

Representations and Warranties Clauses in Commercial Contracts: Avoiding Drafting and Negotiation Pitfalls

Best Practices for Minimizing Risk, Allocating Liability and Enforcing Indemnity Clauses

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Representations, Warranties and Covenants Overview

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GRT, Inc. v. Marathon GTF Tech., Ltd., 2011 Del.
Ch. LEXIS 99, 44-45 (Del. Ch. July 11, 2011)

“As most corporate lawyers know, there are a number of valuable treatises and casebooks on mergers and acquisitions that address the corporate and securities laws that influence such transactions. But, much harder to find is any learned consideration of the important contract issues that are often even more central to the parties to such transactions. n64 In law school, the basic contracts class does not often delve into the admittedly obscure differences between covenants, representations, warranties, and conditions, and how they work together in an acquisition agreement. The mysteries of bring-down clauses and indemnification are difficult to shoehorn into a first-year course, and do not seem to tickle the fancy of many scholars.”

Citizens Prop. Ins. Co. v. Bertot, 14 So. 3d 1073, 1075 (Fla.
Dist. Ct. App. 3d Dist. 2009)

“These claims are referred to by the various litigants and courts in Florida as breaches of the "covenant of good faith and fair dealing" or the "implied warranty of good faith and fair dealing"; we perceive no substantive difference between the labels.”

Representations, Warranties and Covenants

- Representations are statements of present facts as of the time they are made
- Warranties are promises that something is and will remain true in the future
- Covenants are promises to do or not do something.
- Draft when they end and if they survive, as relevant
- Merger clauses will not preclude fraud

Representations and Warranties

The difference between a representation and a warranty is that the former is a statement of fact, and the second is a promise that the fact is true. A covenant is an agreement that something is done or will be done, and failure to do it results in breach. In various cases, they may be used interchangeably or the nuances not always apparent.

Case Interpretation

- Representation is a statement of present fact, and a warranty is a statement of future performance
- *CBS v. Ziff-Davis Publ. Co.*, 75 NY 2d 496 (1990): A warranty is a promise that something is true. If it is not true, there is a kind of strict liability for the fact that the promise proved false. Scienter or reliance by the other side is not relevant.
- “The critical question is not whether the buyer believed in the truth of the warranted information, as Ziff-Davis would have it, but "whether [it] believed [it] was purchasing the [seller's] promise [as to its truth]." *Id.* at 503.

Importance

- There may be a grace period or other time frame in which a party has the right to cancel a contract without penalty, if any of the contractually expressed representations are discovered to be false during the due diligence period. *See, e.g., Harsco Corp. v. Segui*, 91 F.3d 337, 340-341 (2nd Cir. 1996)(agreement provided for termination if any of representations were not correct in material respects).
- To the extent there is a merger clause, where reliance is not on an oral representation that preceded the contract but rather, a written representation in the contract itself, a specific disclaimer of that representation can bar the suit. *Id.* at 344-345.

Contract versus Tort

- If a claim is based on breach of contract, there are certain established elements of proof and certain recognizable categories of damages.
- Tort actions lie for breaches of duties imposed by law as a matter of social policy, while contract actions lie only for breaches of duties imposed by mutual consensus agreements between particular individuals. *Bash v. Bell Tel. Co.*, 411 Pa. Super. 347, 601 A.2d 825 (Pa. Super. 1992).

Scope

- The scope of the representations and warranties, and what they cover, is important not only in terms of breach issues, or whether they are tort or contract claims, but also in terms of indemnification and contribution claims. *See e.g., BP Amoco Chemical Co. v. Sun Oil Co.*, 166 F. Supp. 2d 984, 995 (D. Del. 2001).

Warranties

- A warranty is future-oriented. It is “an assurance by one party to a contract of the existence of a fact upon which the other party may rely” and effectively constitutes a promise to indemnify the promisee for any loss it may suffer if the fact warranted proves untrue.
Metropolitan Coal Co. v. Howard, 155 F.2d 780 at 784 (2nd Cir. 1946).

Express Warranty

- **Express warranty:** Affirmation of fact, description, sample or model relating to the goods that becomes part of the basis of the bargain
- **Not an express warranty:** Affirmation of the value of the goods, seller's opinion or commendation of the goods

UCC 2-313, Comment 4

- “. . . a contract is normally a contract for a sale of something describable and described. A clause generally disclaiming ‘all warranties, express or implied’ cannot reduce the seller's obligation with respect to such description and therefore cannot be given literal effect under Section 2-316.” (U.C.C. § 2-313, Comment 4.)

Non-Contractual Activity

- Be careful as to non-contractual representations, whether oral or written, "hard copy" or electronic.
- Even if they are not contractual obligations, they may be relied on and give rise to claims outside of the contract.
- Conduct matters: Non-contract claims, such as fraud and reliance and misrepresentation, may result from behavior.

Warranty Defined

- "A warranty is an assurance by one party to a contract of the existence of a fact upon which the other party may rely. It is intended precisely to relieve the promisee of any duty to ascertain the fact ...; it amounts to a promise to indemnify the promisee for any loss if the fact warranted proves untrue, for obviously the promisor cannot control what is already in the past." *Metropolitan Coal Co. v. Howard*, 155 F.2d 780, 784 (2d Cir. 1946)(Learned Hand, J.).

Future Performance

- “A breach of warranty occurs when tender of delivery is made, except that where a warranty explicitly extends to future performance of the goods and discovery of the breach must await the time of such performance the cause of action accrues when the breach is or should have been discovered.” U.C.C. § 2-725(2)

Service Warranties

- Service warranties imply that the services will be workmanlike, using reasonable and appropriate skill. *Fed. Ins. Co. v. Winters*, 354 S.W.3d 287 (Tenn. 2011).
- “Best efforts”
- “Satisfaction contracts”
- “Sole discretion”

Repair or Replace

- In drafting warranty provisions that include “repair or replace” options, the remedy must be fair and not deprive the aggrieved party of the purpose of the contract; in other words, the contract cannot fail of its essential purpose or otherwise not afford any remedy. It must be a “fair quantum” of remedy; a limitation of remedy will be enforced except “when the remedy is ineffectual or when the seller fails to live up to the remedy's provisions, either of which deprives the buyer of the benefit of the bargain.” *Waukesha Foundry v. Industrial Eng'g*, 91 F.3d 1002, 1010 (7th Cir. 1996).

Who Chooses

- The choice of repair or replacement can have costs, and should be dealt with up front. Parties are best served by drafting clear language. An example illustrates this. In *Compagnie des Bauxites de Guinee v. Three Rivers Insurance Co.*, 2008 U.S. Dist. LEXIS 28498 (W.D. Pa. 2008), the insurance policy provided for repair or replacement, but the court found that because there was express agreement that the insurer did not control the disposition of the damaged property, plaintiff could decide whether repair or replacement was desired.

Integration Clauses

- The merger clause, sometimes known as an “entire agreement” clause or an “integration clause,” arises in several contexts. Prior to the execution of an agreement, the parties may have exchanged term sheets, “letters of intent,” or made statements that might conceivably be capable of construction as an agreement. When they finally sign the agreement, they want to make sure that this agreement, its carefully negotiated languages and specific terms, are all that the court looks to in determining the rights and obligations of the parties. It is an attempt to prevent a party from introducing “parol evidence” or other extrinsic matter to redefine the terms of the agreement.

Impact of Merger Clauses

- “merger clause” that purports to eliminate the ability to rely on parol evidence or oral representations will not protect against fraud in the inducement. *Danann Realty Corp. v. Harris*, 5 NY 2d 317, 320 (1959)(“A reiteration of the fundamental principle that a general merger clause is ineffective to exclude parol evidence to show fraud in inducing the contract would then be dispositive of the issue.”).
- One drafting technique to attempt to minimize this is to have a clear set of representations and state, in the merger clause, that the only representations relied on were those specified.

Enforcement

- Courts begin with the rule that where the “four corners” of a contract are clear, external evidence will not be permitted to vary the plain meaning or express terms of the contract. *Vision Development Group of Broward County, LLC v. Chelsey Funding, LLC*, 43 AD 3d 373 (1st Dep’t 2007). In *Vision Development*, the court particularly referenced the merger clause that precluded any “oral modification.” *Id.*
- Conversely, the absence of a merger clause will not necessarily lead to the reverse conclusion, that is, that the agreement must by definition be partial or incomplete. *Massey v. Town of Branford*, 985 A. 2d 335 (Conn. App. Ct. 2009).

Severability

- severability means that even if one term of a contract fails, such as, for example, because it violates public policy or unconscionability, then the rest of the contract may still be enforced.

Section 208 of the Restatement (Second) of Contracts

- titled “unconscionable contract or term,” makes the distinction and states:
- If a contract or term thereof is unconscionable at the time the contract is made a court may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable term, or may so limit the application of any unconscionable term as to avoid any unconscionable result.

Pitfall

- The major pitfall is to consider whether you actually want the contract to survive if one clause is deemed illegal or otherwise unenforceable. It may be critical to the entire business purpose. Care should be given to not simply throw this clause in.

Indemnification Issues

- The indemnification can provide specifically for damages flowing from breach of representations, warranties and covenants.
- If not referenced, litigatable issue as to scope:
- Should also specify point at which indemnification obligation arises—at time of claim or actual loss, or on other hand, liability—or include both as is common

Example

- "9. INDEMNITY
- (A) AGS shall at all times indemnify and hold harmless HLTD [Hooper], its successors and assigns and any of its officers, directors, employees representatives, and/or agents, and their heirs, executors, administrators, successors and assigns or each of them against and from any and all claims, damages, liabilities, costs and expenses, including reasonable counsel fees arising out of:
- (i) Any breach by AGS of any express or implied warranty hereunder and any express representation or provision hereof . . ." *Hooper v. AGS Computers*, 74 NY 2d 487 (1989)

Representations, Warranties and Covenants: UCC

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Do UCC Warranties Apply?

- Many transactions involve mixed contracts for sales and services. Question: Does the UCC apply?
- Most courts apply the predominant purpose test.
- Courts consider a variety of factors to determine the predominant purpose of a contract: (1) the contract's language, (2) the terms of payment—that is, whether the price is primarily calculated based on the costs of the goods or services, (3) the mobility of the goods, and (4) the value of both the goods and services, and (5) the business of the seller. *Boardman Steel Fabricators, Ltd. v. Andritz, Inc.*, 2015 U.S. Dist. LEXIS 119562 (E.D. Ky. 2015).

Examples of “Predominant Purpose” Test

- *Examples: Boardman Steel Fabricators, Ltd. v. Andritz, Inc., supra* (fabrication and supply of steel generally regarded as transaction for sale of goods); *Noble Roman’s, Inc. v. Hattenhauer Distrib. Co.*, 2015 U.S. Dist. LEXIS 44392 (S.D. Ind. 2015) (predominant thrust of a franchise agreement is to grant a franchise and allow and enable the franchisee to use the franchisor’s marks and products; the sale of goods is only an indirect aspect of it); *Brandewie v. Wal-Mart Stores, Inc.*, 2015 U.S. Dist. LEXIS 12068 (N.D. Ohio 2015) (Wal-Mart’s refund policy not subject to UCC, although the initial sale was).

U.C.C. § 2-312: Warranty of Title and Against Infringement

(1) . . . there is in a contract for sale a warranty by the seller that

(a) the title conveyed shall be good, and its transfer rightful; and

(b) the goods shall be delivered free from any security interest or other lien or encumbrance of which the buyer at the time of contracting has no knowledge.

U.C.C. § 2-312: Warranty of Title and Against Infringement

. . .

(3) Unless otherwise agreed a seller who is a merchant regularly dealing 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.

U.C.C. § 2-313: Express Warranties

(1) Express warranties by the seller are created as follows:

(a) Any affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise.

(b) Any description of the goods which is made part of the basis of the bargain creates an express warranty that the goods shall conform to the description.

(c) Any sample or model which is made part of the basis of the bargain creates an express warranty that the whole of the goods shall conform to the sample or model.

U.C.C. § 2-313: Express Warranties

(2) It is not necessary to the creation of an express warranty that the seller use formal words such as "warrant" or "guarantee" or that he have a specific intention to make a warranty, but an affirmation merely of the value of the goods or a statement purporting to be merely the seller's opinion or commendation of the goods does not create a warranty.

U.C.C. § 2-314: Implied Warranty: Merchantability

(1) Unless excluded or modified (Section 2-316), a warranty that the goods shall be merchantable is implied in a contract for their sale if the seller is a merchant with respect to goods of that kind. Under this section the serving for value of food or drink to be consumed either on the premises or elsewhere is a sale.

U.C.C. § 2-314: Implied Warranty: Merchantability

(2) Goods to be merchantable must be at least such as

(a) pass without objection in the trade under the contract description; and

(b) in the case of fungible goods, are of fair average quality within the description; and

(c) are fit for the ordinary purposes for which such goods are used; and

U.C.C. § 2-314: Implied Warranty: Merchantability

- (d) run, within the variations permitted by the agreement, of even kind, quality and quantity within each unit and among all units involved; and
 - (e) are adequately contained, packaged, and labeled as the agreement may require; and
 - (f) conform to the promise or affirmations of fact made on the container or label if any.
- (3) Unless excluded or modified (Section 2-316) other implied warranties may arise from course of dealing or usage of trade.

U.C.C. § 2-315: Implied Warranty: Fitness for Particular Purpose

Where the seller at the time of contracting has reason to know any particular purpose for which the goods are required and that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods, there is unless excluded or modified under the next section an implied warranty that the goods shall be fit for such purpose.

U.C.C. § 2-316:

Exclusion of Warranties

(1) Words or conduct relevant to the creation of an express warranty and words or conduct tending to negate or limit warranty shall be construed wherever reasonable as consistent with each other; but subject to the provisions of this Article on parol or extrinsic evidence (Section 2-202) negation or limitation is inoperative to the extent that such construction is unreasonable.

U.C.C. § 2-316:

Exclusion of Warranties

(2) Subject to subsection (3), to exclude or modify the implied warranty of merchantability or any part of it the language must mention merchantability and in case of a writing must be conspicuous, and to exclude or modify any implied warranty of fitness the exclusion must be by a writing and conspicuous. Language to exclude all implied warranties of fitness is sufficient if it states, for example, that "There are no warranties which extend beyond the description on the face hereof."

U.C.C. § 2-316:

Exclusion of Warranties

(3) Notwithstanding subsection (2)

(a) unless the circumstances indicate otherwise, all implied warranties are excluded by expressions like "as is", "with all faults" or other language which in common understanding calls the buyer's attention to the exclusion of warranties and makes plain that there is no implied warranty; and

(b) when the buyer before entering into the contract has examined the goods or the sample or model as fully as he desired or has refused to examine the goods there is no implied warranty with regard to defects which an examination ought in the circumstances to have revealed to him; and

(c) an implied warranty can also be excluded or modified by course of dealing or course of performance or usage of trade.

U.C.C. § 2-316:

Exclusion of Warranties

(4) Remedies for breach of warranty can be limited in accordance with the provisions of this Article on liquidation or limitation of damages and on contractual modification of remedy (Sections 2-718 and 2-719).

AEP Indus. v. Thiele Techs. Inc.,
2016 U.S. Dist. LEXIS 119151 (E.D. Wis. 2016)

- AEP purchased industrial packaging machinery and equipment manufactured by Thiele. Thiele made oral and written representations and warranties regarding the performance production capabilities of the equipment: specifically, the machines sold were capable of processing 720 plastic bags and 60 cartons per minute.

AEF Indus. v. Thiele Techs. Inc.,
2016 U.S. Dist. LEXIS 119151 (E.D. Wis. 2016) (2)

- The contract also contained a “warranty” provision: it purported to limit the express warranty to defects in material and workmanship: “Seller warrants that the products sold are free from defects in material and workmanship”

AEP Indus. v. Thiele Techs. Inc.,
2016 U.S. Dist. LEXIS 119151 (E.D. Wis. 2016)(3)

- **Court:** To the extent the warranty disclaimer language was intended to apply to the express warranty relating to *the speed* of the machinery, “the limitation would be inoperative.”
- “. . . it would be unreasonable to permit a seller to create an express warranty in its offer and then add a term or condition at the end that effectively excludes the very warranty it created.”

Warranties: Statute of Limitations

- Generally, warranties warrant that goods will do certain things or be a certain way ***at the time of delivery***. Thus, generally, “[a] breach of warranty occurs when tender of delivery is made.” U.C.C. § 2-725(2).
- The statute of limitations starts to run from the date of delivery, *not* from the time a problem with the product manifests itself.

Warranties: Extend to Future Performance

- ***Exception--U.C.C. § 2-725(2)***: When a warranty extends to “future performance of the goods” (*e.g.*, when the warranty mentions a specific period of time into the future such as: “product shall be free of manufacturing defects for ten years from the date of sale”).
- “Future performance” warranty delays finding of breach/running of the statute of limitations until buyer discovers or reasonably should discover the product does not meet warranty.

Warranties: Extend to Future Performance

- Thus, the drafter can, in effect, “extend” the statute of limitations many years.
- Example: *Hoctor v Polchinski Mems., Inc.*, 50 Misc. 3d 65 (N.Y. App. Term 2015) tombstone purchased and installed in 2003. The seller’s literature stated the tombstones were guaranteed to “last forever” and were “backed by a perpetual warranty.” A problem was discovered in 2013—and because of the language in defendant’s literature, the court held the cause of action did not accrue until discovery.

Warranties: Extend to Future Performance

- *Leprino Foods Co. v. Dci, Inc.*, 2017 U.S. Dist. LEXIS 800 (D.Colo. 2017): “The [warranty] provisions of this Paragraph shall survive acceptance of the Equipment by Leprino, and shall run to Leprino's successors, assigns, customers and users of Leprino's product.”
- **Court:** “This language does not speak at all to the future performance of the goods.”

Warranties: Extend to Future Performance

- *Leprino Foods Co. v. Dci, Inc.*, 2017 U.S. Dist. LEXIS 800 (D.Colo. 2017): “. . . for a warranty to explicitly extend to future performance, the warranty ‘must expressly provide a guarantee that the product will perform as promised in the future.’”

Post-Formation Warranties

- ***Your client can make warranties after the contract is signed:*** “The precise time when words of description or affirmation are made or samples are shown is not material. The sole question is whether the language or samples or models are fairly to be regarded as part of the contract. If language is used after the closing of the deal (as when the buyer when taking delivery asks and receives an additional assurance), the warranty becomes a modification, and need not be supported by consideration if it is otherwise reasonable and in order (Section 2-209).” U.C.C. § 2-313, Comment 7.

Case Study: *CGBM*

- *CGBM 100 v. Flowserve US*, 2016 U.S. Dist. LEXIS 179517 (S.D. Tex. December 29, 2016).
 - Flowserve promised that the pumps it sold would be capable of pumping coker feed at a flow rate of 3500 gallons per minute.
 - The court construed this as a warranty regarding the flow rate even though it was not included in the parties' written contract.

Case Study: *CGBM*

The contract contained a merger clause and standard provisions designed to limit Flowserve's financial exposure in the event of its breach. *These included:*

- A disclaimer of warranty clause;
- A clause limiting plaintiffs' remedies to repair or replace the pumps, at Flowserve's option;
- A damages cap limiting damages to the price of the pumps (\$1.3 million);
- A clause excluding Flowserve's liability for "special, consequential, incidental or penal damages."

Case Study: *CGBM*

The pumps did not perform as orally warranted. The court held the clauses designed to protect the seller were inoperative:

- ***Disclaimer of warranty***: A party can't both give *and* negate a warranty.
- ***The merger clause did not negate the prior oral warranty***: Plaintiffs did not intend the written contract to be the complete and exclusive statement of their agreement.
- ***The limitations of remedies***: The jury could find that the remedy *failed of its essential purpose* and that the contract did not provide a fair quantum of remedy, thus allowing buyer to recover incidental damages and damages in excess of the contract price.

Representations and Warranties Clauses in Commercial Contracts

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Typical Paragraph of Representations, Warranties and Covenants

9. Representations, Warranties and Covenants.

a. The Supplier represents, warrants and covenants that competent, knowledgeable, and experienced personnel in the type of services to be performed under this Supply Agreement, any Purchase Order and the Supplier Business Guide shall perform such services in a professional and workmanlike manner consistent with industry standards and such services shall meet all specifications set forth in the Supply Agreement, any Purchase Order and in this Supplier Business Guide; provided, however, that where any such Purchase Order specifies a particular standard or criteria for performance more particular than the foregoing, this warranty is not intended to and does not diminish that standard or criteria for performance. Further, in any case where detailed requirements for a service are not mutually agreed upon or set forth in this Supply Agreement, Purchase Order or in the Supplier Business Guide, such services shall be fit and sufficient for the purposes expressed in, or reasonably to be inferred from, such Supply Agreement, Purchase Order or the Supplier Business Guide, as the case may be.

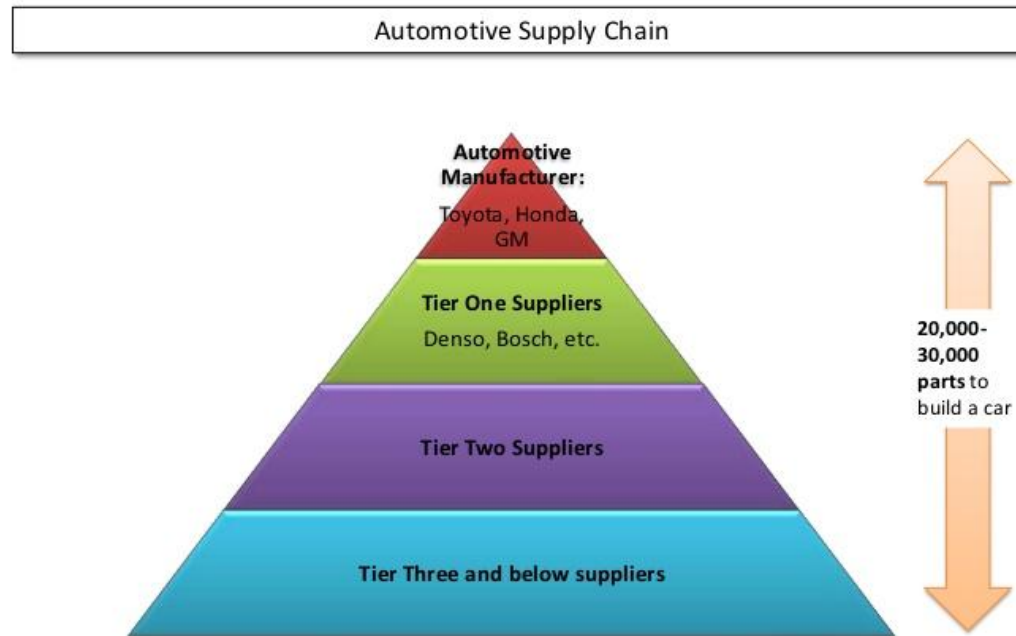
b. The Supplier expressly represents and warrants that the Product and/or services shall be of good and merchantable quality, free from defects (latent or otherwise) in material and workmanship (and free from defects in design if the design is owned by or provided by the Supplier) and strictly conform to the Specifications, Quality Standards and the terms of this Supplier Business Guide. The Supplier acknowledges that the Supplier knows Purchaser's and Purchaser's consumers intended use and expressly warrants that Products covered by a Purchase Order have been and will be selected, designed, manufactured, and assembled by the Supplier based upon such intended use and will be fit and sufficient for the particular purpose intended. In addition to its other rights and remedies, Purchaser reserves the right to cancel a Purchase Order in whole or in part or have the Supplier reimburse the Purchaser for any direct, indirect, incidental, special, and consequential damages caused by nonconforming Product and/or services, including, but not limited to, costs and expenses incurred by the Purchaser for inspecting, sorting, repairing, and replacing such nonconforming Product and/or services, if said Product and/or services do not satisfy the foregoing representations and warranties.

c. Supplier covenants that it will comply with any labeling requirements provided by Purchaser (whether herein or separately provided).

BACKGROUND:

Manufacturing Environment

- The supply chain – Just In Time/Lean Manufacturing
 - Automotive example

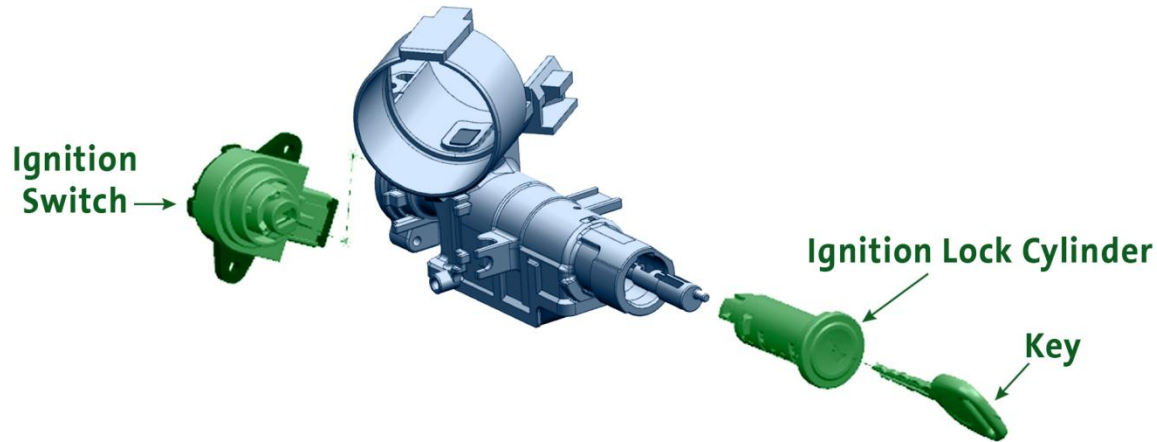


BACKGROUND:

Supply Chain Complexity and Liability

PARTS INVOLVED IN GM IGNITION RECALLS

This diagram displays the three parts that are affected by the recalls for the Chevrolet Cobalt, Pontiac G5, Saturn ION, Chevrolet HHR, Pontiac Pursuit, Pontiac Solstice, and Saturn Sky.

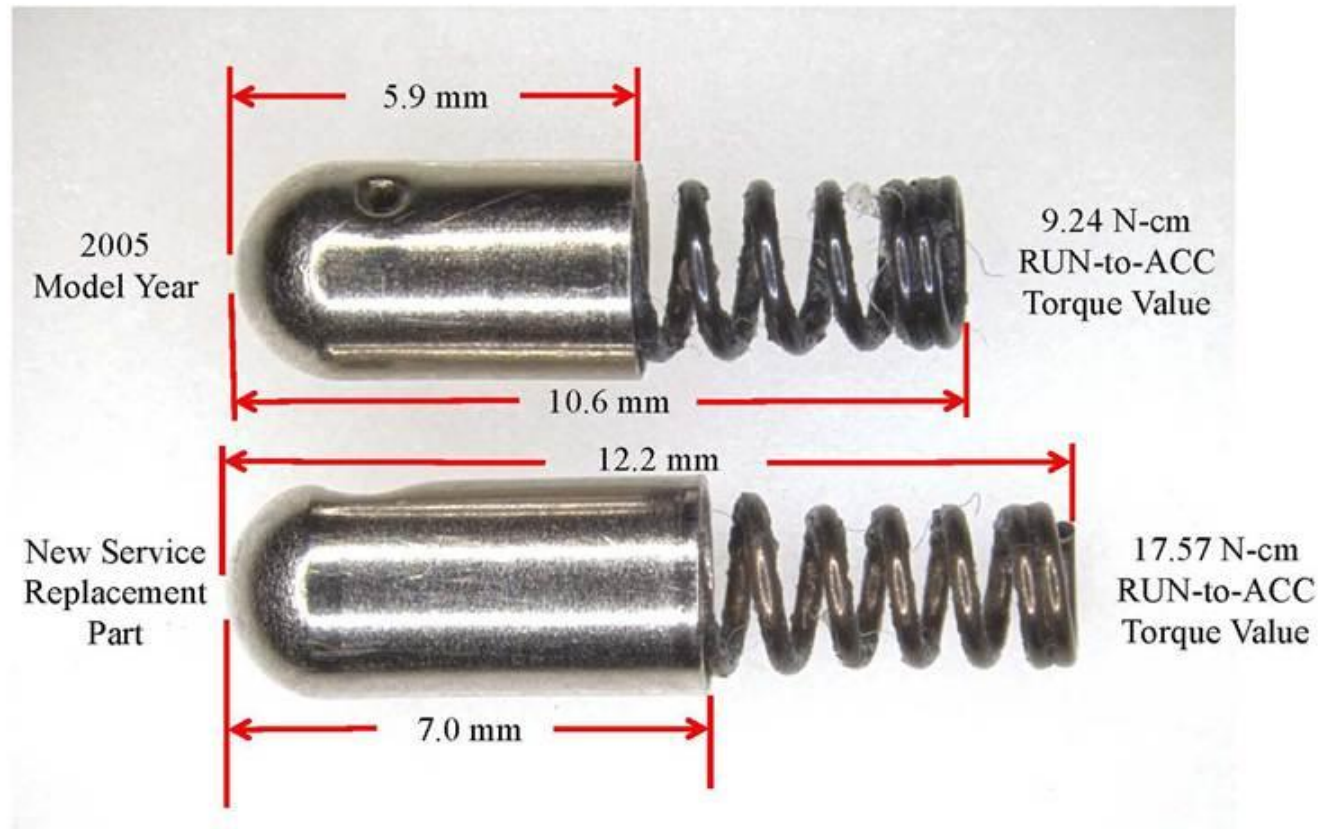


Complete Steering Column Assembly
(for reference only)



BACKGROUND: Example of Détente Plunger in Switch – GM Recall

Exemplar Chevrolet Cobalt Switch Detent Plungers



Delineating Areas of Control and Fault

- Common types of losses subject to indemnification include breach of representation or warranty; breach of a covenant; losses incurred under specified conditions; and third-party claims against the indemnitee.
- Assuming equal bargaining strength, parties should only warrant and indemnify for things under their control. Likewise, in the indemnification provision, the types of fault that could reasonably occur should be defined and spelled out as attributable to a certain party.
- Factors to consider in allocating risk are as follows:
 - Who would be at fault for the loss? Who is in the best position to control/mitigate the risk? If the indemnities are delineated by areas of control and fault, as a practical matter, they should be easy for each party to accept.
 - What is the customary industry practice?
 - Who has the bargaining power?
 - Who is in the best position to insure against the risk?

Design Responsibility Affects Responsibility for Actual and Alleged Product Defects

- a. Purely manufacturer's design
- b. Purely Customer's design
- c. Design By A Third Party in the Supply Chain – usually ultimate seller (e.g., automotive; white goods)
- d. Jointly Designed – Custom negotiation of liability allocation
- e. “Industry” Design with modifications – more like “Purely Manufacturer's design”

a. Purely manufacturer's design

Complete product, including packaging, instructions and warnings

- Sold direct to ultimate user
- Sold through sales reps
- Sold through distributors
 - » Who provide services/add value (system design, installation and maintenance, advice relating to use-pharmacists)
 - » Who resell with other products for integrated use (e.g., municipal sewage pumps and grinders)
 - » Who merely resell
- Private Label – sold to customer but shipped directly to ultimate user

Separable part/component of the main product, no packaging

- Sold to ultimate user (e.g., custom part for manufacturing machinery)
- Sold to upper tier supplier (e.g., 3rd-tier automotive)
- Sold to buyer that incorporates and sells to ultimate user (e.g., 1st-tier automotive)

Inseparable component/ingredient, no packaging/only shipping packaging (raw materials; food ingredients)

- Sold to customer that incorporates and sells to ultimate user (e.g., food ingredients)
- Sold to ultimate user (e.g., in-house fabrication; environmental treatments)

b. Purely Customer's design

- i. Complete product, including packaging
 - 1. Sold direct to ultimate user in a private label arrangement
 - 2. Sold to the customer, who simply resells
- ii. Separable part/component of the main product, no packaging/only shipping packaging
 - 1. Sold to ultimate user on a private label basis
 - 2. Sold to upper tier supplier (e.g., 3rd-tier automotive)
 - 3. Sold to buyer that incorporates and sells to ultimate user (e.g., 1st-tier automotive)
- iii. Inseparable component/ingredient, no packaging
 - 1. Sold to customer that incorporates and sells to ultimate user (e.g., food ingredients)
 - 2. Sold to ultimate user (e.g., in-house fabrication; environmental treatments)

c. Design By A Third Party in the Supply Chain – usually ultimate seller (e.g., automotive; white goods)

- i. Complete product, including packaging
 - 1. Sold direct to ultimate user
 - 2. Sold through sales reps
 - 3. Sold through distributors
 - a. Who provide services/add value
 - b. Who merely resell
- ii. Separable part/component of the main product, no packaging/only shipping packaging
 - 1. Sold to ultimate user (e.g., custom part for manufacturing machinery)
 - 2. Sold to upper tier supplier (e.g., 3rd-tier automotive)
 - 3. Sold to buyer that incorporates and sells to ultimate user (e.g., 1st-tier automotive)
- iii. Inseparable component/ingredient, no packaging/only shipping packaging
 - 1. Sold to customer that incorporates and sells to ultimate user

Jointly Designed/"Industry" Designed

- d. Jointly Designed – Custom negotiation of liability allocation
 - 2. Similar to Design By A Third Party in Supply Chain
- e. "Industry" Design with modifications – more like "Purely Manufacturer's design"
 - 1. Issues of incorrect advice of product type selected

The Importance of Clear Specifications

- This aspect of contract negotiation and drafting focuses more on facts than the law
- Specifications can be the key to what representations are made, how far warranties extend, and what indemnification obligations will apply
- Many lawyers know the law but fail to understand exactly what is being manufactured/built/performed

USING SPECIFICATIONS AND QC RESPONSIBILITIES TO ALLOCATE LIABILITY FOR PRODUCT DEFECTS

1. Design defects

- a. Design purely by Seller or Seller's agent/contractor
- b. Design purely by Buyer or Buyer's agent/contractor
- c. Joint design
- d. "Industry" design modified by Seller or Buyer
- e. Design not material to personal injury or property damage/limited to economic loss (repair)

USING SPECIFICATIONS AND QC RESPONSIBILITIES TO ALLOCATE LIABILITY FOR PRODUCT DEFECTS

2. Warning/Instruction Defects

a. Packaging/Instructions/Warnings by
Seller

b. Packaging/Instructions/Warnings by
Buyer

c. Effect of Industry standards

USING SPECIFICATIONS AND QC RESPONSIBILITIES TO ALLOCATE LIABILITY FOR PRODUCT DEFECTS

3. Manufacturing defects

- a. Normally all Seller's responsibility
- b. Where Buyer has incoming QC responsibilities
- c. Where nature of installation/product makes defect obvious before installation
- d. Defect not material to personal injury or property damage/limited to economic loss (repair)

Breach of Warranty/Representation

- In the sale of most goods it is necessary to negotiate the warranties and representations in conjunction with the indemnity provisions
- Effect of multiple design warranties in a product that includes multiple components from multiple suppliers
- Beware the warranty that the product will fulfill its intended purpose

Don't Forget Tort Liability: Component Supplier Doctrine

- One Engaged in the business of selling or otherwise distributing product components who sells or distributes a component is subject to liability for harm to persons or property caused by a product into which the component is integrated if:
 - (a) the component is defective in itself, as defined in this Chapter, and the defect causes the harm; or
 - (1) the seller or distributor of the component substantially participates in the integration of the component into the design of the product; and
 - (2) the integration of the component causes the product to be defective, as defined in this Chapter; and
 - (3) the defect in the product causes the harm.

Create A Prioritized Checklist of Important Items, Starting with Detailed Specifications

1. Warrant only that product will conform to specifications provided by Buyer and agreed upon by Seller.
2. Limitations of Liability to Buyer Notwithstanding Breach of Warranty within the 12 month warranty period
3. Indemnity/Defense by Seller
4. Quality Assurance obligations
5. Buyer's Indemnity/Defense of Seller
6. Government-mandated recalls
7. Elective recalls by customer/ultimate manufacturer
8. Order Process
9. Intellectual Property Rights/Indemnity

Key Points Regarding Specifications

- Manufacture to specifications provided by Buyer and agreed upon by Seller.
 - Recommendations of Seller have been independently approved and adopted by customer
 - Clear description of “specifications” without any ambiguity or vagueness
 - Exclude “intended use” or “purpose” clauses
 - Avoid incorporation of unknown or overbroad documents
 - Incorporated documents are overbroad if they include language that goes beyond merely building to customer’s specifications