

Drafting Contract Provisions to Reduce Business Disputes

November 12, 2014

Greg Call, Crowell & Moring
Rob Crea, Crowell & Moring
Denelle Dixon-Thayer, Mozilla

Introduction

- There are provisions that receive little attention when negotiated, but can have a big impact in a dispute:
 - Recitals
 - MFN Clauses
 - Waiver/Estoppel
 - Limitation of Liability
 - Stipulated Damages

Introduction

- Look at provisions and how they play out in litigation
- General conclusions Judges, Arbitrators and Jurors
 - Will seek to honor the deal
 - Will read the words of the contract and interpret
 - Will interpret words without industry experience

RECITALS

What Does A Recital Do?

- Recitals provide context and factual background.
- Recitals may help to interpret ambiguous terms in the contract (for better or worse).
- Parties will be presumptively bound by the facts recited in the recitals.
- Recitals should **not** include deal terms.

When Is A Recital Not A Recital?

“Recital C is not a recital, despite its label. It is not a mere recitation of facts, but contains the operative language.”

Golden West Baseball Co. v. City of Anaheim, 25 Cal. App. 4th 11, 37 (1994)
(dispute over recital that purported to give Anaheim control over portion of parking lot not necessary for minimum number of parking spaces).

How Can Recitals Cause Problems?

- Conflict between the “deal terms” and the information recited in the recitals
- Ambiguity created if any “deal terms” or “agreements” are included as a “recital”
- Presumption is you have set forth all recitals that matter
- Problems:
 - Eliminates certainty in interpretation
 - Breeds expensive litigation
 - Inaccuracy

Aramony v. United Way of Am., 254 F. 3d 403 (2001) (former CEO sues the United Way after he was fired for “fraud and financial improprieties” claiming that he was contractually entitled to a larger pension based on a term in a recital)

MOST FAVORED NATION CLAUSES

Basic Questions

- What is a Most Favored Nation (MFN) clause?
 - Adapted from bilateral treaties
 - AKA “Most Favored Customer”
 - One party is assured best pricing / best terms from the other party
- Common applications
 - Supply contracts, service agreements, licensing agreements, leases, private equity funds

Types

- Broad range
 - Some are very specific
 - Others are general
 - Some go to specific terms, others to the overall deal

Considerations

- What are you trying to achieve?
- Will the clause achieve those goals?
- Is this appropriate long-term?
- Will management be difficult/feasible?
- Will enforcement be difficult or intrusive?
- Are there antitrust implications?

Effectiveness

- Will the clause achieve your goals?
 - Drafting can require an intimate understanding of a particular business or market
 - Complex pricing schemes may make these clauses impractical or even impossible to implement
- Can term be viewed in isolation?
- How can you determine whether a package of terms is better or worse (on the whole) than another?

Term

- How long is the MFN clause effective?
 - Will this arrangement work for both parties in the long-term?
 - Markets can shift dramatically.
 - Charges can be packaged in different ways in the future.

Enforceability

- Can you enforce the MFN clause?
 - How will the enforcing party know whether the other party is in compliance?
 - Are prices or other terms transparent?
 - Is periodic certification required?
- Enforcement by the courts
 - Judges and juries will honor the clauses
 - Basic concept can be explained

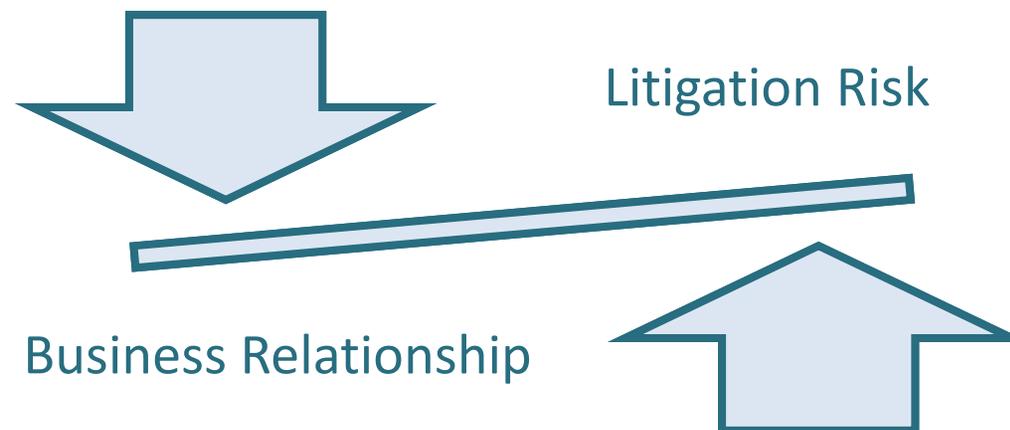
Drafting Considerations

- Make clear what other customers are in the reference set
- Set time limits
- Make clear what terms the MFN applies to
- Explain the election process
- Prohibit cherry-picking
 - The buyer must be required to choose an overall package of terms rather than select specific terms offered to other customers

WAIVER/ESTOPPEL

How Your Emails Become Waivers

- Innocuous emails spawn waiver claims
 - Party A emails Mr. Smith, tells him that its development is a little delayed, and makes excuses. Mr. Smith says nothing.



Typical Non-Waiver Clause

No Waiver: No provision of this Agreement shall be waived except by a writing duly executed by the Parties. No delay, failure or waiver by any party to exercise any right or remedy under this Agreement, will operate to limit, preclude, cancel, waive or otherwise affect such right or remedy. No course of dealing among any or all of the parties hereto shall operate as a waiver of the rights hereof.

Non-Waiver Clauses Can Be Waived

- “Even a waiver clause may be waived by conduct.”

Bettelheim v. Hagstrom Food Stores, Inc., 113 Cal. App. 2d 873, 878 (1952).

- “It has long been the rule that parties may waive a ‘no-waiver’ clause.”

Lee v. Wright, 485 N.Y.S.2d 543, 544 (N.Y. App. Div. 1985).

Elements Of A Waiver Claim

- Waiver is the intentional relinquishment of a known right after full knowledge of the facts.
- It depends upon the intention of one party only—no act or conduct by the other party is required.
- Excuses performance of an obligation—does not modify the terms of a prior agreement.
- Does not require consideration.
- Must be proven by “clear and convincing evidence.”

DRG/Beverly Hills, Ltd. v. Chopstix Dim Sum Cafe & Takeout III, Ltd. , 30 Cal. App. 4th 54, 59 (1994); *AeroGlobal Capital Mgmt., LLC v. Cirrus Indus., Inc.*, 871 A.2d 428, 444 (Del. 2005).

Affirmative Defense - Waiver

336. Affirmative Defense—Waiver

[Name of defendant] claims that [he/she/it] did not have to [insert description of performance] because [name of plaintiff] gave up [his/her/its] right to have [name of defendant] perform [this/these] obligation[s]. This is called a “waiver.”

To succeed, [name of defendant] must prove both of the following by clear and convincing evidence:

- 1. That [name of plaintiff] knew [name of defendant] was required to [insert description of performance]; and**
- 2. That [name of plaintiff] freely and knowingly gave up [his/her/its] right to have [name of defendant] perform [this/these] obligation[s].**

A waiver may be oral or written or may arise from conduct that shows that [name of plaintiff] gave up that right.

If [name of defendant] proves that [name of plaintiff] gave up [his/her/its] right to [name of defendant]’s performance of [insert description of performance], then [name of defendant] was not required to perform [this/these] obligation[s].

Example: Nice Guys Finish Last

- Owner of two hotels consistently delayed paying its licensing fees to Holiday, the franchisor of the brands.
 - Holiday had the right under the contract to terminate the license upon notice.
 - But in practice, it gave a 60-day grace period for over 8 years.
- In April 1999, Holiday ended informal policy with notice.
 - Owner fails to comply with payment of arrears by May deadline.
 - Holiday extended deadlines while Owner made only partial payments.
- In February 2000, hotels were removed from reservation system and Owner obtains TRO to restore hotels.
- Held: Holiday *waived* its right to terminate on the April 1999 payment simply through its delay in enforcing.

Limited Retraction Of Waiver

- Waiver can be withdrawn by written notice, with a reasonable opportunity for compliance
 - Consider our *Holiday* example
- Unless the conduct has resulted in an estoppel
 - “Having permitted [Owner] to become addicted to payment delays, Holiday could not simply cut them cold turkey.”

Effect Of Waiver Claim

- Waiver based on conduct or oral representations likely weak claim at trial
BUT
- Requires extensive discovery
- Creates a credibility dispute that kills summary judgment
- Increases expense of litigation

Practice Tips

- Continue to include non-waiver clauses in your contracts.
- Take notes of phone calls describing problems in performance.
- Evaluate risk of whether a waiver may have occurred.
- Send a no-waiver email or letter?
- Enter a non-waiver agreement?
- Preserve the business relationship.

LIMITATION OF LIABILITY

Preventing “Excessive” Exposure

- Limitation of liability provisions limit a party’s exposure in the event of a dispute.
- Parties may limit:
 - Total amount of damages
 - Types of damages (e.g., consequential or punitive damages)
 - Nonmonetary relief

Example Of Limitation Of Liability

Each party's liability, whether in contract, tort, otherwise, arising out of or in connection with this Agreement ... shall not exceed the amount of the License Fee.

IN NO EVENT SHALL EITHER PARTY BE LIABLE FOR ANY SPECIAL, INCIDENTAL, PUNITIVE, CONSEQUENTIAL (INCLUDING LOST PROFITS) OR TORT DAMAGES ARISING OUT OF OR IN CONNECTION WITH THIS AGREEMENT...

Enforceability

- Courts generally enforce liability limitations in claims for breach of contract and negligence.
 - May not be enforced for intentional torts
 - Limitations for “gross negligence” subject to challenge

Compare City of Santa Barbara v. Superior Court, 41 Cal. 4th 747, 758 (2007) and *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006).
 - NY courts define gross negligence more like intentional misconduct.
 - Other issues include statutory violations and active negligence.
- The language of the limitation is “strictly construed.”
- Litigation often results over the language used.

Categories Of Damages

- There are different categories of damages that contracts identify:
 - Direct
 - Consequential / Special
 - Incidental
 - Punitive

Limiting Direct Damages

- Direct damages “follow from the type of wrong complained of.”
 - Black’s Law Dictionary 446 (9th ed. 2009).
- Courts generally uphold caps on direct damages to the amount paid under the contract.
 - *Markborough v. Superior Court*, 227 Cal. App. 3d 705 (1991) (limiting recovery to the amount of the consulting fee paid to the defendant).
- Caps of less than the amount paid under the contract may also be upheld.
 - *See, e.g., Sch. Dist. of the City of Niagara Falls v. CrossPointe, LLC*, 2011 U.S. Dist. LEXIS 143739 (W.D.N.Y. 2011) (limitation on damages to annual service fee presumed valid); *Rob-Win, Inc. v. Lydia Sec. Monitoring, Inc.*, 2007 Del. Super. LEXIS 421, *20-21 (Del. Super. Ct. 2007) (upholding cap of \$250 for security alarm monitoring).

Intentional Breach

- Limitation on direct damages upheld for intentional breach of contract.
 - Example: in a services agreement, the limitation of liability is \$100,000. The cost to perform increases by more than \$100,000. The vendor stops performing.
 - Result: Customer's direct damages limited to \$100,000.

An “economically motivated decision cannot, as a matter of law, rise to the level of malice or intentional wrongdoing necessary to invalidate” a limitation of liability provision.

See Net2Globe Int'l, Inc. v. Time Warner Telecom, 273 F. Supp. 2d 436, 451 (S.D.N.Y. 2003).

- *Caution*: The contract may also include a specific performance clause, which could also be invoked.

Consequential Damages

- Consequential damages are “[l]osses that do not flow directly and immediately from an injurious act but that result indirectly from the act.”
 - Black’s Law Dictionary 446 (9th ed. 2009).
- Courts generally uphold limitations on consequential damages.
- Consider whether to define direct or consequential damages.

Avoiding Ambiguity

- The line between what is a direct damage and what is a consequential damage is blurry, at best.
- One way to avoid ambiguity is to clearly define direct damages:

For the avoidance of doubt, the following shall be considered direct damages and Vendor shall not assert that they are indirect, incidental, consequential or special damages to the extent they result from Vendor's failure to perform in accordance with this Agreement: (a) commercially reasonable costs and expenses of restoring or reloading any Client Data that is lost, stolen or damaged due to Vendor's failure to safeguard the Client Data and (b) reasonable expenses incurred by Client, including overhead allocations for employees, wages and salaries of employees, travel expenses, overtime expenses and similar charges, due to a failure of Vendor to provide all or a portion of the Services.

Key Question

Are “lost profits” consequential
or direct damages?

Lost Profits

- Lost profits may be categorized as either consequential damages or direct damages, or both.
- A contract that does not cap direct damages but excludes consequential damages invites litigation over the availability of lost profit damages.
 - *See Coremetrics, Inc. v. AtomicPark.com, LLC*, 2005 U.S. Dist. LEXIS 40484, *8 (N.D. Cal. 2005) (lost profits recoverable despite exclusion of consequential damages).

Incidental Damages

- Incidental damages are:
 - Losses reasonably associated with or related to actual damages.
 - A Seller’s commercially reasonable expenses incurred in stopping delivery or in transporting and caring for goods after a buyer’s breach.
 - A buyer’s expenses reasonably incurred in caring for goods after a seller’s breach.”
 - Black’s Law Dictionary 446 (9th ed. 2009).
- Example:
 - Reasonable expenses, such as shipping or storing charges incurred in coping with the other party’s breach.
- Incidental damages may be disclaimed.

Limitation Of Liability: Revised Contract Language

Vendor's liability for all damages, whether in contract, tort or otherwise arising out of or in connection with this Agreement, including from any and all claims related to the breach of this Agreement or nonperformance by Vendor. . . shall not exceed the amount of the License Fee.

Without limiting the foregoing, in no event will Vendor be liable for any lost or prospective profits, indirect, incidental, consequential, special, exemplary or punitive damages, arising out of or in connection with this Agreement . . .

Punitive Damages

- A contractual elimination of punitive damages is of limited utility.
- Punitive damages are not available for a breach of contract claim, but . . .
 - See *E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436 (Del. 1996); *Rocanova v. Equitable Life Assur. Soc’y*, 83 N.Y.2d 603, 613 (N.Y. 1994).
- Requires a showing of “oppression, fraud, or malice.”
 - Cal. Civ. Code § 3294.
- Liability limitations unlikely to be upheld for the kind of intentional misconduct that is a prerequisite for the imposition of punitive damages.

“Unconscionable” Limitations

- Courts will not enforce “unconscionable” limitation of liability provisions.
- Requires a showing of severely unequal bargaining power (e.g., “take it or leave it” form contract) and substantive unfairness.
- Unlikely to exist in commercial contracts.
 - *Markborough Cal. v. Superior Court*, 227 Cal. App. 3d 705, 715 (1991) (no unconscionability found in standard form contract where opportunity to negotiate existed).

Fraud In The Inducement

- Defense to enforcement of limitation of liability: claims of fraud in the inducement of the contract.
- Delaware: Liability limitations invalid where representations and warranties contained intentional and material misrepresentations.
 - See *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006).
- California: Entire contract invalid where induced by any misrepresentations.
 - *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Ass’n*, 55 Cal. 4th 1169 (2013) (“when fraud is proven, it cannot be maintained that the parties freely entered into an agreement reflecting a meeting of the minds”).

Drafting Considerations

- Consider whether to include a direct damage cap.
- Choose a reasonable amount for the cap.
- Define lost profits as either direct or consequential damages, or both.
- Ensure that the limitation of liability covers all available forms of potential liability.
- Consider whether there are any claims (such as indemnifiable third party claims or breaches of confidentiality) that should be outside the limitation of liability.

STIPULATED DAMAGES

Types Of Stipulated Damages

Type	Definition
Liquidated Damages	Sets damages for breach before the breach occurs.
Termination Fees	Permits parties to terminate an agreement early by paying a fee.
Take-or-Pay	Requires a buyer to either purchase the contractually agreed quantity of goods or pay the value of those goods to the supplier.
Breakup Fees	Permits a party to terminate a merger agreement by paying an agreed fee.

Purpose

- Provides a reasonable measure of compensation in the event of a breach
- A clause designed to prevent breach by coercing performance, or to punish breach after it occurs, is void as a penalty.

24 Williston, Contracts § 65:2-65:3 (4th ed. 2002).

Presumption Of Validity

- **CA:** Stipulated damages presumed valid unless:
 - The party seeking to invalidate establishes that the provision is unreasonable, or
 - One party is a consumer (in certain consumer transactions).

Cal Civ. Code § 1671.

Compensation v. Penalty

- Courts will look to the proportionality of stipulated damages to actual damages.

Majority View: Stipulation must be reasonable in light of anticipated damages at the time of contracting (California, New York)

Minority View: Stipulation must be reasonable in light of damages after breach (Indiana, Kentucky, New Hampshire)

Unreasonable Approximation: The Shotgun Approach

- “Shotgun” Clauses: A ‘shotgun’ or ‘blunderbuss’ clause is one that fixes a single large sum for any breach without regard for the severity of the breach.
 - These clauses are unenforceable even in the case of a substantial breach, because they are not a reasonable forecast of an insubstantial breach.

3 Farnsworth, Contracts § 12.18 (2d ed. 1998).

Damages Difficult To Estimate

- Employment/Non-Compete Agreements
- Merger Agreements
- Minimum Purchase Agreements
- Early Termination
- Exclusive Rights to Market or Sell
- Disclosure of Confidential Information

Drafting Considerations

- Avoid the word “penalty.”
- Carefully consider actual damages:
 - A provision setting graduated damages based on length of delay or quantity of defective goods is more likely to pass muster.
 - Courts are less likely to enforce a “shotgun” approach setting a single lump sum for every breach.
- Include an upper limit as well as a lower limit on recovery.
- Use a deposit approach clearly identifying the deposit as the liquidated damages amount and allowing the holder to retain the deposit as liquidated damages.
- Make a condition, not a covenant.

Questions?