CHAPTER 19

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PRACTICAL CONTRACTS

Two true stories:

One

Holly (on the phone to her client Judd): Harry's lawyer just emailed me a letter that Harry says he got from you last year. I'm reading from the letter now: "Each year that you meet your revenue goals, you'll get a 1 percent equity interest." Is it possible you sent that letter?

Judd: I don't remember the exact wording, but probably something like that.

Holly: You told me, absolutely, positively, you had never promised Harry any stock. That he was making the whole thing up.

Judd: He was threatening to leave unless I gave him some equity, so I said what he wanted to hear. But that letter didn't *mean* anything. This is a family business, and no one but my children will ever get stock.

> **I don't know what the *contract* says—that's just the legal stuff.**

Two

Grace (on the phone with her lawyer): Providential has raised its price to $12 a pound. I can't afford to pay that! We had a deal that the price would never go higher than 10 bucks. I've talked to Buddy over there, but he is refusing to back down. We need to do something!

Lawyer: Let me look at the contract.

Grace (her voice rising): I don't know what the *contract* says—that's just the legal stuff. Our *business* deal was no more than $10 a pound!

You have been studying the *theory* of contract law. This chapter is different—its purpose is to demonstrate how that theory operates in *practice*. We will look at the structure and content of a standard agreement and answer questions such as: do you need a written agreement? What do all these legal terms mean? Are any important provisions missing? By the end of the chapter, you will have a road map for understanding a written contract.[1] (Note that we do not repeat here what you have learned in prior chapters about the *substantive* law of contracts.) This chapter has another goal, too: we will look at the relationship between lawyers and their clients and their different roles in creating a contract.

Businesspeople, not surprisingly, tend to focus more on business than on the technicalities of contract law. However, *ignoring* the role of a written agreement can lead to serious trouble. Both of the clients in the opening scenario ended up being bound by a contract they did not want.

To illustrate our discussion of specific contract provisions, we will use a real contract between an actor and a producer to make a movie. For reasons of confidentiality, however, we have changed the names.

Before we begin our discussion of written contracts, let's ask: **do you need a written agreement at all?** Some years ago, this author was with a group of lawyers, all of whom had done a major home renovation and *none of whom* had signed a contract with their builder. All of the projects had turned out well. The lawyers had not prepared a written contract because they trusted their builders. They all had good recommendations from prior clients. Also, a building project by its very nature requires regular negotiations because it is impossible to predict all the potential changes: How much would it cost to move that door? How much do we save if we use Caesarstone instead of granite?

These cases worked out well without a written contract, but there are times when you should *definitely* sign an agreement:

1. The Statute of Frauds requires it.
2. The deal is crucial to your life or the life of your business.
3. The terms are complex.
4. You do not have an ongoing relationship of trust with the other party.

Once you decide you need a written contract, then what?

THE LAWYER

The American Bar Association commissioned a study to find out what people think of lawyers. Survey participants responded with these words: greedy, corrupt, manipulative, snakes, and sharks.[2] Businesspeople refer to their lawyers with terms like *business prevention department*. They are reluctant to ask an attorney to draft a contract for fear of the time and expense that lawyers can inject into the process. And they worry that the lawyers will interfere in the business deal itself, at best causing unnecessary hindrance, at worst killing the deal. Part of the problem is that lawyers and clients have different views of the future.

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[1]For further reading on practical contracts, see Scott Burnham, *Drafting and Analyzing Contracts*, Lexis/Nexis, 2003; Charles M. Fox, *Working with Contracts*, Practical Law Institute, 2008; George W. Kuney, *The Elements of Contract Drafting*, Thomson/West, 2006.

[2]Robert Clifford, *Opening Statement: Now More than Ever*, Litigation, 28 Litigation 1, Spring 2002.

Lawyers and Clients

Businesspeople are optimists—they believe that they have negotiated a great deal and everything is going to go well—sales will boom, the company will prosper. **Lawyers have a different perspective—their primary goal is to protect their clients by avoiding litigation, now and in the future.** For this reason, lawyers are trained to be pessimists—they try to foresee and protect against everything that can possibly go wrong. Businesspeople sometimes view this lawyering as a waste of time and a potential deal-killer. What if the two parties cannot agree about what to do in the event of a very unlikely circumstance? The deal might just collapse.

To take one example of this lawyerly perspective, a couple happily married nigh on 40 years went to see a lawyer about changes in their will. The husband wanted to transfer some assets to his wife. The lawyer advised against it—after all, the couple might divorce. They became angry and indignant because *they would never divorce.* And they may very well be right. However, just that week, the lawyer had seen another couple who did divorce after 41 years of marriage. He thought it better to be on the safe side and consider the possibility that such events might happen.

Lawyers also prefer to negotiate touchy subjects at the beginning of a relationship, when everyone is on friendly terms and eager to make a deal, rather than waiting until trouble strikes. In the long run, nothing harms a relationship more than unpleasant surprises. For example, the Artist in the movie contract we will refer to throughout this chapter did not know in advance what conditions on the set would be, how grueling the shooting schedule, or how many friends and family would visit him. So his lawyer negotiated a deal in which the Producer agreed to provide a driver, a "first-class star trailer (which shall be a double pop-out)," a luxury hotel suite, and an adjacent room for visitors. In the end, because the role called for the Artist to live in the wilderness, he ultimately slept in a tent on the set to experience his part more fully, so he did not need the double pop-out trailer or the luxury suite. He also dispensed with the driver. But, under different circumstances, he might have wanted those luxuries, and his lawyer's goal was to protect his interests. It is a lot easier to forgo an expense than to add one to a movie budget.

Another advantage of using lawyers to conduct these negotiations is that they can serve as the bad guys. Instead of the client raising tough issues, the lawyers do. Many a client has said, "but my lawyer insists …" If the lawyer takes the blame, the client is able to maintain a better relationship with the other party. And hiring a lawyer communicates to the other parties that you are taking the deal seriously, and they will not be able to pull a fast one on you.

Of course, this lawyerly protection comes at a cost—legal fees, time spent bargaining, the hours used to read complex provisions, and the potential for good will to erode during negotiations.

Do you need a lawyer? The answer largely depends on the complexity of the deal. Most people do not hire a lawyer to review an apartment lease—the language is standard, and the prospective tenant has little power to change the terms of the deal. On the other hand, you should not undertake a significant acquisition or purchase agreement on your own.

Hiring a Lawyer

If you do hire a lawyer, be aware of certain warning signs. Although the lawyer's goal is to protect you, a good attorney should be a dealmaker, not a deal-breaker. She should help you do what you want and, therefore, should never (or, at least, hardly ever) say, "You cannot do this." Instead, she should say, "Here are the risks to this approach" or "Here is another way to achieve your goal."

Moreover, your lawyer's goal should not be to annihilate the other side. In the end, the contract will be more beneficial to everyone if the parties' relationship is harmonious. Trying

to exact every last ounce of flesh, using whatever power you have to an abusive extreme, is not a sound long-term strategy. In the end, the best deals are those in which all the parties' incentives are aligned. Success for one means success for all—or at least, success for one party does not *prohibit* a positive outcome for the other side. If either side in the movie contract behaved unreasonably, word would quickly spread in the insular Hollywood world, damaging the troublemaker's ability to make other deals.

Now either you have a lawyer or you do not. The next step is to think about developing the contract.

The Contract

In this section, we discuss how a contract is prepared and what provisions it should include.

Who Drafts It?

Once businesspeople have agreed to the terms of the deal, it is time to prepare a draft of the contract. Generally, both sides would prefer to *control the pen* (that is, to prepare the first draft of the contract) because the drafter has the right to choose a structure and wording that best represents his interests. Typically, the party with the most bargaining power prepares the drafts. In the movie contract, Producer's lawyer prepared the first draft. The contract then went to Artist's lawyer, who added the provisions that mattered to the client.

How to Read a Contract

Reading a contract is not like cracking open a novel. Instead, it should be a focused, multi-step process:

- **Pre-reading**. Before you begin reading the first draft of a contract, spend some time thinking about the provisions that are important to you. If you skip this step, you may find that as you read, your attention is so focused on the specific language of the contract that you lose sight of the larger picture.
- **The first read.** Read through once, just to get the basic idea of the contract—its structure and major provisions.
- **What-ifs.** This is the time to think about various outcomes, good and bad. Under the terms of the contract, what happens if all goes according to your plan? Also consider worst-case scenarios. In both situations, does the contract produce the result that you want? What happens if sales are higher than you expect, or if the product causes unexpected harm?
- **The second read.** Now read the contract to make sure that it handles the what-ifs in a manner that is satisfactory to you. Think about the relationship between various provisions—does it make sense?

Following this approach will help you avoid mistakes.

Mistakes

This author once worked with a lawyer who made a mistake in a contract. "No problem," he said. "I can win that one in court." Not a helpful attitude, given that one purpose of a contract is to *avoid* litigation. In this section, we look at the most common types of mistakes and how to avoid them.

Vagueness

Businesspeople sometimes *deliberately* choose vagueness. They do not want the terms of the contract to be clear. It may be that they are not sure what they can get from the other side, or in some cases, even what they really want. So they try to form a contract that leaves their options open. However, as the following case illustrates: **Vagueness is your enemy.**

QUAKE CONSTRUCTION V. AMERICAN AIRLINES

141 Ill. 2d 281, 565 N.E.2d 990, 1990 Ill. LEXIS 151
Supreme Court of Illinois, 1990

Facts: Jones Brothers Construction was the general contractor on a job to expand American Airlines' facilities at O'Hare International Airport. Jones Brothers invited Quake Construction to bid on the employee facilities and automotive maintenance shop ("the project"). After Quake bid, Jones Brothers orally informed Quake that it was awarding Quake the project and would forward a contract soon. Jones Brothers wanted the license numbers of the subcontractors that Quake would be using, but Quake could not furnish those numbers until it had assured its subcontractors that they had the job. Quake did not want to give that assurance until *it* was certain of its own work. So Jones Brothers sent a letter of intent that stated, among other things:

> We have elected to award the contract for the subject project to your firm as we discussed on April 15. A contract agreement outlining the detailed terms and conditions is being prepared and will be available for your signature shortly.
>
> Your scope of work includes the complete installation of expanded lunchroom, restaurant, and locker facilities for American Airlines employees, as well as an expansion of American Airlines' existing Automotive Maintenance Shop. A sixty (60) calendar day period shall be allowed for the construction of the locker room, lunchroom, and restaurant area beginning the week of April 22. The entire project shall be completed by August 15.
>
> Subject to negotiated modifications for exterior hollow metal doors and interior ceramic floor tile material as discussed, this notice of award authorizes the work set forth in the [attached] documents at a lump sum price of $1,060,568.00.
>
> Jones Brothers Construction Corporation reserves the right to cancel this letter of intent if the parties cannot agree on a fully executed subcontract agreement.

The parties never signed a more detailed written contract, and ultimately Jones Brothers hired another company. Quake sued, seeking to recover the money it spent in preparation and its loss of anticipated profit.

Issue: ***Was the letter of intent a valid contract?***

Excerpts from Justice Calvo's Decision: [A]lthough letters of intent may be enforceable, such letters are not necessarily enforceable unless the parties intend them to be.

In determining whether the parties intended to reduce their agreement to writing, the following factors may be considered: whether the type of agreement involved is one usually put into writing, whether the agreement contains many or few details, whether the agreement involves a large or small amount of money, whether the agreement requires a formal writing for the full expression of the covenants, and whether the negotiations indicated that a formal written document was contemplated at the completion of the negotiations.

[We conclude that] the letter was ambiguous. The letter of intent included detailed terms of the parties' agreement. The letter stated that Jones awarded the contract for the project to Quake. The letter stated further, "this notice of award authorizes the work." Moreover the letter indicated that the work was to commence approximately 4 to 11 days after the letter was written. This short period of time reveals the parties intent to be bound by the letter so that work could begin on schedule. We also agree that the cancellation clause exhibited the parties' intent to be bound by the letter because no need would exist to provide for the cancellation of the letter unless the letter had some binding effect. The cancellation clause also implies the parties' intention to be bound by the letter, at least until they entered into the formal contract. These factors evinced the parties' intent to be bound by the letter.

On the other hand, the letter referred several times to the execution of a formal contract by the parties, thus indicating the parties' intent not to be bound by the letter. The cancellation clause could be interpreted to mean that the parties did not intend to be bound until they entered into a formal agreement.

Thus, we hold that the letter of intent in the case at bar is ambiguous regarding the parties' intent to be bound by it. Therefore, on remand, the circuit court shall allow the parties to present parol evidence regarding their intent. The trier of fact must then determine, based on the parties' intent, whether the letter of intent is a binding contract.

So after years of litigation, Jones Brothers and Quake had to go *back* to court to try to prove whether they intended the letter to be binding. The problem is that both sides permitted vagueness to enter their negotiations. Sometimes parties adopt vagueness as a *strategy*. One party may be trying to get a commitment from the other side without obligating itself. A party may feel *almost* ready to commit and yet still have reservations. It wants the *other* party to make a commitment so that planning can go forward. This is understandable but dangerous.

If you were negotiating for Jones Brothers and wanted to clarify negotiations without committing your company, how could you do it? State in the letter that it is *not a contract*, and that *neither side is bound by it*. State that it is a memorandum summarizing negotiations thus far, but that neither party will be bound until a full written contract is signed.

But what if Quake cannot get a commitment from its subcontractors until they are certain that it has the job? Quake should take the initiative and present Jones Brothers with its own letter of intent, stating that the parties *do* have a binding agreement for $1 million worth of work. Insist that Jones Brothers sign it. Jones Brothers would then be forced to decide whether it is willing to make a binding commitment. If Jones Brothers is not willing to commit, let it openly say so. At least both parties will know where they stand.

The movie contract provides another example of deliberate vagueness. In these contracts, nudity is always a contentious issue. Producers believe that nudity sells movie tickets; actors are afraid that it may tarnish their reputation. In the first draft of our contract, Artist's lawyer specified:

> Artist may not be photographed and shall not be required to render any services nude below the waist or in simulated sex scenes without Artist's prior written consent.

(This clause also applied to any double depicting Artist.) However, the script called for a scene in which Artist was swimming nude and the director wanted the option of showing him below the waist from the back. Ultimately, the nudity clause read as follows:

> Producer has informed Artist that Artist's role in the Picture might require Artist to appear and be photographed (a) nude, which nudity may include only above-the-waist nudity and rear below-the-waist nudity, but shall exclude frontal below-the-waist nudity; and (b) in simulated sex scenes. Artist acknowledges and agrees that Artist has accepted such employment in the Picture with full knowledge of Artist's required participation in nude scenes and/or in simulated sex scenes and Artist's execution of the Agreement constitutes written consent by Artist to appear in the nude scenes and simulated sex scenes and to perform therein as reasonably required by Producer. A copy of the scenes from the screenplay requiring Artist's nudity and/or simulated sex are attached hereto. Artist shall have a right of meaningful prior consultation with the director of the Picture regarding the manner of photography of any scenes in which Artist appears nude or engaged in simulated sex acts.
>
> Artist may wear pants or other covering that does not interfere with the shooting of the nude scenes or simulated sex scenes. Artist's buttocks and/or genitalia shall not be shown, depicted, or otherwise visible without Artist's prior written consent. Artist shall have the absolute right to change his mind and not perform in any nude scene or simulated sex scene, notwithstanding that Artist had prior thereto agreed to perform in such scene.

What does this provision mean? Has Artist agreed to perform in nude scenes or not? He has acknowledged that the script calls for nude scenes and he has agreed, in principle, that he will appear in them. However, he did not want to agree categorically, before shooting had even started and he had experience working with this director. Actor has a number of options—he can refuse to shoot nude scenes altogether, or he can shoot them and then, after viewing them, decide not to allow them in the movie. With a clause such as this one, the director shot different versions of the scene—some with nudity and some without—so that if Artist rejected the nude scene, the director still had options.

The true test of whether a vague clause belongs in a contract is this: would you sign the contract if you knew that the other side's interpretation would prevail in litigation? In this example, each side was staking out its position, and deferring a final negotiation until there was an actual disagreement about a nude scene. If you would be happy enough with the other side's position in the end, the vague clause simply defers a fight that you can afford to lose. But if the point is really important to you, it may be wiser to resolve the issue before you sign the contract by writing the clause in a way that clearly reflects your desired outcome.

EXAM Strategy

Question: The nudity provision in the movie contract is vague. Rewrite it so that it accurately expresses the agreement between the parties.

Strategy: This is easy! Just say what the parties intended the deal to be.

Result: "The script for the Picture includes scenes showing Artist (a) with frontal nudity from the waist up and with rear below-the-waist nudity (but no frontal below-the-waist nudity); and (b) in simulated sex scenes. However, no scenes shall be shot in which Artist's buttocks and/or genitalia are shown, depicted, or otherwise visible without Artist's prior written consent. Artist shall have the absolute right not to perform in any nude scene or simulated sex scene. If shot, no nude or sex scenes may appear in the Picture without Artist's prior written consent."

Ambiguity

Vagueness occurs when the parties do not want the contract to be clear. Ambiguity is different—it means that the provision is *accidentally* unclear. It occurs in contracts when the parties think only about what *they* want a provision to mean, without considering the literal meaning or the other side's perspective. When reading a contract, try to imagine all the different ways a clause can be interpreted. Because you think it means one thing does not mean that the other side will share your view. For example, suppose that an employment contract says, "Employee agrees not to work for a competitor for a period of three years from employment." Does that mean three years from the date of hiring or the date of termination? Unclear, so who knows?

To take another example, the dictionary defines vandalism as *deliberately mischievous or malicious destruction or damage of property*. Arson is *the malicious burning of a house or property*. Seems clear enough—but does arson count as vandalism? In the following case, no one thought about this question until a house burned down.

CIPRIANO V. PATRONS MUTUAL INSURANCE COMPANY OF CONNECTICUT

2005 Conn. Super. LEXIS 3577
Superior Court of Connecticut, 2005

Facts: Juacikino Cipriano purchased an insurance policy on his house from Patrons Mutual Insurance Company. The policy stated that the company would not pay for any damage to the residence caused by vandalism or burglary if the residence was vacant for more than 30 days in a row just before the loss. Furthermore, the company would not pay for damage to personal property caused by fire, lightning, or vandalism.

After Cipriano's house had been vacant for more than 30 days, an arsonist burned it down. Patrons denied his claim on the grounds that arson is vandalism, which his policy did not cover. Cipriano filed suit against Patrons. The insurance company filed a motion for summary judgment.

Issues: ***Does arson count as vandalism? Must Patrons pay Cipriano's claim?***

Excerpts from Judge Devine's Decision: [T]here are no genuine issues of fact that the fire was the result of arson and that the dwelling house was vacant for more than 30 days prior to the fire. The defendant contends that the term "vandalism" includes the act of arson. The plaintiff argues that, in reviewing the insurance policy as a whole, an insured may not be able to discern what "vandalism" means, as that term is used in the separate sections of the insurance policy.

Under our law, the terms of an insurance policy are to be construed according to the general rules of contract construction. It is a basic principle of insurance law that policy language will be construed as laymen would understand it and not according to the interpretation of sophisticated underwriters, and that ambiguities in contract documents are resolved against the party responsible for its drafting; the policyholder's expectations should be protected, as long as they are objectively reasonable from the layman's point of view. However, a court will not torture words to import ambiguity where the ordinary meaning leaves no room for ambiguity, and words do not become ambiguous simply because lawyers or laymen contend for different meanings.

In the present case, the defendant has drafted an insurance policy where "vandalism" and "fire" are undefined terms. Reading the insurance policy as whole, the terms "vandalism" and "fire" are found to be included as separate perils covered under the personal property coverage. In the exclusionary provision for the coverage of the residence, "vandalism" is listed as an excluded loss. "Fire" is not mentioned.

Because the terms "vandalism" and "fire" are undefined, and are listed as two distinct perils, it is ambiguous as to which peril, "vandalism" or "fire," covers arson. Therefore, "vandalism" is susceptible of two reasonable interpretations. As such, the insurance policy must be construed against the party responsible for its drafting.

The defendant's motion for summary judgment is hereby denied.

This case illustrates an important rule of contract drafting: **Any ambiguity is interpreted against the drafter of the contract**. (The *Cipriano* policy is a good example of how incomprehensible insurance policies can be. This complexity tends to erode judicial sympathy for the perpetrator.) Although both sides need to be careful in reading a contract—litigation benefits no one—the side that prepares the documents bears a special burden. This rule is meant to

1. Protect laypeople from the dangers of form contracts that they have little power to change. Even if the insured in this case had read the contract carefully, it is unlikely that an insurance company would change its form contract for him.
2. Protect people who are unlikely to be represented by a lawyer. Most people do not hire a lawyer to read insurance contracts (or any form contract). And without an experienced lawyer, it is highly unlikely that an insured would ask, "So is arson included in the vandalism clause?"
3. Encourage those who prepare contracts to do so carefully.

Typos

The bane of a lawyer's existence! This author worked on a securities offering in which the sales document almost went out with part of the company's name spelled *Pertoleum* instead of *Petroleum*. (And legend has it that a United Airlines securities offering once featured "Untied Airlines.") Although clients tend not to have a sense of humor about such errors, at least there would be no adverse legal result. That is not always the case with typos.

A group of condominium buyers ended up in litigation over a tiny typo in their purchase agreements: an "8" instead of a "9." What difference could that possibly

make? A lot, it turns out. Extell Development Corporation built the Rushmore, a luxury condominium complex in Manhattan. When Extell began selling the units, it agreed to refund any buyer's down payment if the first closing did not occur by September 1, 2009. (The goal was to protect buyers who might not have any place to live if the building was not finished on time.) In the end, the first closing occurred in February 2009. No problem, right? No problem except that, by accident, the purchase contract said September 1, *2008* rather than *2009*. In the meantime, the Manhattan real estate market tumbled, and many purchasers of Rushmore condominiums wanted to back out. After litigation all the way to the Federal Court of Appeals, Extell was required to refund the deposits.

What is the law of typos? First of all, the law has a fancier word than *typo*—it is **scrivener's error.** A scrivener is a clerk who copies documents. **In the case of a scrivener's error, a court will reform a contract if there is clear and convincing evidence that the mistake does not reflect the true intent of the parties.** In the Rushmore case, an arbitrator refused to reform the contract, ruling that there was no clear and convincing evidence that the parties intended something other than the contract term as written.

In the following case, even more money was at stake. What would you do if you were the judge?

Daisy Beatty

Because of a tiny typo, purchasers of condominiums in this building were able to back out of their deals.

Scrivener's error A typo.

You be the Judge

Heritage Technologies v. Phibro-Tech

2008 U.S. Dist. LEXIS 329
United States District Court for the Southern District of Indiana, 2008

Facts: Heritage wanted to buy a substance called tribasic copper chloride (TBCC) from Phibro but, because of uncertainty in the industry, the two companies could not agree on a price for future years. It turned out, though, that the price of TBCC tended to rise and fall with that of copper sulfate, so Heritage proposed that the amount it paid for TBCC would increase an additional $15 per ton for each $0.01 increase in the cost of copper sulfate over $0.38 per pound.

Two top officers of Heritage and Phibro met in the Delta Crown Room at LaGuardia Airport to negotiate the purchase contract. At the end of their meeting, the Phibro officer hand wrote a document stating the terms of their deal and agreeing to the Heritage pricing proposal.

Negotiations between the two companies continued, leading to some changes and additions to their Crown Room agreement. In a draft prepared by Phibro, the $.01 number was changed to $0.1—that is, from 1 cent to 10 cents. In other words, in the original draft, Heritage agreed to a first increase if copper sulfate went above 39 cents per pound, an additional price rise at 40 cents, and so on. But in the Phibro draft, Heritage's first increase would not occur until the price of copper sulfate went to 48 cents a pound, with a second rise at 58 cents. In short, the Phibro draft was much more favorable to Heritage than the Heritage proposal had been.

At some point during the negotiations, the lawyer for Heritage asked his client if the $0.1 figure was accurate. The Heritage officer said that the increase in this amount was meant to be payment for other provisions that favored Phibro. There is no evidence that this statement was true. The contract went through eight drafts and numerous changes, but after the Crown Room meeting, the two sides never again discussed the $0.1 figure.

After the execution of the agreement, Heritage discovered a different mistake. When Heritage brought the error to Phibro's attention, Phibro agreed to make the change even though it was to Phibro's disadvantage to do so.

All was peaceful until the price of copper sulfate went to $0.478 per pound. Phibro believed that because the price was above $0.38 per pound, it was entitled to an increased payment. Heritage responded that the increase would not occur until the price went above $0.48. Phibro then looked at the agreement and noticed the $0.1 term for the first time. Phibro contacted Heritage to say that the $0.1 term was a typo and not what the two parties had originally agreed in the Delta Crown Room. Heritage refused to amend the agreement and Phibro filed suit.

You Be the Judge: ***Should the court enforce the contract as written or as the parties agreed in their Crown Room meeting? Which number is correct—$0.10 or $0.01?***

Argument for Phibro: In the Delta Crown Room, the two negotiators agreed to a $15 per ton increase in the price of TBCC for each 1-cent increase in copper sulfate price. Then by mistake, the contract said 10 cents. The two parties never negotiated the 10-cent provision, and there is no evidence that they had agreed to it. The court should revise this contract to be consistent with the parties' agreement, which was 1 cent.

Also, the 10-cent figure makes no economic sense. The point of the provision was that the price of TBCC would go up at the same rate as copper sulfate, and 1 cent for each ton is a much more accurate reflection of the relationship between these two commodities than 10 cents per ton.

Argument for Heritage: The Delta Crown Room agreement was nothing more than a draft. The contract went through eight rounds of changes. The change in price was in return for other provisions that benefited Phibro.

The parties conducted negotiations by sending drafts back and forth rather than by talking on the phone. Both parties were represented by a team of lawyers, the agreement went through eight drafts, and this pricing term was never altered despite several other changes and additions. There is no clear and convincing evidence that both parties were mistaken about what the document actually said. Ultimately, the parties agreed to 10 cents, and that is what the court should enforce.

Ethics When Heritage found a different mistake in the contract, Phibro agreed to correct it, even though the correction was unfavorable to Phibro. But when a mistake occurred in Heritage's favor, it refused to honor the intended terms of the agreement. Is Heritage behaving ethically? Does Heritage have an obligation to treat Phibro as well as Phibro behaved towards Heritage? Is it right to take advantage of other people's mistakes? What Life Principle would you apply in this situation?

Preventing Mistakes

Here are ways to prevent mistakes in a contract.

> As a general rule, your lawyer is less likely to make mistakes than you are.

Let your lawyer draft the contract. As a general rule, your lawyer is less likely to make mistakes than you are. Of all the players in the *Heritage* case, only one person noticed the error—Heritage's lawyer.

Resist overlawyering. Yes, your lawyer should draft the contract, but that does not mean she should have free rein, no matter what. This author once worked with a real estate attorney who had developed his own standard mortgage contract, of which he was immensely proud. Whenever he saw a provision in another contract that was missing from his own, he immediately added it. His standard form contract soon topped 100 pages. That contract was painful to read and did no service to his clients.

Read the important terms carefully. Before signing a contract, check *carefully* and *thoughtfully* the names of the parties, the dates, dollar amounts, and interest rates. If all these

elements are correct, you are unlikely to go too far wrong. And, of course, having read this chapter, *you* will never mistake $0.10 for $0.01.

Finally, when your lawyer presents you with a written contract, you should follow these rules:

1. Complain if your lawyer gives you a contract with provisions that are irrelevant to your situation.
2. If you do not know what a provision means, ask. If you still do not know (or if your lawyer does not know), ask her to take it out. Lawyers rarely draft from scratch; they tend to use other contracts as templates. Just because a provision was in another agreement does not mean that it is appropriate for you.
3. Remember that a contract is also a reference document. During the course of your relationship with the other party, you may need to refer to the contract regularly. That will be difficult if you do not understand portions of it, or if the contract is so disorganized you cannot find a provision when you need it.

Which brings us to our next topic—the structure of a contract. Once you understand the standard outline of a contract, it will be much easier for you to find your way through the thicket of provisions.

The Structure of a Contract

Traditional contracts tended to use archaic words—*whereas* and *heretofore* were common. Modern contracts are more straightforward, without as many linguistic flourishes. Our movie contract takes the modern approach.

Title

Contracts have a title, which generally is in capital letters, underlined, and centered at the top of the page. The title should be as descriptive as possible—a generic title such as AGREEMENT does not distinguish one contract from another. Much better to entitle it EMPLOYMENT AGREEMENT or CONFIDENTIALITY AGREEMENT. The title of our movie contract is MEMORANDUM OF AGREEMENT (not a particularly useful name), but in the upper right-hand corner, there is space for the date of the contract and the subject. Let's say the subject is Dawn Rising/Clay Parker. It would have been even better if the title of the movie had been: Agreement between Clay Parker and Winterfield Productions for Dawn Rising.

Introductory Paragraph

The introductory paragraph includes the date, the names of the parties, and the nature of the contract. The names of the parties and the movie are defined terms, e.g., Clay Parker ("Artist"). By defining the names, the actual names do not have to be repeated throughout the agreement. In this way, a standard form contract can be used in different deals without worrying about whether the names of the parties are correct throughout the document.

The introductory paragraph should also include specific language indicating that the parties entered into an agreement. In our contract, the opening paragraph states:

> This shall confirm the agreement ("Agreement") between WINTERFIELD PRODUCTIONS ("Producer') and CLAY PARKER ("Artist") regarding the acting services of Artist in connection with the theatrical motion picture tentatively entitled "DAWN RISING" (the "Picture")[3], as follows:

This introductory paragraph is not numbered.

[3]These are not the parties' real names but are offered to illustrate the concepts.

It is here that traditional contracts included their "Whereas" provisions. Thus, for example, a traditional movie contract might say the following:

> WHEREAS, Producer desires to retain the services of Artist for the purpose of making a theatrical motion picture; and
>
> WHEREAS, Artist desires to work for Producer on the terms and subject to the conditions set forth herein;
>
> NOW, THEREFORE, in consideration of the mutual covenants contained herein, and for other good and valuable consideration, the receipt and adequacy of which are hereby acknowledged, the parties agree as follows:

None of these flourishes are necessary, but some people prefer them.

Definitions

Most contracts have some definitions. As we have seen in the movie contract, *Artist*, *Producer*, and *Movie* were defined in the introductory paragraph. Sometimes, definitions are included in a separate section. Alternatively, they can appear throughout the contract. The movie contract does not have a definitions section, but many terms, such as *fixed compensation* and *teaser*, are defined within it.

Covenants

Now we get to the heart of the contract: What are the parties agreeing to do? Failure to perform these obligations constitutes a breach of the contract and damages will result. **Covenant** is a legal term that means a promise in a contract.

Covenant
A promise in a contract.

At this stage, the relationship between lawyer and client is particularly important. They will obtain the best result if they work well together. And to achieve a successful outcome, both need to contribute. Clients should figure out what they need for the agreement to be successful. It is at this point that they have the most control over the deal, and they should exercise it. *It is a mistake to assume that everything will work itself out.* Instead, clients need to protect themselves now as best they can. Lawyers can help in this process because they have worked on other similar deals and they know what can go wrong. Listen to them—they are on your side.

Imagine you are an actor about to sign a contract to make a movie. What provisions would you want? Begin by asking what your goals are for the project. Certainly, to make a movie that gets good reviews and good box office. So you will ask for as much control over the process and product as you can get—selection of the director and co-stars, for instance. Maybe influence on the editing process. But you also want to make sure that the movie does not hurt your career. What provisions would you need to achieve that goal? And shooting a movie can be grueling work, so you want to ensure that your physical and emotional needs are met, particularly when you are on location away from home. Try to think of all the different events that could happen and how they would affect you. The contract should make provisions for these occurrences.

Now take the other side and imagine what you would want if you were the producer. The producer's goal is to make money—which means creating a quality movie while spending as little as possible and maintaining control over the process and final product. As you can see, some of the goals conflict—both Artist and Producer want control over the final product. Who will win that battle?

Here are the terms of the movie contract.

The Artist negotiated:

1. A fixed fee of $1,800,000, to be paid in equal installments at the end of each week of filming.
2. Extra payment if the filming takes longer than 10 weeks.
3. 7.5 percent of the gross receipts of the movie.

4. A royalty on any product merchandising, the rate to be negotiated in good faith.
5. Approval over (but approval shall not be unreasonably withheld):
    a. the director, costars, hairdresser, makeup person, costume designer, stand-ins, and the look of his role (although he lists one director and costar whom he has preapproved)
    b. any changes in the script that materially affect his role
    c. all product placements, but he preapproves the placement of Snickers candy bars
    d. locations where the filming takes place
    e. all videos, photos, and interviews of him
    f. the translation of the script for French subtitles (he is fluent in French)
6. Approval (at his sole discretion) over the release of any blooper videos.
7. His name to be listed first in the movie credits, on a separate card (i.e., alone on the screen).
8. That the producer not give any photographs from the set to a tabloid (such as, the *National Enquirer* or the *Star*).
9. At least 12 hours off duty from the end of each day of filming to the start of the next day.
10. That he fly first class to any locations outside of Los Angeles.
11. That the producer pay for 10 first-class airline tickets for his friends to visit him on location.
12. A luxury hotel suite for himself and a room for his friends.
13. A driver and four-wheel-drive SUV to transport him to the set.
14. The right to keep some wardrobe items.

The Producer negotiated:

1. All intellectual property rights to the movie.
2. The right not to make the movie, although he would still have to pay Artist the fixed fee.
3. Control over the final cut of the movie.
4. That the Artist will show up on a certain date and work in good faith for
    a. 2 weeks in pre-production (wardrobe and rehearsals)
    b. 10 weeks shooting the movie
    c. 2 free weeks after the shooting ends, in case the director wants to reshoot some scenes. The Artist must in good faith make himself available whenever the director needs him.
5. The right to fire Artist if his appearance or voice materially changes before or during the filming of the movie.
6. That the Artist help promote the movie on dates subject to Artist's approval, which shall not be unreasonably withheld.

Breach

So now we have the covenants in the movie contract. What happens if one of the parties breaches a covenant? Throughout the life of a contract, there could be many small breaches. Say, Artist shows up one day late for filming or he gains five pounds. Maybe Producer deposits Artist's paycheck a few days late. Perhaps a pop-out trailer is not available. Although these events may technically be violations, a court would not impose sanctions

Material breach
A violation of a contract that defeats an essential purpose of the agreement.

over such minor issues. To constitute a violation of the contract, the breach must be material. A **material breach** is important enough to defeat an essential purpose of the contract. Although a court would probably not consider one missed day to be a material breach, if Artist repeatedly failed to show up, that would be material.

Given that the goal of a contract is to avoid litigation, it is can be useful to define what a breach is. The movie contract uses this definition:

> Artist fails or refuses to perform in accordance with Producer's instructions or is otherwise in material breach or material default hereof," and "Artist's use of drugs [other than prescribed by a medical doctor]."

The contract goes on, however, to give Artist one free pass:

> It being agreed that with regard to one instance of default only, Artist shall have 24 hours after receipt of notice during principal photography, or 48 hours at all other times, to cure any alleged breach or default hereof.

Sometimes, you will recall, contracts state the consequences of a breach, such as the amount of damages. A damages clause can specify a certain amount, a limitation on the total, or other variations. In other words, the contract could say, "If Artist breaches, Producer is entitled to $1 million in damages." (You remember from prior chapters that these are called *liquidated damages*.) Alternatively, a damage clause could say, "Damages will not exceed $1 million." But the vast majority of contracts have neither liquidated damages nor damage caps.

Sole discretion
A party to a contract has the absolute right to make a decision on that issue.

Reasonable
Ordinary or usual under the circumstances.

Good faith
An honest effort to meet both the spirit and letter of a contract.

Good faith. Note that many of the covenants in the movie contract provide that the right must be exercised *reasonably* or that a decision must be made in *good faith* (except for the right to approve blooper videos, over which Artist has *sole discretion*.) A party with **sole discretion** has the absolute right to make any decision on that issue. Sole discretion clauses are not entered into lightly. **Reasonable** means ordinary or usual under the circumstances. **Good faith** means an honest effort to meet both the spirit and letter of the contract. These are the technical definitions. What do *material*, *reasonably*, and *in good faith* mean in practice?

In the following case, a famous athlete felt that the other party had committed a material breach of their contract, behaved unreasonably, and acted in bad faith. Do you agree?

LeMond Cycling, Inc. v. PTI Holding, Inc.

2005 U.S. Dist. LEXIS 742
United States District Court for the District of Minnesota, 2005

Facts: Before Lance Armstrong, Greg LeMond won the Tour de France, cycling's most prestigious race. *Sports Illustrated* named him one of the 40 most influential people in sports during the prior 40 years. He formed LeMond Cycling, Inc. (LCI) to handle his business dealings. Protective Technologies International, Inc. (PTI) sold cycling accessories under brand names like Barbie, Playskool, and Tonka to retailers such as Target, Wal-Mart, K-Mart, and Toys R Us.

LeMond and PTI signed a contract (the Deal Memo) providing that PTI would use LeMond's name to sell bicycle accessories. In return, PTI would pay LCI $500,000 a year plus a 6 percent royalty on annual sales exceeding $8.33 million. The Deal Memo required PTI to

- Use commercially reasonable efforts to produce and market LeMond bicycle accessories
- Keep LCI apprised of PTI's efforts, including information about marketing and media plans

PTI tried to sell LeMond products to Target, Wal-Mart, and Toys R Us. Only Target was interested, and then only in a minor way. It agreed to allocate just 6 feet of shelf space to LeMond products. It also rejected PTI's proposal to install a video kiosk that featured LeMond. PTI did not tell LCI about this deal.

LeMond accessories sold poorly at Target. PTI itself did not do any promotional activities or advertising for the products beyond the initial video for the kiosk, which

Thierry Prat/Sygma/Corbis

Greg LeMond was one of the greatest cyclists ever. Why didn't his products sell?

Target rejected. PTI argued that it was Target's role to advertise the products.

Because of poor sales, Target reduced the amount of shelf space for LeMond items to just 4 feet. Ultimately, Target discontinued these products altogether. In neither instance did PTI inform LCI. PTI did try to sell LeMond accessories to Wal-Mart, Toys R Us, and other stores, but there were no takers.

Shortly thereafter, PTI began to sell Schwinn bicycle accessories to the retailers that had rejected LeMond products. PTI earned over $30 million from Schwinn sales. The company then abandoned all efforts to sell LeMond items.

LCI filed suit against PTI for breach of contract. In response, PTI filed a motion for summary judgment, seeking to have the suit dismissed.

Issue: ***Did PTI breach its contract with LCI?***

Excerpts from Judge Magnuson's Decision: To prevail on a breach of contract claim, LCI must prove that PTI breached a material term of the contract. A material breach goes to the root or essence of the contract and is so fundamental to the contract that the failure to perform that obligation defeats an essential purpose of the contract. Even when express conditions of the contract are violated, the breach is not necessarily material.

LCI contends that PTI's alleged failure to provide LCI with annual marketing and media plans was material. LCI submits that these documents serve a critical purpose in licensing agreements because they allow the licensor to monitor sales and corresponding royalty payments.

The Court disagrees. The fact that PTI failed to give reports or other documents to LeMond does not frustrate the essential purpose of the contract. Furthermore, there is no causal connection between PTI's failure to provide LCI with these reports and LCI's lost profit. Therefore, these terms of the Deal Memo, by themselves, are not material as a matter of law.

However, whether or not PTI used commercially reasonable efforts to produce [and] market the Product Line is a material term of the contract, as it is the primary purpose of the contract itself. Thus, the issue is whether PTI breached this duty.

The Deal Memo fails to define commercially reasonable. LCI is convinced that commercially reasonable requires an examination of customary practices within the licensing industry. LCI's broad argument that only industry standards are relevant to the commercial reasonableness determination is unpersuasive. Although an objective component is instructive as to whether or not PTI acted with commercial reasonableness, there must be a subjective evaluation as well. No business would agree to perform to its detriment, and therefore whether or not PTI performed with commercial reasonableness also depends on the financial resources, business expertise, and practices of PTI.

The Complaint also alleges that PTI breached its implied covenant of good faith and fair dealing with LCI. Good faith requires a party to act honestly. Bad faith exists when a party's refusal to fulfill its obligations is based on an ulterior motive. LCI submits that PTI abandoned LCI and its obligations under the Deal Memo when it engaged in its relationship with Schwinn. Indeed, LCI has submitted evidence that PTI narrowly focused on its Schwinn obligations despite its continuing obligation to LCI under the Deal Memo. There is a dispute of fact as to whether PTI exercised good faith in its performance under the terms of the Deal Memo. Thus, PTI's Motion on this point is denied.

IT IS HEREBY ORDERED that:

Defendants' Motion for Summary Judgment is GRANTED in part and DENIED in part as set forth in this Order.

In drafting covenants, there are two issues to keep in mind.

Reciprocal Promises and Conditions. Suppose that a contract provides that:

1. Actor shall take part in the principal photography of Movie for 10 weeks, commencing on March 1.
2. Producer shall pay Artist $180,000 per week.

Reciprocal promises
Promises that are each enforceable independently.

Conditional promises
Promises that a party agrees to perform only if the other side has first done what it promised.

In this case, even if Artist does not show up for shooting, Producer is still required to pay him. These provisions are **reciprocal promises, which means that they are each enforceable independently.** Producer must make payment and then sue Artist, hoping to recover damages in court.

The better approach is for the covenants to be **conditional**—a party agrees to perform them only if the other side has first done what it promised. For example, in the real movie contract, Producer promises to pay Artist "On the condition that Artist fully performs all of Artist's services and obligations and agreements hereunder and is not in material breach or otherwise in material default hereof." And Artist has the right to attend any premieres of the movie and invite three friends, "On the condition that Artist fully performs all services and material obligations hereunder."

In short, if you do not expect to perform under the contract until the other side has met its obligations, be sure to say so.

Language of the covenants. To clarify *who* exactly is doing what, covenants in a contract should use the active, not passive voice. In other words, a contract should say "Producer shall pay Artist $1.8 million," not "Artist shall be paid $1.8 million."

For important issues where disputes are likely to arise, the language should be precise, detailed, and complete. The movie contract uses 453 words to define the Artist's services just for shooting the movie, not including promotional efforts once the film is released. These acting services include, "dubbing, retakes, reshoots, and added scenes."

Representations and Warranties

Representations and warranties
Statements of fact about the past or present.

Covenants are the promises the parties make about what they will do in the future. Representations and warranties are statements of fact about the past or present; they are true when the contract is signed (or at some other specific, designated time).[4] These representations and warranties are important—without them, the other party might not have agreed to the contract. For example, in the movie contract, Artist warrants that he is a member of the Screen Actors Guild. This provision is important because, if it were not true, Producer would either have to obtain a waiver or pay a substantial penalty.

In a contract between two companies, each side will generally represent and warrant facts such as: they legally exist, they have the authority to enter into the contract, their financial statements are accurate, they have revealed all material litigation, and they own all relevant assets. In a contract for the sale of goods, the contract will include warranties about the condition of the goods being sold.

EXAM Strategy

Question: Producer does not want Artist to pilot an airplane during the term of the contract. Would that provision be a warranty and representation or a covenant? How would you phrase it?

Strategy: Warranties and representations are about events in the past or present. A covenant is a promise for the future. If, for example, Producer wanted to know that Artist had never used drugs in the past, that provision would be a warranty and representation.

[4]Although, technically, there is a slight difference between a representation and a warranty, many lawyers confuse the two terms, and the distinction is not important. We will treat them as synonyms, as many lawyers do.

Result: A promise not to pilot an airplane is a covenant. The contract could say, "Until Artist completes all services required hereunder, he shall not pilot an airplane."

Boilerplate

These standard previsions are typically placed in a section entitled *Miscellaneous*. Many people think that *boilerplate* is a synonym for *boring and irrelevant*, but it is worth remembering that the term comes from the iron or steel that protects the hull of a ship—something that shipbuilders ignore to the passengers' peril. A contract without boilerplate is valid and enforceable—so it can be tempting to skip these provisions, but they do play an important protective role. In essence, boilerplate creates a private law that governs disputes between the parties. Courts can also play this role and, indeed, in the absence of boilerplate they will. But remember that an important goal of a contract is to avoid court involvement.

Here are some standard, and important, boilerplate provisions.

Choice of Law and Forum. **Choice of law** provisions determine which state's laws will be used to interpret the contract. **Choice of forum** determines the state in which any litigation would take place. (One state's courts can apply another state's laws.) Lawyers often view these two provisions as the most important boilerplate. Individual states might have dramatically different laws. Even the so-called uniform statutes, such as the Uniform Commercial Code, can vary widely from state to state. Variations are even more pronounced in other areas of the law, in particular in the common law, which is created by state courts. As for forum, it is a lot more convenient and cheaper to litigate a case in one's home courts.

Choice of law provisions
Determine which state's laws will be used to interpret the contract.

Choice of forum provisions
Determine the state in which any litigation would take place.

When resolving a dispute, the choice of law and forum can strongly influence the outcome. For this reason, sometimes parties are reluctant to negotiate the provision and instead decide not to designate a forum and just take their chances. Or they may choose a neutral, equally inconvenient forum like Delaware. Without a choice of forum clause, the parties may well end up litigating where to litigate, or they may find themselves even worse off—with parallel cases filed by each in his preferred forum.

The movie contract states: "This Agreement shall be deemed to have been made in the State of California and shall be construed and enforced in accordance with the law of the State of California." The contract did not, but might have, also specified the forum—that any litigation would be tried in California.

Modification. Contracts should contain a provision governing modification. The movie contract states: "This Agreement may not be amended or modified except by an instrument in writing signed by the party to be charged with such amendment or modification."

"Charged with such amendment" means the party who is adversely affected by the change. For example, if Producer agrees to pay Artist more, then Producer must sign the amendment. Without this provision, a conversation over beers between Producer and Artist about a change in pay might turn out to be an enforceable amendment.

The original version of the movie contract said that Artist would be photographed nude only above the waist. He ultimately agreed to rear-below-the-waist photography. That amendment (which the parties called a **rider**—another term for amendment or addition) took the form of a letter from Artist agreeing to the change. Producer then signed the letter, acknowledging receipt and acceptance. The amendment would have been valid even without Producer's signature because Artist was "charged with such Amendment."

Rider
An amendment or addition to a contract.

If a contract has a provision requiring that amendments be in writing, there are three ways to amend it:

1. Signing an amendment (or rider).
2. Crossing out by hand the wrong language and replacing it with the correct terms. It is good practice for both parties to initial each change. This method is typically used before the document is signed—say, at the closing if the parties notice a mistake.
3. Rewriting the entire contract to include the changed provisions. In this case, the contract is typically renamed: The Amended and Restated Agreement. This method is most appropriate if there are many complex alterations.

Note that amending a contract may raise issues of consideration, a topic discussed in Chapter 12.

Assignment of rights
A transfer of benefits under a contract to another person.

Delegation of duties
A transfer of obligations in a contract.

Assignment of Rights and Delegation of Duties. An **assignment of rights** is a transfer of your benefits under a contract to another person, while **delegation of duties** is a transfer of your obligations. In the movie contract, Producer has the right to *assign* the contract, but he must stay secondarily liable to it. In other words, someone else can take over the contract for him, but if that person fails to live up to his obligations, Producer is liable. Artist might be unhappy if another production company takes over the movie, but he is still required under the contract to perform his acting services. At least he knows that Producer is liable for his paycheck.

Delegation means that someone else performs the duties under the contract. It certainly matters to Producer which actor shows up to do the shooting. Artist cannot say, "I'm too busy—here's my cousin Jack." So the movie contract provides:

> It is expressly understood and agreed that the services to be rendered by Artist hereunder are of the essence of this Agreement and that such services shall not be delegated to any other person or entity, nor shall Artist assign the right to receive compensation hereunder.

In essence, Producer not only cares who shows up for shooting, he also wants to make sure that no one else cashes the checks. He wants to deal only with Artist. And he worries that if Artist assigns the right to receive payment, he will feel less motivated to do his job well.

Arbitration. Some contracts prohibit the parties from suing in court and require that disputes be settled by an arbitrator. The parties to a contract do not have to arbitrate a dispute unless the contract specifically requires it. Arbitration has its advantages—flexibility and savings in time and money—but it also has disadvantages. For example, most contracts between consumers and brokerage houses require arbitration. Consumer advocates argue that the arbitrators in these disputes are biased in favor of the brokerage houses—who engage in many arbitrations—over consumers who are likely to be one-time customers. And many believe that employees receive a less favorable result when they arbitrate, rather than litigate, disputes with their employer. Also, if a court makes a mistake in applying the law, an appellate court can correct the error. But if an arbitrator makes a mistake, there is generally no appeal. The movie contract does not include an arbitration provision.

Attorney's fees. As a general rule, parties to a contract must pay their own legal fees, no matter who is in the wrong. But contracts may override this general rule and provide that the losing party in a dispute must pay the attorney's fees for both sides. Such a provision tends to discourage the poorer party from litigating with a rich opponent for fear of having to pay two sets of attorney's fees. The movie contract provides:

> Artist hereby agrees to indemnify Producer from and against any and all losses, costs (including, without limitation, reasonable attorneys' fees), liabilities, damages, and claims of any nature arising from or in connection with any breach by Artist of any agreement, representation, or warranty made by Artist under this Agreement.

There is no equivalent provision for breaches by Producer. What does that omission tell you about the relative bargaining power of the two parties?

Integration. During contract negotiations, the parties may discuss many ideas that are not ultimately included in the final version. The point of an integration clause is to prevent either side from later claiming that the two parties had agreed to additional provisions. The movie contract states:

> This Agreement, along with the exhibits attached hereto, shall constitute a binding contract between the parties hereto and shall supersede any and all prior negotiations and communications, whether written or oral, with respect hereto.

Without this clause, even a detailed written contract can be amended by an undocumented conversation—a dangerous situation since the existence and terms of the amendment will depend on what a court *thinks* was said and intended, which may or may not be what actually happened.

EXAM Strategy

Question: Daniel and Annie signed a contract providing that Annie would sell craft beers to Daniel's grocery stores at a price of $20 per case. During negotiations, Daniel and Annie agreed that the price would go up to $22 per case once he had bought 1,000 cases. This provision never made it into the contract. After the contract had been signed, Daniel agreed to a price of $23 per case once volume exceeded 1,000 cases. The contract had an integration provision but no modification clause. What price must Daniel pay for cases in excess of 1,000?

Strategy: If a contract has an integration provision, then side agreements made during negotiations are unenforceable unless included in the written contract. Without a modification provision, oral agreements made after the contract was signed may be enforceable.

Result: A court would not enforce the side agreement that required Daniel to pay $22 a case. It is possible that a court would enforce the $23 agreement—which leaves Daniel with a choice of paying $23 a case or the cost of having his lawyer defend a lawsuit.

Severability. If, for whatever reason, some part of the contract turns out to be unenforceable, a severability provision asks the court simply to delete the offending clause and enforce the rest of the contract. For example, courts will not enforce *unreasonable* non-compete clauses. (California courts will not enforce *any* non-competes, unless made in connection with the sale of a business.) In one case, a consultant signed an employment contract that prohibited him from engaging in his occupation "anyplace in the world." The court struck down this non-compete provision but ruled that the rest of the contract (which contained trade secret clauses) was valid.

The movie contract states:

> In the event that there is any conflict between any provision of this Agreement and any statute, law, or regulation, the latter shall prevail; provided, however, that in such event, the provision of this Agreement so affected shall be curtailed and limited only to the minimum extent necessary

to permit compliance with the minimum requirement, and no other provision of this Agreement shall be affected thereby and all other provisions of this Agreement shall continue in full force and effect.

Force majeure event
A disruptive, unexpected occurrence for which neither party is to blame that prevents one or both parties from complying with a contract.

Force Majeure. A **force majeure event** is a disruptive, unexpected occurrence for which neither party is to blame that prevents one or both parties from complying with the contract. Force majeure events typically include war, terrorist attack, fire, flood, or general acts of God. If, for example, a major terrorist event were to halt air travel, Artist might not be able to appear on set as scheduled. The movie contract defines force majeure events thus:

> fire, war, governmental action or proceeding, third-party breach of contract, injunction, or other material interference with the production or distribution of motion pictures by Producer, or any other unexpected or disruptive event sufficient to excuse performance of this Agreement as a matter of law or other similar causes beyond Producer's control or by reason of the death, illness, or incapacity of the producer, director, or a member of the principal cast or other production personnel.

Notices. After a contract is signed, there may be times when the parties want to send each other official notices—of a breach, an objection, or an approval, for example. In this section, the parties list the addresses where these notices may be sent. For Producer, it is company headquarters. For Artist, there are three addresses: his agent, his manager, and his lawyer. The notice provision also typically specifies when the notice is effective: when sent, when it would normally be expected to arrive, or when it actually does arrive.

Closing. To indicate that the parties have agreed to the terms of the contract, they must sign it. A simple signature is sufficient, but contracts often contain flourishes. The movie contract, for example, states:

> IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the date first written above.

With clauses like this, it is important to make sure that there is an (accurate) date on the first page. If not otherwise provided in the "Notices" section, it is a good idea to include the parties' addresses. The movie contract also listed Artist's social security number.

When a party to the contract is a corporation, the signature lines should read like this:

Winterfield Productions, Inc.
By:_____
Name:
Title:

If an individual signs her own name without indicating that she is doing so in her role as an employee of Winterfield Productions, Inc., she would be personally liable.

In the end, both parties signed the contract and the movie was made. According to Rotten Tomatoes, the online movie site, professional reviewers rated it 7.9 out of 10.

Chapter Conclusion

You will undoubtedly sign many contracts in your life. Their length and complexity can be daunting. (In the movie contract, one of the paragraphs is 1,000 words.) The goal of this chapter is to help you understand the structure and meaning of the most important provisions so that you can read and analyze contracts more effectively.

Exam Review

1. **AMBIGUITY** Any ambiguity in a contract is interpreted against the party that drafted the agreement. (pp. 433–434)

2. **SCRIVENER'S ERROR** A scrivener's error is a typographical mistake. In the case of a scrivener's error, a court will reform a contract if there is clear and convincing evidence that the mistake does not reflect the true intent of the parties. (p. 435)

EXAM Strategy

Question: Martha intended to transfer a piece of land to Paul. By mistake, she signed a contract transferring two parcels of land. Each piece was accurately described in the contract. Will the court reform this contract and transfer one piece of land back to her?

Strategy: Begin by asking if this was a scrivener's error. Then consider whether the court will correct the mistake.

3. **BEFORE SIGNING A CONTRACT** Before signing a contract, check carefully and thoughtfully the names of the parties, the dates, dollar amounts, and interest rates. (p. 437)

4. **MATERIAL BREACH** A material breach is important enough to defeat an essential purpose of the contract. (pp. 439–442)

EXAM Strategy

Question: Laurie's contract to sell her tortilla chip business to Hudson contained a provision that she must continue to work at the business for five years. One year later, she quit. Hudson refused to pay her the amounts still owing under the contract. Laurie alleged that he is liable for the full amount because her breach was not material. Is Laurie correct?

Strategy: What was the essential purpose of the contract? Was Laurie's breach important enough to defeat it?

5. **SOLE DISCRETION** A party with sole discretion has the absolute right to make any decision on that issue. (p. 440)

EXAM Strategy

Question: A tenant rented space from a landlord for a seafood restaurant. Under the terms of the lease, the tenant could assign the lease only if the landlord gave her consent, which she had the right to withhold "for any reason whatsoever, at her sole discretion." The tenant grew too ill to run the restaurant and asked permission to assign the lease. The landlord refused. In court, the tenant argued that the landlord could not unreasonably withhold her consent. Is the tenant correct?

Strategy: A sole discretion clause grants the absolute right to make a decision. Are there any exceptions?

6. **REASONABLE** Reasonable means ordinary or usual under the circumstances. (p. 440)

7. **GOOD FAITH** Good faith means an honest effort to meet both the spirit and letter of the contract. (p. 440)

8. **STRUCTURE OF A CONTRACT** The structure of a contract looks like this:

   a. Title
   b. Introductory Paragraph
   c. Definitions
   d. Covenants
   e. Conditions
   f. Representations and Warranties
      i. Covenants are the promises the parties make about what they will do in the future.
      ii. Representations and warranties are statements of fact about the present or past—they are true when the contract is signed (or at some other specific, designated time).
   g. Remedies
   h. Boilerplate
      i. Choice of Law and Forum
      ii. Modification
      iii. Assignment of Rights and Delegation of Duties
      iv. Arbitration
      v. Attorney's Fees
      vi. Integration
      vii. Severability
      viii. Force Majeure
      ix. Notices
      x. Closing (pp. 437–446)

2. Result: The court ruled that it was not a scrivener's error because it was not a typo or clerical error. Therefore, the court did not reform the contract and the land was not transferred back to Martha.

4. Result: The purpose of the contract was for Hudson to build up the business and make a profit. Laurie's departure interfered with that goal. The court ruled that the breach was material and Hudson did not have to pay the sums still owing under the contract.

5. Result: The court ruled for the landlord. She had the absolute right to make any decision as long as the decision was not illegal. The moral: Sole discretion clauses are serious business. Do not enter into one lightly.

Multiple-Choice Questions

1. In the *Quake* case, the appellate court ruled
(a) the letter of intent was a valid contract.
(b) letters of intent are *never* a valid contract.
(c) a letter of intent can be a valid contract, but this one was not.
(d) the trial court had to determine if the letter of intent was a valid contract.

2. In the *Cipriano* case, what happened?
(a) The jury decided in favor of Cipriano because arson is vandalism.
(b) The jury decided against Cipriano because arson is not vandalism.
(c) The judge dismissed the motion for summary judgment because the contract was ambiguous.
(d) The judge granted the motion for summary judgment because the contract was not ambiguous.

3. In the case of a scrivener's error, what happens?
(a) A court will not reform the contract. The parties must live with the document they signed.
(b) A court will reform the contract if there is clear and convincing evidence that the clause in question does not reflect the true intent of the parties.
(c) A court will reform the contract if a preponderance of the evidence indicates that that the clause in question does not reflect the true intent of the parties.
(d) A court will invalidate the contract in its entirety.

4. In the *LeMond* case, the court ruled:
(a) PTI's failure to supply marketing and media plans was a material breach of the contract because without those plans, LCI could not monitor sales.
(b) PTI's failure to supply marketing and media plans was a material breach of the contract because PTI had agreed to supply the plans.
(c) the requirement that PTI use commercially reasonable means to promote the product line was not enforceable because the term was ambiguous.
(d) PTI's failure to supply marketing and media plans was not a material breach of the contract.

5. A contract states (1) that Buzz Co. legally exists and (2) will provide 2,000 pounds of wild salmon each week. Which of the following statements is true?
(a) Clause 1 is a covenant and Clause 2 is a representation.
(b) Clause 1 is a representation and Clause 2 is a covenant.
(c) Both clauses are representations.
(d) Both clauses are covenants.

Essay Questions

1. List three types of contracts that should definitely be in writing, and one that probably does not need to be.

2. Make a list of provisions that you would expect in an employment contract.

3. List three provisions in a contract that would be material, and three that would not be.

4. Slimline and Distributor signed a contract which provided that Distributor would use reasonable efforts to promote and sell Slimline's diet drink. Slimline was already being sold in Warehouse Club. After the contract was signed, Distributor stopped conducting in-store demos of Slimline. It did not repackage the product as Slimline and Warehouse requested. Sales of Slimline continued to increase during the term of the contract. Slimline sued Distributor, alleging a violation of the agreement. Who should win?

5. **YOU BE THE JUDGE WRITING PROBLEM** Chip bought an insurance policy on his house from Insurance Co. The policy covered damage from fire but explicitly excluded coverage for harm caused "by or through an earthquake." When an earthquake struck, Chip's house suffered no fire damage, but the earthquake caused a building some blocks away to catch on fire. That fire ultimately spread to Chip's house, burning it down. Is Insurance Co. liable to Chip? **Argument for Insurance Co.:** The policy could not have been clearer or more explicit. If there had been no earthquake, Chip's house would still be standing. The policy does not cover his loss. **Argument for Chip:** His house was not damaged by an earthquake; it burned down. The policy covered fire damage. If a contract is ambiguous, it must be interpreted against the drafter of the contract.

Discussion Questions

1. In the movie contract, which side was the more successful negotiator? Can you think of any terms that either party left out? Are any of the provisions unreasonable?

2. What are the advantages and disadvantages of hiring a lawyer to draft or review a contract?

3. What are the penalties if Artist breaches the movie contract? Why are the penalties so light?

4. **ETHICS** In the *Heritage* case, the two companies had agreed to a price change of $0.01. When Heritage's lawyer pointed out to his client the change to $0.10, the Heritage officer did not tell Phibro. The change was subtle in appearance but important in its financial impact. Was Heritage's behavior ethical? When the opposing side makes a mistake in a contract, do you have an ethical obligation to tell them? What Life Principles would you apply in this situation?

5. Blair Co.'s top officers approached an investment bank to find a buyer for the company. The bank sent an engagement letter to Blair with the following language:

   > If, within 24 months after the termination of this agreement, Blair is bought by anyone with whom Bank has had substantial discussions about such a sale, Blair must pay Bank its full fee.

   Is there any problem with the drafting of this provision? What could be done to clarify the language?