respect to the roof's age, he would be able to sue for a breach of warranty postclosing—so long as he told Sally when they were closing that he was reserving his right to make a claim.<sup>6</sup>

Deal lawyers almost always negotiate for both representations and warranties. For example, in the house purchase agreement between Sally and Bob, the representations and warranties article would be introduced with the following language:

*The Seller represents and warrants to the Buyer as follows:*

By virtue of this one line, every statement in the sections that followed would be both a representation and a warranty.<sup>7</sup>

In the purchase agreement between Sally and Bob, Sally's representations and warranties would resemble the following:

**Seller's Representations and Warranties.** The Seller represents and warrants to the Buyer as follows:

- (a) The house was built in 1953, along with the other houses in the neighborhood.
- (b) The roof is four years old.
- (c) All the appliances are in excellent condition.
- (d) The house is wired for cable television, and it is functioning properly.
- (e) There is a swimming pool.
- (f) There is a swimming pool water heater, and it uses propane gas for fuel.

3. *Id.* at 1321-1324. *See also Shambaugh v. Lindsay*, 445 N.E.2d 124, 125-127 (Ind. Ct. App. 1983).

4. *See CBS Inc. v. Ziff-Davis Publg. Co.*, 554 N.Y.S.2d 449, 452-453 (1990).

5. *See id.* Since *CBS*, a majority of states have followed the New York rule. *See, e.g., Wikoff v. Vanderveld*, 897 F.2d 232 (7th Cir. 1990) (applying Illinois law). *But see Hendricks v. Callahan*, 972 F.2d 190 (8th Cir. 1992) (applying Minnesota law).

6. *See Galli v. Metz*, 973 F.2d 145, 150-151 (2d Cir. 1992) (holding that where a buyer closes with full knowledge that the facts disclosed by seller are not as warranted, the buyer may not sue on the breach of warranty, unless it expressly preserves the right to do so).

7. In unusual circumstances, a practitioner might recommend to a client that it make only a warranty. *See* §9.4.

- (g) The tank is exactly one-half full with propane gas.
- (h) The living room's walls are painted eggshell white and were painted one year ago.
- (i) The house was built on a one-acre lot.

Finally, when determining whether a party made a misrepresentation and breached a warranty, a statement's truthfulness is always determined by comparing the statement to reality *as of the moment in time when the statement was made*, not when the determination of truthfulness is made.<sup>8</sup> Therefore, Sally's representation and warranty are truthful so long as the living room walls were painted eggshell white when she stated that they were that color. It would be irrelevant with respect to claims for misrepresentation and breach of warranty that she painted the walls pale blue after she made the representation in the contract for sale but before she sold the house to Bob. Of course, the painting of the walls would not be irrelevant to Bob. However, to obtain a remedy, he would need to rely on a cause of action other than misrepresentation and breach of warranty. He would need a covenant.<sup>9</sup>

### 3.2.2 REMEDIES

Representations and warranties are common law concepts. As such, they carry with them common law remedies. The differences in these remedies can directly affect which cause of action is the most favorable for a plaintiff to plead.

A party can make three types of misrepresentations: innocent,<sup>10</sup> negligent,<sup>11</sup> and fraudulent.<sup>12</sup> A litigation alleging any of these misrepresentations is a suit in tort.

Typically, innocent and negligent misrepresentations must be material to support a remedy.<sup>13</sup> The law with respect to fraudulent misrepresentations depends upon the jurisdiction. In some jurisdictions, a misrepresentation need not be material for it to constitute a fraudulent misrepresentation,<sup>14</sup> while in others it must.<sup>15</sup>

If a misrepresentation is innocent or negligent, the usual remedies are **avoidance** and **restitutionary recovery**.<sup>16</sup> Avoidance permits the injured party to unwind the contract.<sup>17</sup> Both lawyers and courts often refer to it as *rescission*. Restitutionary

8. See *Union Bank v. Jones*, 411 A.2d 1338, 1342 (Vt. 1980).

9. See §3.3.

10. See *Bortz v. Noon*, 729 A.2d 555, 563-564 (Pa. 1999); *Restatement (Second) of Torts* §552C (1977) (misrepresentations in sales, rental, or exchange transactions).

11. See *Liberty Mut. Ins. Co. v. Decking & Steel, Inc.*, 301 F. Supp. 2d 830, 834 (N.D. Ill. 2004); *Restatement (Second) of Torts* §552 (1977) (information negligently supplied for the guidance of others).

12. See *Skurnowicz v. Lucci*, 798 A.2d 788, 793 (Pa. Super. Ct. 2002).

13. See *Restatement (Second) of Contracts* §164 (1981).

14. See *Sarvis v. Vt. State Colleges*, 772 A.2d 494, 498 (Vt. 2001). Compare *Restatement (Second) of Contracts* §164 (1981) (providing that a fraudulent misrepresentation need not be material to make it voidable) with *Restatement (Second) of Torts* §538 (1977) (providing that reliance upon a fraudulent representation is not justifiable unless the matter misrepresented is material).

15. See *Skurnowicz v. Lucci*, 798 A.2d 788, 793 (Pa. Super. 2002).

16. See *Norton v. Poplos*, 443 A.2d 1, 4-5 (Del. 1981) (innocent misrepresentation); *Patch v. Arsenault*, 653 A.2d 1079, 1081-1083 (N.H. 1995) (negligent misrepresentation). Damages have been awarded in cases of innocent and negligent misrepresentation. See *Restatement (Second) of Torts* §552B and §552C (1977). See generally Dan B. Dobbs, *Dobbs Law of Remedies*, vol. 2, §9.2(2), 554-556 (2d ed., West 1993).

17. See *Kavarco v. T.J.E., Inc.*, 478 A.2d 257, 261 (Conn. App. Ct. 1984). See generally E. Allan Farnsworth, *Farnsworth on Contracts*, vol. 1, 495-496 (3d ed., Aspen 2004).

recovery requires each party to return to the other what it received, either in kind, or if necessary, in money.<sup>18</sup>

A misrepresentation may also be fraudulent—a misstatement made with knowledge of its falsity (**scienter**).<sup>19</sup> In this case, an injured party has a choice of remedies. First, it may void the contract and seek restitution,<sup>20</sup> just as with innocent and negligent misrepresentations. Alternatively, it may affirm the contract, retain its benefits, and sue for damages based on a claim of fraudulent misrepresentation,<sup>21</sup> sometimes referred to as the tort of deceit. The injured party's damages claim could also include **punitive damages**,<sup>22</sup> which, of course, can be significantly larger than general damages.

If an injured party decides to affirm the contract by suing for fraudulent misrepresentation, the measure of damages depends upon which state's law governs the contract. Most states use the **benefit of the bargain** measure of damages,<sup>23</sup> with the minority using the **out-of-pocket** measure of damages.<sup>24</sup>

The benefit of the bargain measure of damages results in a higher damages award and is the measure of damages that a party generally receives upon a contract breach. It is equal to the value that the property was represented to be *minus* the actual value. So, if the property was represented to be worth \$10,000 but was actually only worth \$3,000, the damages would be \$7,000.

Value if as represented	\$10,000
Actual value	<u>-3,000</u>
Damages	\$7,000

Out-of-pocket damages are equal to the amount the plaintiff paid for the property *minus* the actual value. Thus, if the plaintiff paid \$5,000 for property that was only worth \$3,000, it could recover only \$2,000 in damages.

Amount Paid	\$5,000
Actual value	<u>-3,000</u>
Damages	\$2,000

The difference in recovery between the benefit of the bargain damages and out-of-pocket damages can be important when a plaintiff decides whether to sue for fraudulent misrepresentation or breach of warranty. Specifically, if an injured party asserts a claim for breach of warranty, a contract claim, the remedy for that breach is full benefit of the bargain damages.<sup>25</sup> Therefore, in a state that follows the out-of-pocket rule of damages for fraudulent misrepresentations, a plaintiff would probably be better off pursuing a breach of warranty claim, as its benefit of the bargain damages would be

18. See E. Allan Farnsworth, *Farnsworth on Contracts*, vol. 1, 499 (2d ed., Aspen 2004). Some cases hold that the injured party is also entitled to reliance damages. See *In re Letterman*, 799 F.2d 967, 974 (5th Cir. 1986).

19. See *Bortz v. Noon*, 729 A.2d 555, 560 (Pa. 1999).

20. See *Smith v. Brown*, 778 N.E.2d 490, 497 (Ind. Ct. App. 2002).

21. See *Stebins v. Wells*, 766 A.2d 369, 372 (R.I. 2001).

22. See generally Dan B. Dobbs, *Dobbs Law of Remedies*, vol. 2, §9.2(5), 565-568 (2d ed., West 1993).

23. See, e.g., *Lightning Litho, Inc. v. Danka Indus., Inc.*, 776 N.E.2d 1238, 1241-1242 (Ind. Ct. App. 2002).

24. See *Reno v. Bull*, 124 N.E. 144, 146 (N.Y. 1919). Some states follow neither rule exclusively, but instead have a more flexible approach that varies the damage award based upon specific factors. See, e.g., *Selman v. Shirley*, 85 P.2d 384, 393-394 (Or. 1938).

25. See *Nunn v. Chem. Waste Mgt., Inc.*, 856 F.2d 1464, 1470 (10th Cir. 1988).

greater.<sup>26</sup> A claim for fraud might become the preferable claim, however, if a plaintiff could successfully argue for **punitive damages**.

The following chart summarizes the remedies associated with representations and warranties.

INNOCENT AND NEGLIGENT MISREPRESENTATIONS	FRAUDULENT MISREPRESENTATIONS	WARRANTIES
Avoidance and restitutionary recovery	Avoidance and restitutionary recovery  <i>or</i> Damages: <ul style="list-style-type: none"> <li>• Out-of-pocket damages</li> <li><i>or</i></li> <li>• Benefit of the bargain damages</li> <li>• Punitive damages</li> </ul>	Benefit of the bargain damages

In this discussion, false representations have been referred to as *misrepresentations*. Although some lawyers colloquially speak of *breaches of representations*, that terminology is incorrect. A breach is a violation of a promise. Because representations are not promises, they cannot be breached. Instead, a party makes *misrepresentations*. It is correct, however, to speak of *breaches of warranties*, as warranties are promises.

### 3.2.3 WHY A PARTY SHOULD RECEIVE BOTH REPRESENTATIONS AND WARRANTIES

As the preceding sections have made clear, multiple benefits accrue to a party who receives both representations and warranties. To summarize, they are the following:

- **First**, a party will have the option to void the contract and receive restitution only if that party receives representations.
- **Second**, a party may sue for punitive damages only by claiming a fraudulent misrepresentation.
- **Third**, if a party cannot prove justifiable reliance on a representation, that party can still sue for breach of warranty.
- **Fourth**, if a state follows the out-of-pocket rule for damages for fraudulent misrepresentations, a party can still recover the greater benefit of the bargain damages by suing for breach of warranty.
- **Fifth**, a breach of warranty claim may be easier to prove than a fraudulent misrepresentation claim. As noted earlier, to prove fraudulent misrepresentation, a plaintiff must demonstrate *scienter*; that the defendant knowingly made a false representation. As proving a party's state of mind can be difficult, a breach of warranty claim, which has no such requirement, may be the easier claim to win.<sup>27</sup>

26. See *Ainger v. Mich. Gen. Corp.*, 476 F. Supp. 1209, 1233-1234 (S.D.N.Y. 1979).

27. See W. Page Keeton, Dan B. Dobbs, Robert E. Keeton & David G. Owen, *Prosser and Keeton on Torts* §107, 741 (5th ed., West 1984).

### 3.2.4 RISK ALLOCATION

Each representation and warranty establishes a standard of liability. If a statement is false—if the statement does not reflect reality—then the standard has not been met and the party making the statement is subject to liability.

By establishing standards of liability, representations and warranties serve an important business purpose. They are a **risk allocation** mechanism. This means that the degree of risk that each party assumes with respect to a statement varies depending upon how broadly or narrowly the statement is drafted.

Recall that Sally told Bob that the propane gas tank was exactly one-half full. That is a precise statement. It is posited as an absolute, without any kind of wiggle room. It is a **flat representation**. It is a high-risk statement for Sally because if she is even a little wrong, Bob has a cause of action for misrepresentation and breach of warranty. Sally could have reduced her risk by making a less precise statement. She could have made a **qualified representation**. For example, she could have said that the tank was *approximately* half-filled. Then if the propane gas tank was less than one-half its capacity, Sally might still be able to contend that her statement was true. Her risk of having made a false statement is reduced. Bob, however, has now assumed a greater risk with respect to Sally's statement about the amount of fuel in the tank. Originally, Bob would have had a cause of action if the tank was even a little less than half full. Now, in order to prove a misrepresentation and breach of warranty, Bob must argue what *approximately* means. The risk allocation has shifted more of the risk to Bob.<sup>28</sup>

To see how risk allocation works in a more sophisticated context, imagine that you are general counsel of a \$100 million company that is selling all of its shares in a wholly owned subsidiary (the Target). Your current task is to negotiate the *no litigation* representation and warranty that appears in the stock purchase agreement.<sup>29</sup> You know the statement needs to be qualified. But how?

Immediately following this paragraph are five versions of a *no litigation* representation and warranty. The first version is the language in the agreement. The subsequent versions represent the evolution of your thinking with respect to what kind of qualifications would be appropriate. Read all of the versions and see if you can explain how each version changes the risk allocation.

#### Version 1

**No Litigation.** No litigation is pending or threatened against the Target.

#### Version 2

**No Litigation.** Except as set forth in **Schedule 3.14**, no litigation is pending or threatened against the Target.

<sup>28</sup> If this issue arose in the real world, the parties would most likely deal with it by a purchase price adjustment. It is used here to demonstrate risk allocation.

<sup>29</sup> In an acquisition agreement, a *no litigation* representation and warranty details what litigation exists so that a buyer can determine if that litigation presents a significant risk to the business it is buying. Similar representations and warranties exist in other agreements. For example, in a license agreement, the licensor generally represents and warrants that there are no litigations challenging the licensor's ownership of the trademark.

**Version 3**

**No Litigation.** Except as set forth in **Schedule 3.14**, no litigation is pending or, to the Seller's knowledge, threatened against the Target.

**Version 4**

**No Litigation.** Except as set forth in **Schedule 3.14**, no litigation is pending or, to the knowledge of any of the Seller's officers, threatened against the Target.

**Version 5**

**No Litigation.** Except as set forth in **Schedule 3.14**, no litigation is pending or, to the knowledge of any of the Seller's three executive officers, threatened against the Target. For the purpose of this representation and warranty, "knowledge" means

- (a) each executive officer's actual knowledge; and
- (b) the knowledge that each executive officer would have had after a diligent investigation.

Again, Version 1 is how the representation and warranty appears in the stock purchase agreement. It is a flat representation and warranty. You immediately recognize its most obvious flaw: it is false. Virtually every company has some litigation, and the Target is no exception. If the representation and warranty is not changed, the Seller is at great risk because it knows that the statement is false. A cause of action for misrepresentation could allege fraud. Therefore, the first qualification is that the representation and warranty must indicate pending litigations. The typical way to do this is to list them on a **disclosure schedule** and then to refer to the schedule in the representation and warranty. Version 2 does this. For a more detailed discussion of schedules, see §23.9.

The easy part is now over. Upon further review, you see that the representation and warranty actually makes two statements, one about pending litigation and the other about threatened litigation. At first, you do not see this as a concern as the disclosure schedule can qualify the representation and warranty not only with respect to pending litigation, but also with respect to known, threatened litigation. But what if the Seller does not know of an existing, threatened litigation against the Target? Perhaps someone is claiming that a product malfunctioned and intends to sue. It is an unknown, threatened litigation. After concluding that this is an unfair risk for the Seller to assume, you ask the Buyer's counsel for a knowledge qualification with respect to unknown, threatened litigation.<sup>30</sup> He acquiesces, and the representation and warranty is redrafted as set forth in Version 3.<sup>31</sup>

While the form of the Version 3 representation and warranty decreases the Seller's risk of liability, it increases the Buyer's risk. Because the Seller is no longer making a representation and warranty about unknown, threatened litigation, the Buyer will have no cause of action if unknown, threatened litigation against the Target actually exists.

30. Another common qualification of representations and warranties is **materiality**. That qualifier is discussed in §9.3 and is the subject of Exercise 9-1.

31. Agreeing to this qualification is so common that a buyer's first draft often includes it. The parties do, however, often negotiate the definition of *knowledge*.

Version 4 addresses the problem of what constitutes the Seller's knowledge. In the hypothetical, the Seller is a corporation, a juridical entity formed when its certificate of incorporation was filed with the appropriate governmental authority. As it is not a living, breathing human being, what constitutes its knowledge is not immediately apparent. Is it the knowledge of the company's managers, or the knowledge of everyone from the president to the employees on the shop floor?

From your perspective as general counsel (to put words in your mouth), it undoubtedly is an unfair risk for the Seller to be liable for the knowledge of every company employee. Accordingly, you request that the representation and warranty be further qualified so that the Seller is responsible only for its officers' knowledge.<sup>32</sup> With this change, the Seller no longer takes a risk as to the knowledge of an employee on the shop floor. However, the Seller's decrease in risk means that the Buyer's risk has commensurately increased. If an employee on the shop floor, in fact, knows of a threatened litigation, the Buyer will have no cause of action against the Seller because its representation and warranty is true: No officer knew. Thus, should the threatened litigation turn into an actual litigation and result in an award of damages, the Buyer would be obligated to pay it.

At this point, you are on a roll. You decide that even *knowledge of any of the Seller's officers* is too great a risk. Therefore, you go to the well again and ask the Buyer's counsel to change the qualification so that it reads *knowledge of any of the Seller's three executive officers*. This is the language in the first sentence of Version 5.

At this point, however, the Buyer's counsel says: "Enough. If knowledge is limited to three executive officers, they could walk around with blinders on doing their best to acquire no knowledge of threatened litigation. This is too much risk for the Buyer to assume." The Buyer's counsel instead proposes to define *knowledge* as the actual knowledge of each of the executive officers and their **imputed knowledge**; that is, the knowledge each executive would have had if the executive had performed a diligent inquiry. This is the compromise language in the remainder of Version 5. The Seller has limited its risk to the knowledge of the three executive officers, while, concurrently, the Buyer has eliminated its risk of the executive officers' intentional oblivion.

Understanding the impact of risk allocation is essential to fulfilling your role as a counselor. Clients too often misunderstand the purpose of representations and warranties and think that the time spent negotiating them is mere **wordsmithing**.<sup>33</sup> By explaining to a client that the wording of the representations and warranties can affect potential liability, you have explained that money is on the table, something that clients readily understand.

### 3.3 COVENANTS

#### 3.3.1 DEFINITIONS AND USES OF COVENANTS

We will first look at covenants in the context of the sale of Sally's house to Bob and then in other contexts.

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<sup>32</sup> The qualification in Version 4 uses the phrase "to the knowledge of *any* of the Seller's officers." Thus, if any one of the Seller's officers knows of any threatened litigation, that alone creates a misrepresentation and breach of warranty. If *any* were replaced with *each*, however, then all three of the Seller's officers would have to know of the threatened litigation to cause a misrepresentation and breach of warranty. For a more detailed discussion of the proper use of *any* and *each*, see §23.16.

<sup>33</sup> **Wordsmithing** has a pejorative connotation. It suggests that a lawyer is changing language for no substantive reason and is wasting time and money.

Imagine that after Sally and Bob have agreed to a price, Bob tells Sally that he cannot immediately purchase the house as he needs to obtain a mortgage. A delayed closing is acceptable to Sally, and they agree to close the sale on the last day of the next month. This delay creates a gap period between the signing of the purchase contract and the closing.<sup>34</sup> (A **closing** is when parties exchange the agreed performances. Typically, closings occur only in acquisitions and financings. In an acquisition, it would be the day the seller transfers its property to the buyer, and the buyer pays the seller; in a financing, it would be the day the bank makes the loan to the borrower, and the borrower agrees to repay it.)

As Bob and Sally finalize their agreement, Bob tells Sally that he is concerned about what will happen to the house during the gap period. Specifically, he does not want the living room walls painted, and he wants to make sure that the propane gas tank is at least one-third full with propane gas when he moves in on the closing date. Sally agrees. To incorporate Sally's agreement into the purchase contract, the lawyers use **covenants**, sometimes called **promises**.

A **covenant** is a promise to do or not to do something. It creates a **duty** to perform.

The duty to perform is sometimes called the **obligation** to perform.

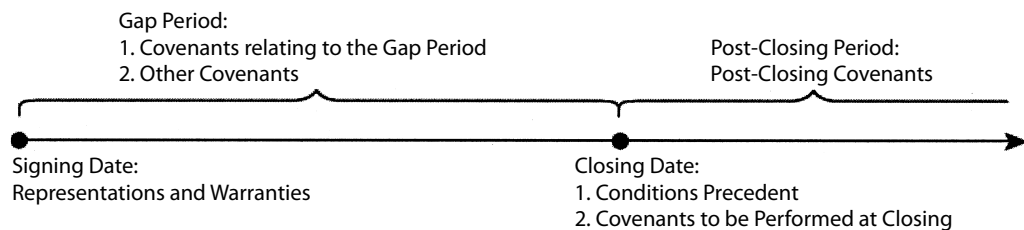
In the purchase agreement between Sally and Bob, the covenants will resemble the following:

#### Seller's Covenants. The Seller

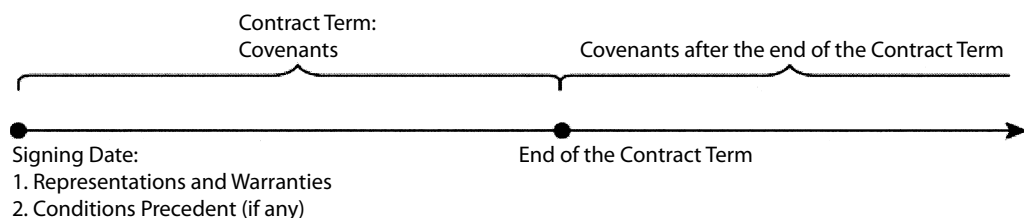
- (a) shall not paint the walls between the signing and the Closing; and
- (b) shall cause the propane gas tank to be at least one-third full with propane gas on the Closing Date.

Although the need for covenants in the purchase agreement arose because of the gap period between signing and closing, covenants are not used only in this context. The need for them can arise in multiple contexts. Look at the following timelines of an acquisition agreement and a license agreement.

#### Example 1. Acquisition Agreement



#### Example 2. License Agreement



34. A gap period between signing and closing is routine in acquisition transactions. It arises for multiple reasons. First, the buyer may need to obtain financing. Second, the parties may need to obtain consents to

Example 1 is the timeline of an acquisition agreement. As we have seen, in this type of transaction the parties use covenants during the gap period to control the seller's actions with respect to the subject matter of the contract (e.g., the house).<sup>35</sup> However, an acquisition agreement also has covenants that are unrelated to the gap period. Some covenants, such as confidentiality provisions, apply both before and after closing. Other covenants apply only at closing; for example, the promise to pay the purchase price and the promise to transfer the assets. And finally, some covenants apply only to the post-closing period. Indemnities and noncompetition provisions are classic examples.

The timeline of a license agreement, Example 2, differs from the timeline of an acquisition agreement. The license agreement has no gap period. Its term begins and ends on agreed-upon dates.<sup>36</sup> Each party covenants to the other as to its behavior during the term. The licensee promises to use its best efforts to manufacture and market products using the trademark, to pay license fees, and to submit for approval a prototype of each product. In turn, the licensor promises not to license the trademark to anyone else, to defend the trademark, and to promptly approve or disapprove each prototype submitted for approval. Occasionally, covenants relate to the period after the term. For example, the contract will typically set out the parties' obligations post-term with respect to any unsold inventory that the licensee owns at the end of the term.

### 3.3.2 DEGREES OF OBLIGATION

In the same way that representations and warranties are a risk allocation mechanism, so too are covenants. The allocation manifests itself in terms of how absolute a party's promises are. The business differences between the different ways of expressing a party's obligations are **degrees of obligation**.<sup>37</sup>

Consider a transaction in which the buyer hopes to acquire a lease for property that the seller uses in its business operations. To effect this acquisition, the seller must assign its rights under the lease to the buyer, but the seller's lease prohibits it from doing so. Therefore, the buyer insists that the seller must promise to obtain the landlord's consent to the assignment. Review the following covenants and see if you can determine how the risk allocation shifts depending upon the degree of the seller's obligation.<sup>38</sup>

#### Version 1

**Consents.** The Seller shall obtain the consent of Landlord Corp. to the Seller's assignment of the Lease to the Buyer.

the transaction or to the transfer of particular assets. Finally, the buyer may want to perform **due diligence** if it did not previously do so. (Due diligence is the corporate equivalent of test-driving a car before purchasing it. To be sure that the target company is worth purchasing, the buyer-to-be examines, among other things, the seller's contracts, equipment, and financial statements.)

35. Buyers also give covenants, such as promising to obtain any necessary consents.

36. Sometimes the parties sign on a date before the term begins. The period between the signing and the beginning of the term differs from the gap periods in acquisition agreements. During the license agreement's "gap period," generally, no covenants must be performed or conditions satisfied. Instead, the delayed beginning of the term is for administrative ease, so that the term begins either on the first day of a month or immediately after one party's relationship with a third party concludes. For example, a licensor and a licensee may negotiate and sign a license agreement in October, but the license term will not begin until January 1, the day after the licensor's current arrangement with another licensee terminates.

37. I thank my colleague, Alan Shaw, for coining this most useful phrase, *degrees of obligation*.

38. These covenants are based upon covenants that Alan Shaw drafted.

**Version 2**

**Consents.** The Seller shall use its best efforts to obtain the consent of Landlord Corp. to the Seller's assignment of the Lease to the Buyer.

**Version 3**

**Consents.** The Seller shall use its best efforts to obtain the consent of Landlord Corp. to the Seller's assignment of the Lease to the Buyer. For purposes of this provision, the Seller is deemed to have used its best efforts if it offers Landlord Corp. at least \$10,000 as an inducement to consent to the assignment.

**Version 4**

**Consents.** The Seller shall use commercially reasonable efforts to obtain the consent of Landlord Corp. to the Seller's assignment of the Lease to the Buyer.

**Version 5**

**Consents.** The Seller shall request that Landlord Corp. consent to the Seller's assignment of the Lease to the Buyer.

Version 1 is the equivalent of a flat representation. It is the Seller's absolute promise to obtain consent. The promise is dangerous for the Seller to make as it has no control over the outcome: Landlord Corp. has no obligation to consent, and it could just as easily refuse consent as grant it. Because the Seller has no control, it risks breaching the covenant. The Seller, therefore, wants to reduce its risk by reducing its degree of obligation.

From the Buyer's perspective, Version 1 is a terrific covenant. If the Seller obtains Landlord Corp.'s consent, the Buyer is in position immediately to continue the Seller's business on the same premises. If the Buyer does not obtain consent, however, the Buyer should still come out whole as it has the right to sue for damages. If the current lease's rent is under market, the Buyer's damages might be equal to the rent the Buyer would have to pay for comparable leased property *minus* the rent the Seller is paying under its lease.

Versions 2 through 5 each change the Seller's risk but in a different way. Version 2 does not require the Seller to obtain consent. Instead, the standard is that the Seller must have tried to obtain consent and must have used its best efforts in that endeavor. This change substantially reduces the degree of the Seller's obligation and, therefore, its risk. Now, the focus is on the degree of effort, rather than the result. So long as the Seller uses its best efforts to obtain consent, the Buyer has no cause of action for breach if the consent is not obtained. Any difference between the cost of the existing lease and a new lease is for the Buyer's account. The decrease in the Seller's risk has shifted risk to the Buyer.

From the Seller's perspective, Version 2 is definitely better than Version 1. Nonetheless, it still sets a high standard of performance for the Seller. What does *best efforts* mean? Must the Seller spend all of its money to induce Landlord Corp. to grant consent?<sup>39</sup> Version 3 directly addresses this issue by capping, at \$10,000, the amount that the Seller needs to spend to comply with the covenant.

39. See, e.g., *Bloor v. Falstaff Brewing Corp.*, 601 F.2d 609 (2d Cir. 1979).

The cap shifts risk to the Buyer. To see this more vividly, assume the Seller offers Landlord Corp. \$10,000 to consent, but Landlord Corp. refuses to consent and demands \$10,500. In this event, the Seller has performed its covenant and, therefore, is not in breach, even though it did not obtain consent. Accordingly, the Buyer is on the hook for any increased lease expense—even though a slightly increased payment to Landlord Corp. would have resulted in a consent.

Although Version 3 changes the Seller's risk, the Seller may not see the change as an improvement. It might not want to take on a monetary obligation. It might prefer instead to take the risk of the vague, but seemingly softer, standard set forth in Version 4. That Version arguably changes the Seller's risk by changing the standard from *best efforts* to *commercially reasonable efforts*. Thus, to comply with the covenant, the Seller must do what the reasonable businessperson would do to obtain the consent. If it does that but still cannot obtain the consent, the Buyer must pay for any increased lease expense.

Finally, Version 5 eliminates any obligation by the Seller to obtain consent. Instead, it must merely request that consent. Its degree of obligation is minimal, and the Buyer assumes almost all the risk with respect to the Seller's failure to obtain consent.

### 3.3.3 REMEDIES

In the same way that representations and warranties carry with them their own common law remedies, so too do covenants. In general, breach of a covenant entitles the injured party to sue for damages<sup>40</sup> and, if the facts are appropriate, specific performance.<sup>41</sup> The measure of damages is full benefit of the bargain damages. (If the breach is so material that it is a breach of the whole contract that cannot be cured, then a party may have a right to cancel as well as other remedies.<sup>42</sup>)

If a party breaches a covenant, that party need not also have made a misrepresentation and breached a warranty. First, as is often the case, the party may not have made a representation and warranty on the same topic. Second, even if it has, the truthfulness of a representation and warranty is determined as of the time it was made. So, if a representation and warranty was true at the time that it was made, no misrepresentation or breach of warranty would occur just because the related covenant was breached.

To put this in context, assume that, at the signing of the contract, Sally represents and warrants that the walls of the living room are eggshell white and covenants to maintain their color. Then, during the gap period, Sally decides that she wants blue walls for her last few weeks in the house, and she paints them. By doing so, Sally breaches her covenant not to paint the walls, giving Bob a cause of action for breach of the covenant. Bob will not, however, have a cause of action for misrepresentation or breach of warranty because the walls were eggshell white when Sally represented and warranted their color.<sup>43</sup>

## 3.4 RIGHTS

A contract **right** flows from another party's duty to perform; that is, from a covenant. The person to whom the performance is owed has a right to that performance. There-

40. See generally Dan B. Dobbs, *Dobbs Law of Remedies*, vol. 3, §12.2, 21-50 (2d ed., West 1993).

41. See generally *id.* at §12.8, 189-245.

42. See U.C.C. §§2-106(4), 2-612, 2-703, U.L.A. §§2-106(4), 2-612, 2-703 (2004).

43. See §3.2.1.

fore, if there is a duty, there is a correlative right. More colloquially, the flip side of every duty is a right. Because of this relationship, a right's business purpose is the same as a duty's: to allocate risk by establishing standards of liability.

Although a duty is generally expressed as a covenant for business and legal reasons, that duty can alternatively be expressed as a right. For example:

**Version 1**

**Payment of Purchase Price.** The Buyer shall pay the Seller \$200,000 at Closing. *(Drafted as the Buyer's duty.)*

**Version 2**

**Entitlement to Purchase Price.** The Seller is entitled to be paid \$200,000 at Closing. *(Drafted as the Seller's right.)*

In both examples, the Buyer must pay \$200,000. The difference is the focus: the Buyer's duty to pay versus the Seller's right to payment.

When determining whether a particular business point is a right, the correlative duty is not always immediately apparent. For example:

**Entitlement to Deposit.** If the Buyer fails to close because it did not obtain financing, the Seller is entitled to keep the deposit.

In this instance, the correlative duty would be the Buyer's obligation not to seek return of the deposit.