A Litigator's Perspective on Drafting Contracts that Keep You Out of Court

Part 3 of 5

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Everybody wants options. Blockbuster destroyed the "mom and pop" video stores because of the sheer volume of movies on their shelves. Wal-Mart trampled other retailers large and small because the volume of its offerings allowed it to obtain better prices from its suppliers and pass those savings onto it customers. Costco clobbered traditional grocers because the variety (and size) of products they offered.

In this third edition of Vidal's Contract University, I address three types of contract provisions that can help to expand a contracting party's options under the contract. A thorough and well-drafted contract creates flexibility.

Introduction

A. Maximizing Options

While people like options, they tend to dislike commitment. Commitment is often risky. This is especially true in business.

When entering a deal to buy supplies, for example, a businessperson would prefer to lock the seller into a very low price and still have the freedom not to buy anything from the seller—even at such a "rock bottom" price. (Maybe sales are low and the company does not want to part with any more cash; maybe the buyer wants to use a different kind of supply to perform the same function; etc.)

We have a term for those kinds of contracts—illusory.[1] They are illusory because they bind one party to some performance but do not bind the other party in any way.

The law does not enforce an illusory contract. Both parties must be bound to something—both parties' options must be restricted in some way—to make a contract enforceable. In the above example, if the businessperson agreed to purchase at least a certain amount of product from the supplier, no matter how little that amount may be, the contract would be enforceable. She could also agree that she would buy all the product she requires (if any) from the supplier and promise she would not buy from any other supplier. This would also be enforceable because the businessperson's options have been restricted in some way.

We refer to this as the bargain theory of consideration. A contract does not exist unless there is bargained-for exchange between the parties. Each party has to give up some freedom in order to create an enforceable contract.

Consequently, the businessperson realizes that in order to do a deal he will have to give up something, but what he wants is to give up as little as possible. He wants to keep his options open.

[1] Illusory means based on illusion, not real.

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In this regard, many businesses think they are better served by a contract that is concise, uses broad language, and just covers the "main" points than they are by a very specific and detailed agreement. They come to this conclusion because they feel the less specific deal gives them flexibility. What they often find, however, is that the reverse is true: minimalist contracts are often painfully inflexible. As time goes on, the business becomes frustrated when circumstances change and the benefits it thought it would achieve under the contract disappear because the contract allows for only one course of action and that action is no longer economically feasible.

The businessperson is then stuck with the unpalatable option of either continuing to perform under a deal that may be costing the company money or trying to get out of the deal.

Often efforts to get out of the deal fail (because the business has no real leverage). When that happens, the situation is ripe for the dissatisfied party to breach the contract. That is usually when I get a phone call.

B. Well-Drafted Contracts Create Flexibility

The best way to minimize the likelihood that a business will be confronted with the hard choice of performing a bad contract or breaching it is to draft contract language that expands the business's options. There are a number of contract provisions that can expand options and create flexibility. The three this article explores are (i) assignment and delegation clauses, (ii) conditions, and (iii) discretionary authority.

Assignments & Delegations

One way a businessperson can increase his options under a contract is the ability to delegate the businessperson's duties or assign his rights under the contract to a third party. Of course, the other party to the contract may not want him to delegate her performance because she wanted to do business with him not somebody else. Moderating these two interests come assignment and delegation clauses.

Assignment and delegation are two distinct—albeit closely related—principles. They are often referred together simply as assignments, but this is wrong. Under California law, an assignment "consists of conferring one's legal rights to another." In the context of contracts, what is being conferred is the right to the other contracting party's performance. After the assignment, the assigning party relinquishes all rights with respect to the contract right being assigned.

If a chocolatier enters into a contract to sell 500 bars of premium chocolate to a buyer who agrees to pay $1 per bar, the chocolatier might wish to assign his right to be paid the $500 to a third party. The buyer, on the other hand, might want to assign his right to take delivery of the chocolate bars to a third party.

Delegation is the reverse. Under delegation, one party to a contract appoints a third party to perform some obligation owed by the delegating party. In the chocolate bar contract described above, the chocolatier may wish to delegate his duty to manufacture the chocolate bars to some third-party chocolate manufacturer.

Note that delegation does not relieve the delegating party of her obligation under the contract. The responsibility for performance of the obligation ultimately rests on the original contracting party.[2] Moreover, the delegate is not obligated to perform unless the delegate assumes the obligation (which itself is an agreement to undertake the delegated duty).

The default rule in most jurisdictions is that assignments and delegations are generally permitted. There are exceptions, however, where assignments are not permissible. For example, an assignment may not be permitted where it materially increases the risk of a non-assigning party. A duty may not be delegated if (i) delegating it is against public policy, (ii) the duty is personal in nature, or (iii) the contract provides that the duty is non-delegable.

If the businessperson accepts the default rule, nothing need be drafted in the contract. However, if it is important to restrict assignments or delegations, the negotiator may need to include an anti-assignment or anti-delegation clauses (or both) in the contract.

Anti-assignment clauses are interpreted by the courts in a variety of ways. First, anti-assignment clauses are typically subject to strict construction by the courts and are narrowly construed against the party trying to enforce the anti-assignment clause.

Second, sometimes anti-assignment clauses are interpreted as anti-delegation clauses (thus the contract would still permit assignments). Third, some courts treat anti-assignment clauses differently depending on whether the clause takes away the right to assign versus taking away the power to assign. For example, if an anti-assignment clause takes away the seller's right to assign, an assignment between the seller and a third-party is an enforceable agreement as against the seller or the buyer! But since the seller did not have the right to assign, the result is a breach of contract by the seller for which the buyer would be entitled to a remedy in court (if she suffered damages from the assignment).

Anti-assignment clauses require very careful drafting to ensure the businessperson achieves her goals under the contract. Anti-delegation clauses are generally enforceable and less tricky to draft.

Conditions

When shopping for a home, unless the buyer is sitting on a pile of cash, he will usually insist on a clause in the purchase contract that he does not have to buy the house if he does not qualify for a mortgage loan in an amount sufficient to cover the purchase price.

The arrangement created by the buyer's mortgage clause is known as a condition, more particularly, a condition precedent. The factual circumstances required by the condition—that the mortgage loan is approved—must exist before the buyer's obligation to purchase will arise. The existence or non-existence of that fact determines whether the buyer's obligation exists.

That is a simple example that most sophisticated businesspeople are aware of, but

[2] There is an exception to this rule. A delegating party will no longer be responsible for the duty if there is a "novation" under the contract. A novation substitutes a new obligation for an old one with the mutual consent of the original parties.

there are lots of times when conditions should be drafted into a contract but are not.

A. What are Conditions?

The formal definition of a "condition," according to the Restatement of Contracts, is the following: "an event, not certain to occur, which must occur, unless its nonoccurrence is excused, before performance under a contract becomes due."[3] More simply, a condition is a state of being that must exist before the contractual obligation will attach. (The state of being must be uncertain to occur.)

For example, in a motion-picture actor's contract the credit provision may require that if the director of the film is credited in a paid ad then the actor will be, too. Thus, the state-of-being in question is whether the director is credited in a paid ad. If he is not credited in the paid ad, then the production company has no obligation to credit the actor in the ad.

A condition is almost always an if-then sequence. If X is true, then Y must happen.

Three things typically happen when a condition does not occur. First, performance of any duty subject to that condition cannot become due unless the condition occurs or its nonoccurrence has been excused. Second, the nonoccurrence discharges the duty subject to the condition when the condition can no longer occur. Third, the nonoccurrence of a condition is not a breach unless a party is under a duty that the condition occur.

Some conditions govern the very existence of the contract between the parties. For example, in an employment contract, the employer's obligations to employ the worker and pay her a salary might be conditioned on the employee providing verification of citizenship or other eligibility of employment. In this case the entire contract terminates if the condition does not occur.

Other types of conditions do not affect the contract as a whole, the parties' relationship continues on whether a particular condition arises or not. In the actor's contract described above, if the director's credit is never put into a paid ad, the producer is not obligated to credit the actor. Still, the contract (including all the other rights, performances, and obligations) between the actor and producer remains active.

Conditions are powerful drafting tools that will help a businessperson minimize his risk under the contract. This is so because a condition <u>qualifies</u> an obligation.

The more carefully a businessperson (or his lawyer) can think about the reasons he is entering into the contract the easier it will be to identify important conditions that he may want to exist to in order for the contract to be valuable.

Take, for example, the following scenario. A wealthy corn farmer from Iowa is introduced to an up-and-coming computer programmer from Silicon Valley who is looking for venture capital to fund development of a new product. The software developer describes the product to the farmer—who dabbles a little in technology—and it appears to the farmer to be a potentially revolutionary product.

The farmer wants to invest and get some of his friends to invest with him. The investor group hires a powerful corporate lawyer who sends

[3] Restatement (second) Contracts § 224.

over a term sheet to the programmer. The programmer calls his dad's occasional lawyer and asks the lawyer for help. The programmer cannot put up a huge retainer for legal fees, but he promises the lawyer that if he helps negotiate the venture capital deal, he will be able to pay the lawyer out of the invested capital.

In order to protect his investment, the farmer may want the following conditions. First, because these deals take a long time to negotiate, he will want the programmer to agree that the warranties and representations negotiated early in the process will remain true at the time of closing. Second, because this deal involves cutting-edge technology, he may want to be sure that a due diligence review of existing patents will not disclose any patents that would be infringed by the programmer's technology. Third, because this is a big deal involving a number of players, the farmer will want to be sure that certain corporate documents (e.g., stock restriction agreements) have been executed and legal compliance (e.g., with securities laws) has been achieved.

B. Drafting Considerations

My first rule of drafting is to always consider what "states of being" are necessary or important for a particular deal. Why is the television producer entering into a blanket publishing and administration agreement with a hot new producer? What issues are important to ensure that both sides achieve that for which they are bargaining?

With those answers, the contract drafter can begin turning those "states of being" issues into if-then conditionals. The drafter may, for example, be negotiating a worldwide sales agreement. Perhaps, the sales agent will receive payment in a country with a blocked currency. The sales agent would want to include a condition dissolving his obligation to remit those blocked-currency revenues to the licensor in U.S. dollars.

Second, it is not good enough to just recognize a condition must exist—it must be drafted into the agreement. Unless the condition is expressed in the contract and dealt with in the contract, the obligation will be unqualified. I have had to break bad news to many potential clients that they could not defend a breach of contract action by telling the judge or jury something along the lines of, "Well, of course, I shouldn't have to deliver the finished goods if my Middle Eastern supplier's plant was destroyed during a rebel bombing." (Of course, there is no way you can predict that your supplier will be damaged during a war; however, the risk that a foreign supplier might not be able to deliver is a foreseeable risk that you can negotiate and draft around.)

Third, when drafting the condition make sure you (1) expressly state that it is a condition, and (2) state the consequences of the occurrence or nonoccurrence of the condition. A simple "if-then" formulation often works quite well. When drafting conditions in a contract section entitled "conditions," use the word "must" instead of "shall." The word "shall" denotes an action or obligation, while the word "must" denotes a set of circumstances: "As of the closing date there must not be suit, action, or other proceeding pending...."

Fourth, always draft carefully the language governing how difficult it will be to satisfy the condition. The more difficult the condition, the

more likely it is not to occur. This may be of critical importance if the drafter (or her client) is the one who will have to satisfy the condition.

Discretionary Authority

Discretionary authority provides a choice to one of the contracting parties (or both in some circumstances). Often times a party to a contract will say that he or she has a "right" to do one thing or another. Most often that "right" is really discretionary authority.

When negotiating a film distribution agreement, a film producer will often insist on an audit clause, which allows him to audit the distributor's books and records with respect to revenues generated from the film. The clause will generally provide something like "Producer, at Producer's own expense, may directly audit distributor's books and records relating to this agreement…."

Sometimes discretionary authority can be exercised anytime, but sometimes that authority is subject to a condition. "If Seller fails to cure any default within 30 days, Buyer may terminate this agreement." Generally you should use the term "may" to signal discretionary authority.

Discretionary authority, like conditions, should be expressly provided for in the contract. Examples of discretionary authority include approval "rights," buy-out "rights," rights arising when one party defaults, and the like. They are not enforceable if they are not included in the contract!

One more example from the entertainment industry is noteworthy. An "A-list" actress is given a script by her agent from an up-and-coming writer. She falls in love with the script and offers to do the project if the writer can get a producer with financing. Based on the actress's commitment to the project a major studio decides to back the film.

The studio, however, sees greater economic potential by making significant changes to the screenplay (assume they have negotiated for the right to make such changes). The studio changes the film from a romantic comedy set in a rustic mid-western community to a horror-thriller set in downtown Manhattan.

The actress is extremely disappointed because she would never have agreed to perform in horror-thriller. What could she have done at the drafting stage to ensure she would not be obligated to perform a role in a film based on the "revised" screenplay?

The actress in this case could have negotiated for a provision in the acting contract that allowed her to terminate the contract if she was dissatisfied with changes to the screenplay, or perhaps if she were really powerful, she could insist that she have "meaningful consultation" on script changes. In an entertainment contract these kinds of clauses are often referred to as "approvals and selections" and they are good examples of discretionary authority.

The grant of discretionary authority can be broad or narrow depending on the goals (and negotiating abilities) of the parties. The actress may try to obtain a blanket right to terminate if she does not like the contract changes. The producer, on the other hand, would not want give such broad authority and would likely insist that the actress's approval over script changes be qualified to a reasonableness standard. That makes the provision a little more objective. An

even stronger provision, from the producer's standpoint, would be to allow the actress to terminate only if the genre of the film changed.

There are other possibilities a drafter could consider, too, depending on the circumstances. Those possibilities are only limited by the negotiator's creativity.

Conclusion

As readers can readily see, contracts can provide a business much greater flexibility to achieve business goals—particularly under changing circumstances—than they may have thought. Using tools like an anti-delegation clause, a business can ensure that when it has specific reason to do business with one party over another its choice will be enforced by the courts.

The careful incorporation of conditions and discretionary authority into the contract can also help the business to achieve finer control over the existence and nature of obligations under the contract.

More importantly, if things do not go as planned and the business ends up litigating over the contract, these provisions provide a roadmap, which enhances the court's ability to interpret the contract favorably.

How Can AGMB Help You?

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