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Risk Allocation in Commercial Contracts

by Practical Law Commercial Transactions

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This Note discusses common risk allocation mechanisms in commercial contracts. It describes how parties can allocate risk through indemnification, limitations on liability, termination rights, force majeure, contractual remedies, UCC product warranties, insurance coverage, payment terms, and guaranties, and provides drafting and negotiating tips.

One of the principal roles of a commercial contract is to allocate risk between the parties. In any commercial arrangement, each party seeks to minimize its risk while maximizing its reward. Often, the more one party's risk decreases, the more the other party's corresponding risk increases. This creates an inherent tension between contracting parties, making the allocation of risk a key contractual negotiation point.

This Note explains how parties can use the following common contractual provisions to allocate risk:

- Indemnification.
- Limitations on liability.
- Termination rights.
- Force majeure.
- Contractual remedies, such as:
  - equitable remedies;
  - cumulative remedies;
  - exclusive remedies; and
  - **liquidated damages**.
- Product warranties under the **Uniform Commercial Code** (UCC).
- Insurance coverage.
- Payment terms.
- Guaranties.

This is not an exhaustive list of contractual risk allocation mechanisms. Parties can use nearly any contract provision to allocate risk (see Box, Using Contractual Building Blocks to Allocate Risk). The sophistication of the parties and nature of the transaction influence which risk allocation tools the parties select.

Indemnification as Risk Allocation Tool

A contractual indemnity is an express agreement by one party to compensate another party for certain agreed costs and expenses. It is often coupled with a duty to defend and hold the indemnified party harmless. Most commercial contracts include an indemnity.

Through a well-drafted indemnity, the parties can customize their risk allocation to:

- Shift the burden of loss.
- Compensate an indemnified party for:
  - risks it did not assume; and
  - expenses that may not be recoverable under common law, such as attorneys' fees.
- Minimize uncertainty regarding the scope of future potential liabilities.
- Reduce the likelihood of litigation concerning the allocation of liability between the parties and the available remedies.
- Shift the cost of defending third-party claims.

Contracting parties have competing interests when negotiating indemnification provisions. Each party benefits most by limiting (or eliminating) its own indemnification obligations, while expanding the indemnification obligations of the other party.

Scope of an Indemnity

The broader the scope of an indemnity, the greater the risk assumed by the indemnifying party. Key factors contributing to the scope of an indemnity include:

- Who is indemnified (see Who is Indemnified), including indemnified third parties (see Indemnified Third Parties).
- What claims are indemnified (see Indemnified Claims).
- The required nexus between the event giving rise to indemnification and the indemnified party's damages (see Nexus).
- The recoverable damages and whether they are the sole remedies available (see Recoverable Damages).
- Whether there are any exceptions to indemnification (see Exceptions to Indemnification).
- The duration of the indemnity (see Duration).
- Whether there are any limits on indemnified amounts (see Limits on Indemnified Amounts).
- The required procedures for indemnification (see Indemnification Procedures).

Who is Indemnified
Between contracting parties, indemnifications provisions may be:

- **Unilateral.** One party indemnifies the other for covered claims. The other party has no indemnification obligations. Unilateral indemnities are unusual. However, they may be used in contracts where one party has:
  - significant negotiation leverage;
  - limited contractual liability; or
  - few contractual obligations.

  For example, in a sale of goods where the buyer's principal obligation under the contract is payment, the seller may unilaterally indemnify the buyer.
- **Mutual.** Each party indemnifies the other for covered claims. Most commercial contracts include mutual indemnification provisions. A mutual indemnification provision can provide both parties with:
  - added certainty regarding the scope of their respective future liabilities; and
  - a sense of reciprocal rights and remedies, even if each party's actual indemnity obligations differ based on their respective liability exposure.

Indemnified Third Parties

Indemnification provisions often include third parties in the definition of indemnified parties, such as a contracting party's:

- **Affiliates**.
- Employees.
- Directors.
- Officers.

Extending indemnification coverage to third parties:

- Shifts additional risk to an indemnifying party. An indemnifying party should assess the magnitude of this additional risk and factor it into its overall evaluation of the transaction.
- Can create contractual inconsistencies if the indemnity is not excluded from any "no third-party beneficiaries provision" in the contract. To avoid these inconsistencies, the indemnity must be carved out from any general restriction in the contract on third-party beneficiaries (see Standard Clauses, General Contract Clauses: Third-Party Beneficiaries: Drafting Note: Indemnified Parties as Third-party Beneficiaries).

Indemnified Claims

An indemnity can cover either or both:

- **Direct claims.** These are claims that an indemnified party has against the indemnifying party, such as for breach of agreement.
- **Third-party claims.** These are claims that a third party has against the indemnified party, such as for product liability.

When determining which claims are covered by an indemnity, parties should consider any remedies otherwise available under common law. Contractual indemnification is generally designated as the exclusive remedy for covered claims so that the indemnity is intended to take the place of any common law remedies. Depending on the scope of the indemnity, the indemnity may significantly narrow or expand a party's available remedies when compared with remedies available under common law.

Nexus

In a contractual indemnity, a nexus phrase defines the degree to which the event giving rise to indemnification and the indemnified party's damages need to be related for the event to be indemnifiable.

Examples of nexus phrases include:

- "Related to," a broad nexus phrase.
- "Caused by," a narrower nexus phrase.
- "Solely result from," an even narrower nexus phrase.
- "To the extent arising out of," another narrow nexus phrase.

Narrower nexus phrases shift risk away from indemnifying parties by limiting their indemnification obligations. Broader indemnification obligations shift risk to indemnifying parties by increasing indemnified parties' opportunities for indemnification. When indemnification is mutual, each party must balance its:

- Incentive to limit its own indemnification obligations through a narrow nexus phrase.
- Competing incentive to expand its indemnification rights through a broader nexus phrase.

Recoverable Damages

Recoverable damages under an indemnity may consist of either or both:

- Actually incurred expenses that an indemnitor must reimburse.
- Unpaid expenses that an indemnitor must advance.

Most indemnity provisions do not explicitly divide recoverable damages into these two categories. Instead, they define recoverable damages as one or more of the following:

- Losses.
- Liabilities.
- Claims.
- Causes of action.
- Related attorneys' fees.

If recoverable damages:

- Consist solely of losses, the indemnifying party generally must reimburse only expenses actually paid by the indemnified party.
- Include liabilities, claims or causes of action, the indemnifying party's liability generally includes the indemnified party's unpaid liabilities, which can significantly increase an indemnifying party's indemnification obligations.

When an indemnity includes a duty to defend or hold harmless, the indemnifying party must also:

- Reimburse actual defense costs.
- Advance payment for covered unpaid defense expenses.

An indemnity that includes a duty to defend implicitly includes attorneys' fees in recoverable damages because often defense costs consist primarily of attorneys' fees. When an indemnity does not include a duty to defend, the parties should make clear whether attorneys' fees are recoverable damages. State law may not award attorneys' fees to an indemnified party without an explicit expression of the parties' intent on this point. To prevent excessive attorneys' fees, indemnity provisions frequently limit reimbursement to reasonable attorneys' fees.

Exceptions to Indemnification

Parties often narrow indemnification provisions by specifying certain exceptions to the parties' indemnification obligations. Common exceptions include losses resulting from the indemnified party's:

- Own acts or omissions.
- Gross negligence or willful misconduct.
- Failure to mitigate losses.

Most indemnifying parties insist on these basic exceptions, refusing to indemnify for losses the indemnified party created or exacerbated. While including these exceptions shifts risk back to the indemnified party, excluding them can create additional risk for both parties. Without these exceptions, a court may challenge the indemnity's validity. If a court views an indemnity as unjust or unenforceable, the resulting uncertainty in the scope and magnitude of available remedies increases both parties' risk.

Limits on Indemnified Amounts

An indemnifying party may seek to limit potential indemnification liabilities through the use of:

- **Baskets.** By establishing a minimal materiality level for indemnity claims, **baskets** shift the risk of small claims to the indemnified party. This reduces the number and frequency of claims, minimizing the financial and administrative burden on the indemnifying party. Baskets can be structured as either:
  - **deductibles**, which allow the indemnified party to recover only losses that exceed the specified basket amount; or
  - thresholds, also called "tipping baskets," which allow the indemnified party to recover all losses from the first dollar lost once losses exceed the specified basket amount.
- **Caps.** These limit the indemnifying party's maximum aggregate liability to specific agreed amounts.

Before agreeing to indemnification limitations, parties should check for conflicts with any provisions in the contract intending to limit the parties' liability. Internal inconsistencies can arise when an indemnity is:

- Uncapped and the contract includes a limitation of liability provision (see Limitation of Liability Clause as Risk Allocation Tool); or
- Capped and the contract contains an unqualified cumulative remedies provision (see Cumulative Remedies Clauses).

Duration

Indemnification provisions often include a contractual statute of limitations for submission of indemnity claims. In the absence of a contractual statute of limitations, state law statutes of limitations apply to indemnified claims.

When considering an indemnity's duration, the parties should evaluate:

- Each potential claim and its respective state law statute of limitation.
- Whether different types of claims should have different durations.
- How to coordinate any time limitations on the covered claims, such as the survival period of representations and warranties, with the duration of the indemnity.

Indemnification Procedures

Indemnification procedures can be an important factor in risk allocation. Well-drafted indemnification procedures address:

- **The process for delivering notice of claims.** An indemnified party generally must provide prompt notice to the indemnifying party of all indemnity claims (though its failure to do so does not extinguish the claim). This ensures the indemnifying party is aware of, and can begin to address, the claim in a timely manner to minimize damages.
- **Control of litigation resulting from indemnified third-party claims.** The parties should make clear whether the indemnified or the indemnifying party will control ligation resulting from indemnified third-party claims. When an indemnity includes a duty to defend, the indemnifying party controls litigation and is responsible for its costs, but often must obtain the indemnified party's written consent to settle any claims.
- **Required cooperation of indemnified party.** An indemnifying party may need the cooperation and assistance of an indemnified party to effectively litigate a claim. However, indemnified parties often want to limit their involvement in potentially complicated and time-consuming litigation. To avoid a dispute, the parties should make clear in the contract any agreed levels of cooperation.

For more information on indemnification clauses in commercial contracts, see Practice Note, Indemnification Clauses in Commercial Contracts. For an example of a standard indemnification provision, see Standard Clauses, General Contract Clauses: Indemnification.

Limitation of Liability Clause as Risk Allocation Tool

Some contracts use limitation of liability clauses to define the scope and magnitude of the parties' contractual liabilities. Through a limitation of liability clause, the parties can exclude liability for:

- Specific types of damages, for example:
  - indirect damages, such as **punitive damages**; and
  - consequential damages.
- Damages that are disproportionate in relation to the economics of the transaction, for example, some limitation of liability clauses may cap compensatory damages to a:
  - flat dollar amount; or
  - multiple of fees paid or payable under the contract.

Limitation of liability provisions can be particularly valuable in commercial agreements when tort remedies, such as punitive damages, could otherwise apply.

Parties should tailor a limitation of liability clause to meet their needs. For example, a limitation of liability clause may apply to:

- The contract as a whole.
- Only specific contract terms.
- Individual transactions, such as purchase orders or lease supplements, entered into under a master agreement.
- One or both parties.

A party's role in a transaction generally determines its position in favor or against a limitation of liability clause. In an agreement for the sale of goods, for example, where the greatest liability risk generally rests with the seller, the seller may push to include a limitation of liability clause. Buyers, however, often resist these clauses because they want a broad range of remedies available to them.

To avoid creating conflicting contract terms, parties must consider a limitation of liability clause together with any contractual indemnities and cumulative remedies provisions (see Cumulative Remedies Clauses). Parties can avoid creating internal conflicts by:

- Carving out any contradictory indemnity provisions from a limitation of liability clause.
- Capping the indemnity by reference to the limitations set out in the limitation of liability clause.
- Subjecting the cumulative remedies provision to any limitation of liability provision.

For more information on limitation of liability clauses, see Standard Clauses, General Contract Clauses: Limitation of Liability.

Termination Rights as Risk Allocation Tools

Termination rights allow a party to terminate a contract under certain circumstances. Because termination ends the parties' relationship entirely, a unilateral termination right creates significant negotiation leverage for the party holding the right.

Termination rights generally fall into two categories:

- Termination with cause (see Termination with Cause).
- Termination for convenience (see Termination for Convenience).

Termination with Cause

Termination is considered with cause when it is triggered by specific events or circumstances that:

- Harm the terminating party.
- Fundamentally alter the nature of the transaction.

Most termination with cause provisions are mutual, reflecting the parties' view that they each deserve the benefit of their bargain. If circumstances caused by or relating to one party prevent another party from receiving its expected benefit or dramatically increase its potential liabilities, that party should be able to exit the transaction. Because the non-terminating party generally controls or is responsible for the circumstances triggering termination, termination with cause provisions often permit a party to terminate the contract with minimal notice or liability to the other party.

Common examples of circumstances triggering a party's right to terminate with cause include:

- Uncured material breach by the non-terminating party, such as an **event of default**.
- **Insolvency** of the non-terminating party.

Parties can customize a termination with cause provision to include any transaction-specific circumstances that they agree should trigger the right to terminate the contract. For example, in a supply of goods agreement, the seller may have the right to terminate if the buyer fails to buy goods in certain minimum agreed volumes over an extended period of time.

Sometimes these specified circumstances do not automatically trigger termination rights, but instead give a party the option to terminate with cause or take other remedial actions, such as:

- Converting the relationship from an exclusive relationship to a non-exclusive relationship if, for example, a distributor fails to satisfy minimum purchase quantities.
- Requiring advance payment of amounts due or payment of additional fees if, for example, a borrower breaches a material covenant in its loan agreement (see Advance Payment).

Termination for Convenience

The right to terminate for convenience (also known as termination without cause) gives a party the ability to terminate a contract at will. Termination for convenience effectively creates an option to end the contractual relationship for any or no reason.

This right is an aggressive risk-shifting tool and is generally used sparingly in commercial contracts. The ability to terminate for convenience gives a party significant leverage over the other party. Because the non-terminating party does not have the opportunity to put contingencies in place or properly prepare for termination, its business can suffer material disruption and harm.

Parties with particularly strong bargaining power may succeed in obtaining the right to terminate for convenience, especially if they threaten to abandon a transaction. However, a court can invalidate a termination for convenience provision if it finds the termination right to be illusory or unsupported by consideration.

In contracts with a termination for convenience provision, the parties can limit their respective exposure by requiring the terminating party's:

- Prior written notice of termination to the non-terminating party.
- Cooperation to ensure a smooth and orderly transition.
- Payment of a termination fee as consideration for its right to terminate for convenience.
- Payment of compensation for:
  - all work done before termination; and
  - any reasonable termination and transition-related expenses.

For more information on termination, see Standard Clauses, General Contract Clauses: Term and Termination.

Force Majeure Provision as Risk Allocation Tool

A force majeure provision excuses a party from performing its contractual obligations if specified events occur that are beyond the party's control. In this way, a force majeure provision allows a contracting party to mitigate its risk of breach due to events or circumstances it did not cause and could not have anticipated.

Force majeure events and circumstances may be either:

- Natural occurrences.
- Man-made events or circumstances.

Common examples of force majeure events include:

- Acts of God.
- Natural disasters, such as:
  - floods;
  - fires;
  - earthquakes; and
  - explosions.
- War.
- Terrorism.
- Government orders.
- Embargoes.
- Organized labor activities, such as:
  - strikes;
  - lockouts; and
  - work slowdowns.

Both obligors and obligees should carefully consider the scope of a force majeure provision because an:

- Obligor risks breach if an event not designated as a force majeure event prevents it from performing its contractual obligations.
- Obligee risks forfeiting a claim of breach if the obligor fails to perform its contractual obligations due to an event that the parties designated as a force majeure event.

An obligor should generally push for as broad a force majeure clause as possible to limit its potential liability. An obligee, however, should:

- Try to structure a force majeure clause more narrowly to limit the obligor's opportunity to be excused from its contractual obligations.
- Negotiate the right to terminate the agreement if the force majeure event continues for a specified amount of time.

For more information on force majeure provisions, see Standard Clauses, General Contract Clauses: Force Majeure and Practice Note, Force Majeure Clauses: Key Issues.

Contractual Remedies as Risk Allocation Tools

Some commercial agreements include provisions addressing the parties' intent regarding the availability of certain remedies. These provisions can allocate risk by:

- Narrowing or expanding available common law remedies.
- Minimizing uncertainty regarding the scope of potential liability.

Although courts have final decision-making authority in awarding remedies, contractual provisions defining the parties' intended remedies generally hold important evidentiary weight.

Contractual remedy provisions may address:

- Equitable remedies (see Equitable Remedies Clauses).
- Cumulative remedies (see Cumulative Remedies Clauses).
- Exclusive remedies (see Exclusive Remedies Clauses).
- Liquidated damages (see Liquidated Damage Clauses).

Depending on the nature of the transaction and each parties' contractual commitments, these provisions may be:

- Unilateral or mutual.
- Applicable to only a specific contract term or the contract as a whole.

When parties use more than one of these provisions in a contract, they must draft the provisions carefully to avoid creating internal conflicts that call into question the parties' intent.

Equitable Remedies Clauses

Some contracts expressly address the parties' intent regarding the availability of equitable remedies for breach. Equitable remedies are non-monetary remedies requiring a party to take certain actions to make the aggrieved party whole. Equitable awards are discretionary and are not available as a matter of legal right. Courts award equitable remedies only when monetary damages are unavailable or inadequate. Common equitable remedies include:

- Specific performance.
- Injunction.
- Reformation.
- Rescission and restitution.

Contract provisions addressing equitable remedies may:

- **Prohibit equitable remedies.** Parties should include a provision prohibiting equitable remedies if they agree that an award of equitable relief would unfairly prejudice the breaching party. A general prohibition on equitable remedies is common in commercial contracts, though the parties often carve out one or more specific provisions to which they intend equitable remedies to apply.
- **Permit equitable remedies.** Parties should include a provision allowing equitable remedies if they agree that monetary relief would be insufficient to compensate an aggrieved party. As equitable relief is generally only appropriate for specific claims, these provisions should be narrowly drafted to limit their scope to a particular type of claim and specific form of equitable relief.

For more information on equitable remedies, see Practice Note, Contracts: Equitable Remedies. For an example of a provision granting the right to obtain equitable remedies provision, see Standard Clauses, General Contract Clauses: Equitable Remedies. For an example of a no-equitable-relief provision, see Standard Clauses, General Contract Clauses: No Equitable Relief.

Cumulative Remedies Clauses

A cumulative remedies clause expands the parties' applicable rights and remedies beyond those explicitly set out in the contract. In a cumulative remedies clause, the parties state their intention that the express rights and remedies in the agreement are in addition to and not in substitution for any implied rights or remedies.

Contract obligees generally favor cumulative remedies because they shift risk to the obligor by expanding an obligee's remedial rights. Contractual obligors tend to resist cumulative remedies provisions as they expand the obligor's assumed risk and can complicate the obligor's attempts to estimate its aggregate potential contractual liability. Without a minimal level of comfort regarding its liability exposure, an obligor may elect to abandon the deal entirely.

When not properly drafted, cumulative remedies clauses can conflict with contractual remedies intended to be exclusive, such as:

- Indemnification provisions (see Indemnification as Risk Allocation Tool).
- Liquidated damages provisions (see Liquidated Damage Clauses).

To avoid creating conflicting contract terms, parties must carve out any exclusive remedies from a cumulative remedies provision (see Exclusive Remedies Clauses). For an example of a provision granting the right to obtain cumulative remedies and carving out certain exclusive remedies, see Standard Clauses, General Contract Clauses: Cumulative Remedies (with Exclusive Remedies Carve-Out).

Exclusive Remedies Clauses

The inverse of a cumulative remedies clause is an exclusive remedies clause. An exclusive remedies clause reflects the parties' intent to limit available remedies to those specifically negotiated and agreed to in the contract. Without an exclusive remedies clause, a court may construe the contractual remedies agreed to by the parties as being in addition to any implied rights or remedies provided by law or equity, and not in substitution for them.

Common examples of exclusive remedies include:

- Liquidated damages (see Liquidated Damage Clauses).
- Indemnification (see Indemnification as Risk Allocation Tool).

Contract obligors generally favor exclusive remedies clauses because they reduce an obligor's risk of incurring liability beyond the remedy specified in the agreement. Obligees generally resist exclusive remedies clauses because they limit the obligee's potential remedies.

If a contract includes both an exclusive remedies provision and a cumulative remedies provision, the parties should:

- Make clear in the contract which remedies are intended to be exclusive.
- Specifically exclude any exclusive remedies from the cumulative remedies provision.

If the parties do not take these steps, internal inconsistencies can arise and a court may award an aggrieved party additional remedies even after the party has obtained the exclusive remedy specified in the contract.

For more information on exclusive remedies clauses, see Standard Clauses, General Contract Clauses: Cumulative Remedies (with Exclusive Remedies Carve-Out).

Liquidated Damage Clauses

Parties sometimes use liquidated damages to define recoverable damages. Liquidated damage clauses can be particularly useful when damages would be difficult to calculate, such as damages relating to lost opportunity. By agreeing in advance on the applicable damages payable for specified breaches or upon specified events, the parties can:

- Minimize the risk of a future dispute regarding appropriate damages.
- More accurately estimate their potential overall transaction liabilities.

A contract that includes a liquidated damage provision should make clear that the liquidated damages are:

- An exclusive remedy carved out from any cumulative remedies provisions in the contract.
- Compensatory and not punitive in nature. Punitive liquidated damage awards are unenforceable.

Liquidated damages offer both contracting parties the advantage of eliminating uncertainty. When a party understands its potential liabilities for breach, it is better able to factor those liabilities into its overall evaluation of the transaction.

For an example of a liquidated damage clause, see Standard Clauses, General Contract Clauses: Liquidated Damages.

UCC Product Warranties as Risk Allocation Tools

Warranties under UCC Article 2 (UCC §§ 2-312 to 2-318) and Article 2A (UCC §§ 2A-210 to 2A-215) can allocate certain risks between:

- Buyer and seller in contracts dealing with the sale of goods under UCC Article 2 (see Practice Note, UCC Article 2 Express Warranties).
- Lessee and lessor in equipment leases under UCC Article 2A (see Practice Note, Equipment Leasing: UCC Article 2A Express and Implied Warranties).

UCC Articles 2 and 2A each provide for two types of product warranties:

- Express warranties (see UCC Express Warranties).
- Implied warranties (see UCC Implied Warranties).

These warranties are created by law and not contract. They are distinct from any transactional representations and warranties in the contract. For more information on transactional representations and warranties, see Practice Note, Representations, Warranties, Covenants, Rights, and Conditions: Representations and Warranties.

UCC Express Warranties

An express warranty under UCC Article 2 or 2A is a promise or affirmation by the seller that a fact about the goods that constitutes part of the basis of the bargain is or will be as stated or promised.

A seller or lessor can create an express warranty by:

- Affirming a fact about the goods.
- Making a promise about the goods.
- Describing the goods.
- Providing a sample or model of the goods.

Because an express warranty need not be in writing or even expressed in words, sellers and lessors subject to the UCC must avoid unintentionally creating an express warranty through their actions. To avoid disputes relating to the existence or scope of any express warranties, contracting parties should consider:

- Explicitly stating each express warranty in the contract.
- Making clear that any stated warranties are the only express warranties given.

Most buyers and lessees will not enter into a sale or lease agreement without having received any express warranties. However, sellers and lessors may limit the scope of express warranties by specifying:

- The duration of each express warranty.
- Any conditions that invalidate an express warranty.
- Exclusive remedies for breach of any express warranty.

For more information on UCC express warranties, see Practice Note, UCC Article 2 Express Warranties and Practice Note, Equipment Leasing: UCC Article 2A Express and Implied Warranties: Express Warranties. For an example of a standard product warranty, see Standard Clauses, General Contract Clauses: Product Warranty and Disclaimers. For an example of an equipment lease agreement (pro-lessor) excluding express warranties, see Standard Document, Equipment Lease: UCC True Lease (Pro-Lessor, Long Form): Drafting Note: Express Warranties.

UCC Implied Warranties

UCC Articles 2 and 2A read certain implied warranties into applicable sales of goods and leases of equipment. Unless expressly disclaimed or modified, these implied warranties apply to a sale or lease transaction subject to the UCC.

The implied warranties under UCC Article 2 are:

- Warranty of title.
- Warranty against infringement.
- Warranty of merchantability.
- Warranty of fitness for a particular purpose.

UCC Article 2A imposes these same implied warranties but replaces the warranty of title with an implied warranty against interference, also called a warranty of quiet possession.

While parties may disclaim or modify any implied warranties, UCC Articles 2 and 2A impose specific requirements for the disclaimer or modification to be effective. For example, disclaimers or modifications must be conspicuously set out in the contract. This means that they should be set out in text that distinguishes them from other text in the contract, such as in bold, capitalized, or italicized letters.

In addition, the UCC specifies the language necessary to disclaim the implied warranties of title, against infringement, and against interference and prohibits the parties from using more general language to disclaim or waive these implied warranties. The contract must include specific language that alerts:

- The buyer, in the case of a sale of goods, that the seller:
  - does not claim title to the goods;
  - purports to sell only the right or title that the seller or a third party may have; and
  - sells subject to any claims or infringement.
- The lessee, in the case of a lease of equipment, that the lessor:
  - cannot provide assurance that its acts or omissions have not created a competing claim or interest in the equipment by a third party; and
  - leases subject to any claims or infringement.

However, disclaimer of these warranties is unusual, since most buyers and lessees will not purchase or lease goods without the basic assurances these warranties provide.

The UCC also specifies the language required to disclaim or modify the implied warranties of merchantability and fitness for a particular purpose. The requirements are less restrictive for these implied warranties than for the implied warranties of title, against infringement, and against interference. While the disclaimer or modification must call attention to any limitation on or exclusion of these warranties, UCC Articles 2 and 2A permit a party to do so with more general language. For example, an effective disclaimer or modification may describe the goods or equipment as being sold or leased:

- "As is."

- "With all faults."

For more information on UCC implied warranties, see Practice Note, UCC Article 2 Implied Warranties.

Insurance Coverage as Risk Allocation Tool

In some commercial agreements, parties allocate risk through covenants requiring one or both parties to maintain specific levels of insurance coverage. Insurance coverage helps to ensure that a party has the financial capacity to satisfy its liabilities under the contract by shifting risk from the insured to its insurer.

The types and levels of required insurance coverage generally depend on the nature of the parties and the transaction. Some insurance covenants reference specific types of coverage the party agrees to maintain, such as:

- Commercial general liability.
- Workers' compensation and employers liability.
- Automobile liability.
- Umbrella liability.

Other insurance covenants are more general, simply affirming that the party has and will continue to have sufficient insurance coverage (or will self-insure) to cover its contractual liabilities.

Most companies maintain basic levels of insurance in the ordinary course of business. Depending on the nature of a commercial transaction, this coverage may be sufficient to cover any transaction-related liabilities. However, one or both parties sometimes need to obtain additional insurance coverage to satisfy claims in connection with a commercial transaction.

Negotiating expanded coverage with an insurer can complicate a transaction. Before agreeing to an insurance covenant, each party should:

- Assess the need for additional insurance coverage.
- Assess the magnitude of any required additional coverage.
- Anticipate that an insurer could:
  - substantially increase the insured's premiums in exchange for the expanded coverage; or
  - deny the request for expanded coverage.
- Consider whether self-insurance is a viable alternative and the additional risk involved if the insured elects to self-insure.

For a sample insurance covenant in a sale of goods agreement, see Standard Clauses, General Contract Clauses: Insurance Covenant (Sale of Goods). For more information on insurance coverage, see Practice Note, Insurance Policies and Coverage: Overview.

Payment Terms as Risk Allocation Tool

Parties may use payment terms to shift and manage risk. Any delay or acceleration of required payments impacts each party's:

- Available cash.
- Risk of default.

Payments can be:

- Deferred (see Deferred Payment).
- Advanced (see Advance Payment).

Deferred Payment

Most commercial agreements involve some form of deferred payment obligation. In a sale of goods, for example, the seller typically invoices the buyer at or shortly after delivery. Payment is due within an agreed time period following the buyer's receipt of the invoice.

The seller can minimize its risk by reducing the amount of time between delivery and payment. By limiting this period, the seller:

- Decreases the risk of the buyer's nonpayment. The more time the buyer has to pay, the more opportunity it has to spend the funds on other things.
- Gives itself more time to recoup its investment in the goods. The sooner the seller receives payment, the sooner it can use those funds to pay its own expenses.

The buyer, by contrast, benefits most by extending the period between delivery and payment, which:

- Increases the buyer's opportunity to use available cash for other business activities.
- Gives the buyer additional time before payment to inspect the goods to confirm they are satisfactory. This can allow the buyer to avoid paying for defective or non-conforming goods.

For an example of standard payment terms in commercial contracts, see Standard Clauses, General Contract Clauses: Payment Terms.

Advance Payment

Some commercial agreements provide for advance payment. Advance payment terms can be either:

- Mandatory (see Mandatory Advance Payment).
- Optional (see Optional Advance Payment).

Mandatory Advance Payment

Mandatory advance payment provisions require a party to pay some or all amounts due prior to the performance of the other party. Mandatory advance payment terms protect an obligee by limiting the risk of non-payment by the obligor.

Commercial agreements typically require advance payment in only extraordinary circumstances. For example, a supplier of goods may require advance payment for orders of custom goods. This advance payment obligation:

- Allows the supplier to use the amounts paid to offset the cost of any special parts or equipment it needs to fulfill the order.
- Protects the seller from the buyer's failure to pay for custom goods with limited resale value.

Optional Advance Payment

Optional advance payment provisions permit a party to voluntarily pay some or all amounts owed before their due date. Optional advance payment terms can provide obligors with useful flexibility regarding the timing of payments. Obligees can also benefit from optional advance payment terms. By receiving amounts owed sooner than expected, the risk of nonpayment is diminished. For example, if a loan agreement allows a buyer to pay borrowed amounts in advance of when they are due, an advance payment has the dual effect of reducing:

- The borrower's aggregate interest on the loan.
- The time it takes the lender to recover the principal.

For more information on advance payment terms in loan agreements, see Practice Note, Loan Agreement: Prepayment and Commitment Reduction Provisions and Standard Clauses, Loan Agreement: Prepayment and Commitment Reduction Provisions.

Guaranties as Risk Allocation Tools

To manage the risk of nonpayment by a contractual counter-party, a party may request a **guaranty**. Guaranties are commonly used when the financial capacity or creditworthiness of a contracting party is uncertain. Often a larger, more secure parent company or investor acts as guarantor.

Guaranty provisions may be included in:

- The commercial agreement, with the guarantor signing the agreement solely with respect to its guaranty obligations.
- A separate guaranty agreement between the guarantor and the obligee. In this case, the obligor should separately seek:
  - a representation in the commercial agreement from the obligee confirming the existence and sufficiency of the guaranty;

- receipt of written evidence of the guaranty (generally a photocopy); and
- a written commitment from the guarantor that the guaranty will remain in place during the term of the contract.

A guaranty shifts risk from the obligor to the guarantor, providing an extra level of protection against default. This generally benefits both an obligee and obligor. Obligors, however, often resist requests for guaranties because involving a guarantor, particularly a parent company or important investor, can:

- Complicate a transaction.
- Impact the financial statements (and for public companies, the periodic reporting) of the guarantor.
- Undermine any liability shield between the obligor and guarantor structured into the transaction (see Practice Note, Piercing the Corporate Veil).

For more information on guaranties, see Practice Note, Guaranties: Overview. For an example of a standard guaranty agreement, see Standard Document, Guaranty.

Using Contractual Building Blocks to Allocate Risk

Other provisions commonly used to allocate risk include certain contractual building blocks. For example:

- **Representations and Warranties**. These allocate risk to the representing party and away from the recipient by providing the recipient with assurance of certain facts and a claim of misrepresentation if the facts are untrue. The broader the representation or warranty, the more risk assumed by the representing party (see Practice Note, Representations, Warranties, Covenants, Rights, and Conditions: Purposes of Representations and Warranties).
- **Covenants**. These allocate risk to the covenanting party by creating a standard of liability. If a covenant is unfulfilled, the covenanting party is in breach. The more absolute a party's covenant, the more risk the party assumes (see Practice Note, Representations, Warranties, Covenants, Rights, and Conditions: Covenants and Rights).
- **Conditions Precedent**. These allocate risk by:
  - making certain rights or obligations dependent on the occurrence of other facts or events (which shifts the risk for failure to satisfy or perform from the obligor to the obligee);
  - eliminating obligor's exposure to damage claims for failure to satisfy or perform; and
  - providing an obligee with a promise of conditional performance when the obligee has not succeeded in obtaining an absolute commitment from obligor.

  The more complicated or unlikely the condition is to occur, the greater the risk assumed by the party expecting to receive performance (see Practice Note, Representations, Warranties, Covenants, Rights and Conditions: Purposes of Conditions).

For more information on how basic contractual building blocks can shift risk, see Practice Notes, Representations, Warranties, Covenants, Rights, and Conditions and Relationship between Representations, Warranties, Covenants, Rights, and Conditions.

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