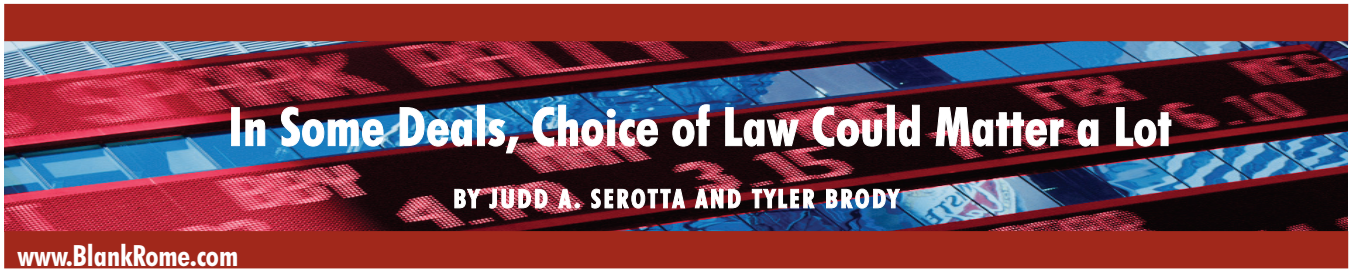

In Some Deals, Choice of Law Could Matter a Lot

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Here is a hypothetical conversation between a CEO and a general counsel:

GC: You know that Morrison deal that we're closing on Thursday? We just found out that Mr. Morrison has been cooking the books. He paid a month of his company's expenses out of his own pocket, so it looks like Morrison Corp. made a profit last year, but if you back those expenses out, we'll be paying $2 million for a company that actually, lost money. We've got to get out of this deal.

CEO: Relax. We've got all the standard representations and warranties. This deal is important to us, and we've gone too far to back out now. Let's just close and then tell Morrison that he needs to make us whole or we'll sue him for breaching the reps and warranties.

GC: How can we do that? He'll be able to prove we knew that the reps and ;warranties weren't true when we closed the deal. So he'll be able to show that we didn't rely. on them.

Who is right, the CEO or the GC? It depends on which state's law applies, and the message of this article is that in your "choice of law," think about your risks and objectives, and select a state's law that meets them.

THE ZIFF-DAVIS RULE

In legal doctrine, the GC and the CEO are arguing about whether a plaintiff needs to show that it relied on the defendant's representations and warranties. Put another way, is a claim for breach of representations and warranties like a fraud claim, where a plaintiff needs to show that it relied on the defendant's misrepresentations? Or is it like a contract claim, where reliance is not an element?

In the well-known 1990 case of *CBS Inc. v. Ziff-Davis Publishing Co*., the New York Court of Appeals resolved the issue for deals that apply New York law. CBS wanted to buy a Ziff-Davis subsidiary and the parties agreed on a price, with standard representations and warranties about the accuracy of the financial statements.

When CBS learned that the financial statements probably were not accurate, it sent a letter to Ziff-Davis explaining its findings, but stating a continued willingness to close the transaction, while reserving its right to recover damages for the inaccuracy of the representations and warranties. When the lawsuit came, Ziff-Davis argued that CBS had not relied on the representations and warranties: CBS knew they were untrue. The reservation of rights letter was, figuratively speaking, Exhibit A in support of the Ziff-Davis defense.

Ziff-Davis won before the trial court, and the ruling was affirmed on the first appeal. CBS appealed to the New York Court of Appeals, the highest court in the state. The court reversed the lower rulings and announced a new rule of law that has come to be know as the "Ziff-Davis Rule."

The Court of Appeals explained that a claim for breach of representations and warranties is just like any other breach of contract claim, not like a tort claim. To prove a breach of contract, a party only has to show three things: the existence of a contract supported by adequate consideration, breach of a material term and damages. The element of reliance is nowhere to be found.

Thus, the Court of Appeals ruled, if the agreement's representations and warranties were material terms that had been bargained for and were supported by adequate consideration, a breach of those terms is just like any other breach of contract claim. The plaintiff does not have to prove that it actually believed the representations, or relied

on them to its detriment, as it would under a fraud cause of action.

So, in our example above, the CEO is probably right in saying the company has nothing to worry about. If the agreement has the right representations and warranties, and if those terms are bargained-for, material terms, the company is protected - that is, if New York law applies.

OTHER JURISDICTIONS

Imagine that you are an attorney representing Tiny Corporation, and your client is about to be sold to Behemoth, Inc. You are amazed by the armies of lawyers and accountants that are poring over your client's financial statements and operations. In fact, the due diligence has been so thorough that only half-jokingly you say to your client, "I think they know our business better than we do."

When it comes to the effect of the deal documents' representations and warranties, that's not a joke. In fact, it could be a critical point.

If Behemoth knows Tiny's business so well, Behemoth could find a breach of the representations and warranties, even an unintentional one, and sue for damages under Ziff-Davis. Tiny might try to protest, like Ziff-Davis did, that there's something unfair about that. Behemoth knew the business so well that it never really relied on the representations and warranties.

The due diligence documents might well prove Tiny's case beyond a doubt. Behemoth might even be forced to admit that Tiny is right, in that Behemoth knew full-well that the representations and warranties were not true even before the deal was done. In New York, though, none of that matters. All Behemoth needs to show a New York court is that the representations and warranties were a material term that had been bargained for and was breached, causing damage. Reliance is not an element. To quote one of our law school torts professors, if your representations and warranties are not true and the plaintiff can prove damages, "You buy the farm."

But in Kansas you don't. In Kansas, Tiny defeats Behemoth's breach of representation and warranty claim on summary judgment if the undisputed evidence (in the absence of an "integration clause") shows that Behemoth did not rely on the representations and warranties. In Texas, Behemoth wins - under the Ziff-Davis rationale. In Delaware, the cases go both ways. Other states handle this question differently. Some follow Ziff-Davis, some do not, and some are still figuring it out.

THINK ABOUT YOUR RISKS AND OBJECTIVES, AND SELECT A STATE'S LAW THAT MEETS THEM.

Courts often are willing to enforce choice of law provisions. That means that, all other things being equal, the lawyer who represents Tiny can negotiate for the law of a non-Ziff-Davis jurisdiction to apply. On the other hand, the lawyer who represents Behemoth can negotiate for a Ziff-Davis state law to apply.

One other issue to think about is whether the particular state will permit the parties to contract into, or out of, the Ziff-Davis rule. This is an unsettled question in many jurisdictions that often depends on whether states think of those breach claims as torts or contracts.

The choice of law provision will probably not be a make-or-break-the-deal issue, and your deal counterpart might not be wise to this issue. In fact, transactional lawyers often save the boilerplate to the end, after the heavily-negotiated deal terms have been resolved. The Ziff-Davis question might not even be particularly important to your transaction, or there may be other choice of law considerations that win out.

But if your deal, like the GC's and CEO's in our hypothetical, could crater because of last-minute revelations, you might consider whether you want reliance to be an element of a claim for breach of representations and warranties, and that might dictate your choice of law.

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