Contracts – Deadly Duels in the Fine Print

New England Supply Chain Collaborative

Kennedy Hudner
Murtha Cullina LLP
860.240.6029
khudner@murthalaw.com

Why We’re Here

“Education is when you read the fine print. Experience is what you get if you don’t.”

--Pete Seeger
Where we’re going...

- Instructive cases:
  - Contract formation
  - Merger clauses
  - Limited remedies/consequential damages
  - Protecting your rights.

Where we’re going...

- Contract mythology
- Common shortcomings
- Exclusivity
- Warranties
- Remedies
- Limiting liability
- Consequential damages
- Intellectual Property
Where we’re going...

- Trade secrets
- Co-developed intellectual property
- Indemnification clauses
- Term and termination
- Force Majeure
- Negotiation techniques

Contract Formation

**D. R. Curtis Company v. Mason**

- Dispute involving 9,000 bushels of spring wheat.
- Buyer called farmer and defined details – price, shipping, quantity, delivery – over telephone.
- Seller asked to see Buyer's contract form.
- Buyer sends written "confirmation memorandum," stating: "[it] is understood that the retention of this confirmation without notifying us of error therein, is an acknowledgment and acceptance of contract as above."
- Buyer then contracts to resell the 9,000 bushels.
 Surprise! Seller does not deliver wheat.
Buyer sues Seller for breach of contract.
Seller says no oral agreement, just wanted to see Buyer’s offer.
No language in a "confirming memorandum" can create an agreement that did not previously exist.

Contract Formation/Arbitration Provision

Senco, Inc. v. Fox-Rich Textiles, Inc.

Buyer placed telephone order with Seller for 1,800 yards of fabric.
Seller confirmed the order and the agreed on terms by letter.
Before goods were shipped, Seller sent a document to Buyer entitled "Sales Contract," which included an arbitration provision. Never signed by Buyer.
- Goods were defective. Buyer sued in court.
- Seller moved to dismiss, citing arbitration clause.
- Court concluded that contract between the parties was formed when Seller memorialized its oral agreement with Buyer in the letter.
- The "Sales Contract" was too late – contract already formed. The arbitration clause was not a contract term and therefore did not govern the dispute between the parties.

The Lesson – Getting Lost in the Negotiations

- Increasingly common problem: Getting lost in the communication flow.
- Too many people negotiating the contract.
- Rapid turnover of contract drafts.
- “Email Flurry”
- More talk, less attention. (Phone, cell phone, fax, email, letter – example of case with three different contract offers pending!)
So, What’s the Deal?

- Need to step back and digest what has been agreed to...**and what has not.**
- Need for good, clear communication within your company.
- Who is assigned the task of keeping track of the deal points? Keep them in the loop.

**Integrated Contract / Merger Clause**

*LPG Holdings v. Casino America*

- LPG has option on land. Wants Casino America to build casino.
- Sept – Dec parties exchanged numerous drafts.

Final contract had clause that Casino America had right to terminate contract any time before all of the property was acquired.

Also had “This is the complete and final understanding” clause.
Guess What?

- As Court noted, “Events did not proceed as LPG had planned.”
- LPG spent $$$ getting ready. Then Casino America backed out.
- LPG sued for $20 Million, saying CA obligated to build casino.
- LPG relied on earlier letter agreements and earlier drafts of final agreement.
- LPG – “Implied Covenant of Good Faith”!!

Court Says Contract is Clear

- Role of court is to give effect to intention of parties.
- Find intent of parties by looking at language of contract.
- If contract is clear, court will not rewrite it.
- Court held contract was clear.
- **Merger clause prevents** court from considering earlier drafts or letter agreements.
Implied Covenant vs. Clear Language

- LPG says its “reasonable and justified expectations” were foiled by Casino America.
- Court says that the terms of the contract reflect the final bargain.
- Court will not upset clear terms of contract.
- Merger clause makes clear this is the complete expression of the deal.

What Happened Here?

- To start with, LPG lost $20 Million in revenues.
- Probably spent $400,000+ in litigation.
- (2 ½ years)
- Spent $30-50K in contract documents.
- Key factor: LPG lost track of the deal terms.
- LPG was not out litigated, it was out drafted.
- Casino Am. took care to limit its risk. LPG was left extremely vulnerable.
Who Bears Risk of Consequential Damages?

- McNally v. NY Electric & Gas Corp.
- Elec. Co. building a dam.
- McNally sells big spillway gates. 500,000 lbs.
- Sale of goods. UCC applies.
- Elec. Co. orders 6 spillway gates. Firm deadlines for delivery. Time of Essence!
- McNally uses subcontractor to make gates.

Mismatched Contract Terms

- Elec. Co. has strong clause re late delivery.
  - If Seller behind schedule, must put on 3 shifts, 7 days/week until back on schedule.
  - But...poor contract coordination!
- Seller’s contract with subcontractor does not have 24/7 clause. Subcontractor refuses.
- Delivery of spillway gates is very, very late.
- Buyer refuses to pay. Seller sues.
Buyer Seeks Damages

- Buyer seeks consequential damages for delay. Big $$$.!
- Not so fast! Disclaimer of Consequential Damages clause:
  - “This limitation of liability shall be effective without regard to Contractor’s performance or failure or delay of performance under any term or condition of this Contract, including those obtained in the warranty article.”

Buyer’s Benefit of the Bargain

- Seller says it delivered 6 spillways. The spillways met the warranty specifications.
- Elec. Co. says limitation on damages not enforceable – “unconscionable!!!”
- Elec. Co. says it will be deprived of the “substantial value of its bargain.”
Will the Court Save the Poor, Beleaguered Buyer?

- Court holds that Elec. Co. “received exactly that for which it originally contracted.”
- Damage limitation not unconscionable – both parties had relatively equal bargaining power.
- Orders Elec.Co. to pay Seller for 6 spillways.

What happened Here???

- End result: Major breach of contract by Seller, but Buyer unable to get damages.
- Buyer needed the spillways on time.
- Sought security by imposing 24/7 work requirement if Seller fell behind schedule.
- Both Buyer and Seller apparently forgot to check terms of the subcontract. No way to force subcontractor to go 24/7.
What happened Here?

- Buyer’s backup was to get consequential damages.
- Did not pay attention to damage disclaimer.
- This was a disaster for Buyer. Did not understand effect of contract terms.
- But! This could have been disaster for Seller. It failed to make sure its subcontractor was on hook for 24/7 remedy that Seller had agreed to.

Harsh Lessons

- Focusing on contract’s terms after you have signed it is too late.
- Pay attention. Be paranoid! Read the entire contract. How do the parts fit together?
- Trying to persuade Court that plain language does not mean what it says is uphill battle.
- Litigation is expensive. Sleepless nights and sore stomachs.
Case of the Droopy Labels

- Buyer buys 2 million labels.
- Problem: Labels don’t stick to bottles.
- Knowing this, Buyer goes ahead with production. Asks Seller for help.
- Seller suggests might be a residue on bottles, so Buyer scrapes clean 880,000 bottles.

Droopy Labels

- In middle of this, Buyer pays for the labels, with a check that says “Payment in Full.”
- Even with clean bottles, labels don’t work.
- Buyer revokes acceptance.
- Court says too late. Buyer knew of problems but used labels anyway. Awards only minor warranty damages.
- Lesson: Don’t sit on your rights. When there is a problem, STOP.
Even Pigs Come with Fine Print

- Farmer wants to buy hogs from Seller, but is worried about rhinitis.
- Seller's rep assures farmer hogs don’t have disease.
- Farmer signs contract that explicitly says Seller cannot guarantee hogs are free of disease.
- Hogs turn out to have rhinitis.

Written Contract Takes Priority

- Contract had “Complete and Final Understanding” clause.
- Court says salesman’s oral representations are not part of the contract.
- Don’t trust this case! Train your sale force.
Battle of Forms

- Common situation:
  - Buyer sends in PO
  - Seller replies with Acknowledgement, but with different terms and conditions.
  - Whose terms control?

Battle of Forms - 2

- Proposed amendment to UCC states that contract terms will consist of:
  - Terms on the forms which agree.
  - Other terms on which parties agree (side letters, emails, etc.)
  - UCC gap fillers.

- Who gets hurt here?
Battle of Forms - 3

- Usually Seller gets hurt.
  - Seller must affirmatively disclaim implied warranties.
  - **Must disclaim liability for consequential damages!**
- If forms don’t agree, then Seller’s disclaimer gets tossed out. No UCC gap filler to save the Seller.

Don’t Lose the Battle!

- If you have an important contract, with offers and acceptances back and forth, seriously consider a final, **signed** agreement.
- This takes you out of the Battle of Forms and allows you to know your rights and obligations.
Let’s Step Back…

Some thoughts about contracts and contracting…

Contracts: The First Rule

- Getting out of a bad contract is harder - and more expensive - than negotiating a good one.
The Second Rule

- The Company will always look for a scapegoat.

The Third Rule

- It might be – you!
Contract Mythology

- Oral Contracts – you can’t be held liable if it’s not in writing, right?
- (Basic offer and acceptance.)
- Letters of Intent – an LOI isn't a contract, is it?
- MOU – Memorandum of Understanding. What is it?

Contract Mythology

- “Partnering Agreements”
- They don’t want to contract with you, they want to “partner” with you.
  - Should not be as complete or as defensive because we’re friends.
  - Do not worry about liability clauses in their proposed agreement – partners always work things out.
Myths Have Teeth

- “Partnering Agreement” is when a big guy tells you he is going to pick your pocket and that you’ll like it because...he’s your partner.

Function of Contract

- Define the business deal.
- Allocate obligations
- Allocate risk.
- Allocate ownership of intellectual property
- Establish conditions for certain things to happen. (You’ll get a license if...
Most Common Shortcoming

- Biggest shortcoming of contracts is that they do not address all of the parties’ expectations.
- Why? Because the parties don’t articulate them...or know them.
- Cannot allocate risks and obligations until you understand them.

What’s the Deal???

- Are you the buyer or seller, or both?
- What are you buying?
- Does it exist already, or does it need to be developed?
- Are there clear specifications for what you need?
What’s the Deal? - 2

- Are there clear specifications for what the seller can sell to you?
- If the specifications don’t exist, Phase I should be to create them.
- Reserve the right to accept the specs, and to terminate the contract at end of Phase I.

The Deal - 3

- Is time of the essence? If so, contract needs to state it.
- Are “goods” being delivered? If so, where and how? FOB, FAS?
- Are you acquiring license to IP?
- Perpetual license or license for a term of years? One time payment? Annual payments?
**The Deal - 4**

- Software - if it is a big project, pay attention to details. Internal costs will often exceed license fee.
- **Define the Functional Specifications in detail!**
- Acceptance Test

**Are You Married, or Just Friends?**

- Exclusive contract?
  - Exclusive as to what?
  - Won’t buy similar items or services from anyone else? What if they can’t deliver? Price increase over time? Price decrease? Consumer Price Index?
- Territory?
- Certain business market?
Conditions for Exclusivity

- Exclusive for a limited time?
- Exclusive only so long as certain revenue goals are met?
- Exclusive so long as certain other market conditions exist (maintenance of competitive price from your seller)?

After the Contract Ends

- Non-compete clause?
- Territory? Product market? Business market?
- How long? 1 year? 5 years?
- Non-solicitation of customers? Employees? What if customer calls you?
- Trade secrets? Clearly defined?
Warranties

- **Know what your warranty is!**
- If you are in a battle of forms, remember that the other party may be defining your warranty.

Warranty vs. Remedy

- Don’t confuse warranty with remedy.
- Warranty tells you what the product or software will do.
- Remedy tells you what the seller will do if the product doesn’t meet warranty.
Remedies

- Is the remedy your sole and exclusive remedy? (You waive right to other damages.)
- If buyer, you want other damages.
- If seller, you want remedy to be sole and exclusive.

Limiting Your Liability

- As Seller, limit your liability by:
  - Defining specifications!!!
  - Disclaiming warranties.
  - Disclaiming consequential damages.
  - Limiting the dollar amount of damages.
  - Applying these limitations to any type of claim Buyer might bring.
Limiting Your Liability

- As Buyer, limit your risk by:
  - **Defining specifications!!!**
  - Requiring acceptance test where appropriate.
  - Insisting on clear warranties.
  - Getting consequential damages. (Tough!)
  - Avoiding damage limitations, or making them realistic.
  - Know the deal!!!

Define the Specifications

- Understand what your product/software can do...and not do.
- Tension between marketing and what you can deliver.
- Understand what customer wants.
- Make sure customer understands what you are delivering.
Writing the Specifications

- Specifications are basis of your warranty and any acceptance test.
- Must be detailed, thorough and complete.
- Must be clear. Minimize jargon and technospeak. (Juror will have 12th grade education, maybe.)

Writing the Specifications

- Read the Specifications. Do you understand them?
- Do they cover all of the functions you are supposed to deliver (or receive)?
- Ambiguous? Too general?
- Do they answer your questions?
Sign Off

- Once Specifications are final, parties are committed. (Avoid “Specification Creep.”)
- Further changes should require a written Change Order.
- Adjust price and deliver dates?

Disclaim Warranties

- Warrant that the software or product will conform to Specifications.
- Disclaim everything else.
- Must affirmatively disclaim the implied warranties of:
  - Fitness for particular purpose
  - Merchantability
Nasty Consequential Damages

- When you accept the risk of consequential damages, you bet the company.

Just Say “No”

- You get tagged with liability for consequential damages:
  - By affirmatively agreeing to them.
  - **By failing to disclaim that liability.**
  - Through many forms of indemnification clauses.
Affirmatively Disclaim Consequential Damages

- Notwithstanding Section _, in no event shall seller be liable for any indirect, special, punitive or consequential damages incurred by buyer as the result of seller’s performance, or lack of performance, of this Agreement, even if seller shall have been put on notice of the possibility of those damages arising.

- If you are Buyer, need compelling reason to negotiate changes to this.

Take Note of Special Circumstances

- “Down stream” liability?
- Is your product going to be a component of some larger product?
- Disclaim liability for any recalls.
- Disclaim liability for labor costs.

- If Buyer, you need to be aware of the downstream risks you are left exposed to. Consider focused indemnification clause.
Applies Even if Sole Remedy Fails

- UCC 2 – 719(2) – “Where circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided...” by law.
- “This disclaimer shall remain in full force and effect even in the event that buyer’s sole and exclusive remedy shall fail of its essential purpose.”

And Don’t Forget Non-Contract Claims

- “This disclaimer of consequential damages shall apply regardless of the basis of buyer’s claim, be it in contract, warranty, tort, product liability, infringement or otherwise.”
Limit Amount of Damages

- In addition to disclaimer of consequential damages, Seller will try to limit total damages.
- Limit Buyer’s damages to repair or replacement of the product.
- Backup: If repair or replacement doesn’t work, refund cost of defective product.

Be Flexible

- If Buyer won’t accept this, raise the damages amount. Seller won’t be liable for more than $10,000. Or no more than total purchases in last 12 months.
- Apply to all claims, be they in contract, warranty, tort, product liability, etc...
Co-developed Intellectual Property

- Straight license of your IP to licensee is relatively simple.
- Problems arise when both parties contribute to development of the IP.
- Pre-existing IP and “New IP”
- Who owns what?

All Good Things Come to an End

- If deal craters, what right will each party have to the old IP and the New IP?
- Model I
  - Both of of you, with equal rights?
  - Need to account for profits to each other? Need to be clear.
Dividing the IP

Model II
- One party keeps the IP and pay royalties to the other.
- Contingent rights of the other party to use the IP?
- Under what conditions?
- Pay royalties?

Model III
- Neither party uses the New IP.
- In any event, the contract must clearly set out the rights of each party.
- Alternative is to have judge try to determine what contract implies.
Indemnification Clauses

- Very technical. (And very boring.)
- Very dangerous.
- Watch out for interplay with disclaimer of consequential damages.

Indemnification

- For what?
- To whom?
- For how much $$$$?
- Unlimited $$$$?!?
- Will your insurance cover this contract obligation? (Don’t assume, you need to check!)
For What?

- "Any damages incurred by buyer in relation to seller’s activities with regard to this Agreement."

  Hmmm...let’s think about this.
  - Doesn’t have to be a breach of contract.
  - Seller does not have to be negligent.
  - Congratulations, you’re an insurance company!

For What?

- “Any damages incurred by buyer in relation to seller’s breach of this Agreement.”
  
  - All damages, including consequential damages?
  - Undermines disclaimer? If Buyer, you want to be clear that indemnification takes precedence over disclaimer.
For What?

- “Any damages incurred by Buyer as the result of personal injury or property damage caused directly or indirectly by Seller’s acts or omissions in the performance of this Agreement.”
  - More narrow.

For What?

- “Any damages incurred by Buyer as the result of personal injury or property damage caused solely and directly by Seller’s acts or omissions in the performance of this Agreement.”
  - Even more narrow.
For What?

- Indemnification only for IP issues:
  - “Indemnify buyer for any damages incurred that result from the software infringing upon the United States patent, copyright or trade secret rights of any third party.”

To Whom?

- Just to the Buyer?
- To the Buyer and its affiliates.
- Buyer’s subcontractors?
- **Buyer’s customers??**
Any $$ Limitations?

- Indemnify up to the amount of money Seller received from Buyer?
- Indemnify up to $100,000? $1,000,000?
- Indemnify up to amount of Seller’s insurance actually paid to it and only when paid to it?
- Buyer beware! If indemnification is conditioned on insurance, you are at risk.

Term of Contract

- What is the duration of the Agreement?
  - No fixed term, but terminate on notice?
  - For cause only? (Be careful, forever is a long time.)
  - Without cause? Or, without cause after first year?
- Who benefits from short term? Long term?
Termination Provisions
(Get Me Out of Here!)

- Don’t get into a contract you cannot get out of.
- Terminate for convenience?
- Terminate only for “cause”? Define cause.
- Cure period? 30 days? 90 days?
- Terminate immediately after cure period, or further notice?

Evergreen Contracts

- Contract automatically renews for another term (1 yr? 5 yrs?) unless you notify other party 90 days before end of current term.
- Very dangerous. Find them in maintenance agreements, etc.
- No one remembers to terminate in time.
Evergreen Contracts

- If other side insists on evergreen clause, give them notice immediately after execution of the contract.
- Or, insist they send you a reminder that the period for notice of termination is coming up. (They’ll hate this.)

Force Majeure

- Seller is not responsible for any delays in performance arising from Act of God, fire, flood, earthquake, civil unrest, terrorism, acts of war, labor strikes or slowdowns, failure of suppliers, *failure of the Yankees to win the World Series*...
- Scope of force majeure events?
**How Long is Too Long?**

- How much delay can you tolerate?
- Consider a clause that says if aggregate delay is greater than 30 days, you have right to terminate contract without further liability to seller.

**Choice of Law, Venue, etc.**

- Routine, but think it through.
- Arbitration? Venue?
  - Home town
  - Mutually inconvenient location.
Negotiation Techniques

- Everything is negotiable, unless it’s not.
- Know your “hot button” issues.
- Know the other side’s hot button issues (e.g., indemnification issues).
- Try to flesh them out early.
- Keep track of where you are in list of points.
- (You’d be surprised how many concessions get lost in the shuffle...)

Negotiations

- Clearly state your demands and your replies - misunderstandings are time consuming and kill your credibility.
- “That’s not what I really meant”
  - You are inarticulate.
  - You are stupid.
  - You are devious.
Negotiations

- Be prepared to walk away!
- Not every deal is worth signing.
- Not every deal can be saved.
- Not every party is worth dealing with
  - trust your instincts.

Or...

- (Or, please, please ignore this advice and help put my children through college.)
Negations – Ego is Not Helpful

- Watch out for the ego trap!
- **Negotiation is about closing an acceptable deal**, not proving you are tougher or smarter than the other guy.
- Watch your lawyer - don’t let him get into an ego contest.
- Watch the other side’s lawyer!

Negotiations

- If you hit an “ego impasse”, bring in the top guys to talk face-to-face.
- Use this sparingly, but use it.
- If the deal is complex, with time limits on performance, make sure your staff knows what the requirements are.
Lesson of the Day

- A pint of sweat, saves a gallon of blood.
  George S. Patton, General (1885-1945)