Contracts

INFORMAL AGREEMENTS CAN LEAD TO INTRACTABLE ARGUMENTS

A litigation involving Facebook.com founder Mark Zuckerberg, described by one judge as a "blood feud," illustrates the need for definitive written agreements. In December 2002, Harvard student Divya Narendra went to his fellow students Cameron and Tyler Winklevoss with an idea for an online social network for college students. They founded a venture, originally called "Harvard Connection" (later called ConnectU), to develop the idea.

Harvard Connection needed a programmer. Mark Zuckerberg, who later founded Facebook, had gained notoriety when he was placed on probation by Harvard University for hacking into the school's servers. Harvard Connection hired Zuckerberg and provided him their business plan and code. It wasn't long after that a dispute arose.

It is alleged that Zuckerberg understood that the information provided was proprietary. There was, however, no written agreement. Supposedly, Zuckerberg stalled Harvard Connection's launch while working on Facebook. In January 2004, 3 days after telling the Harvard Connection team that he had their coding done, Zuckerberg registered the domain name "TheFaceBook.com." E-mail correspondence indicates that the Facebook site was complete prior to a final meeting between Zuckerberg and Harvard Connection.

On September 2, 2004, ConnectU sued Zuckerberg for breach of contract, misappropriation of trade secrets, and copyright infringement. Zuckerberg countered that there was no contract, that he had never promised Harvard Connection anything, and that he was simply helping them out. The litigation lasted 3 years before it was ultimately settled prior to trial.

By February 2008, ConnectU had not been provided with its settlement terms. Nonetheless, the parties agreed to suspend proceedings and submit to mediation. After a two-day mediation, a one-and-a-half page "Term Sheet & Settlement Agreement" was signed. Facebook agreed to give the ConnectU principals a certain amount of cash and Facebook stock in return for their stock in ConnectU. However, ConnectU learned that its understanding of the value of the Facebook stock was in error, and the parties could not agree on the formal documents. ConnectU took the position that the mediation document lacked crucial terms and was insufficient to establish a meeting of the minds. The court disagreed. It held that the document was sufficient to create a contract and that ConnectU could have conditioned the agreement on a specific Facebook valuation or done its own due diligence. It had done none of those things.

Continued

The moral of the story is that complete and definitive agreements can prevent much heartache. Oral agreements and incomplete, imprecise written agreements are grist for the litigation mill.

Source: *ConnectU, Inc.* versus *Facebook, Inc. et al., District Of Massachusetts, case number 1:2007cv10593; The Facebook, Inc.* versus *ConnectU, LLC et al., Northern District of California, case number 5:2007cv01389; O'Brien. Poking Facebook. November/December 2007.*

11.1 INTRODUCTION

A contract is an agreement between two or more parties that is legally binding and enforceable in a court of law. Performance in accordance with the agreement is an obligation or duty under the law. A failure to perform is a breach for which the law offers a remedy.

Businesses are free to agree, within broad legal limits, upon whatever terms they see fit. Those terms define respective rights and obligations of the parties, and/or rules under which they operate, for the duration of the contract. A contract serves, in effect, as the private law of these businesses. That means that it is extremely important to understand when a contract is created and how it can be enforced. A failure to form a valid contract when intended, or inadvertently committing a business to obligations, can be catastrophic. (Just ask the Winklevoss'.)

In this chapter, we will consider the basic sources and concepts of contract law, the anatomy of a typical agreement, and introduce various types of agreements often encountered by technology entrepreneurs.

11.2 SOURCES OF CONTRACT LAW

When an issue of contract law arises, it is generally in connection with one of the following questions: Has a contract been formed? If so, what are the terms? And, if there is a breach, is there an applicable defense? If not, what are the remedies?

Answering these questions, however, is complicated by the fact that a different body of contract law applies depending upon the subject matter of the transaction, the location of the parties to the transaction, and the terms of a written agreement.

Two primary sources of law govern contracts between parties located within the United States. Historically, the common law of a state (precedential judicial decisions) was applied to contracts formed or performed within its boundaries.[1] Consequently, the law varied from state to state. As the frequency of interstate transactions increased, a **Uniform Commercial Code** (UCC) was developed for, among other things, the sale of **goods**.[2] The UCC, consisting of 10 articles, covers the rights of buyers and sellers in commercial transactions. Drafted in 1952, the UCC has been adopted in its entirety by every state except Louisiana (which has adopted about half of the code). Each state has unique adaptations of the code to fit its own common law findings. Generally, business owners can access a state's UCC through that state's Secretary of State Office. The UCC defines goods as all things that are movable at the time of identification to a contract for sale.[3] The UCC does not cover transactions relating solely to services, intangibles such as investment securities or intellectual property (IP), or real property.

The UCC is significantly different than the common law in a number of respects. Most notably, actions that would not create an enforceable contract under the common law may do so under the UCC, and the effective terms of an agreement may be different when interpreted under the UCC rather than under the common law.

In addition, since 1988, the United States has been a signatory to the 1980 United Nations Convention on **Contracts for the International Sale of Goods** (**CISG**). It applies to the sale of **goods** between a party in the United States and a party in another CISG country.[4] Effective October 2013, 80 countries are signatories of the CISG including: Canada, China, Mexico, Japan, Germany, South Korea, France, Venezuela, Netherlands, Italy, and Belgium, all of the top 10 trading partners with the United States, excepting the United Kingdom, and Saudi Arabia.[5]

The CISG covers agreements between parties in different CISG jurisdictions that would otherwise be covered by the UCC. It is, however, significantly different from the UCC in a number of respects, notably whether or not a contract is formed, the requirement for a written agreement,[6] and the availability of certain remedies. However, the parties to a transaction can opt out of the CISG by an express and explicit statement in a written agreement, such as:

> "The rights and obligations of the parties shall not be governed by the United Nations Convention on Contracts for the International Sale of Goods."

It is important to be able to determine the particular body of law that governs a transaction. Whether or not there is a contract, and even if so, the terms of the agreement may be different depending upon the applicable law. The process of determining the applicable law is illustrated in Exhibit 11.1.

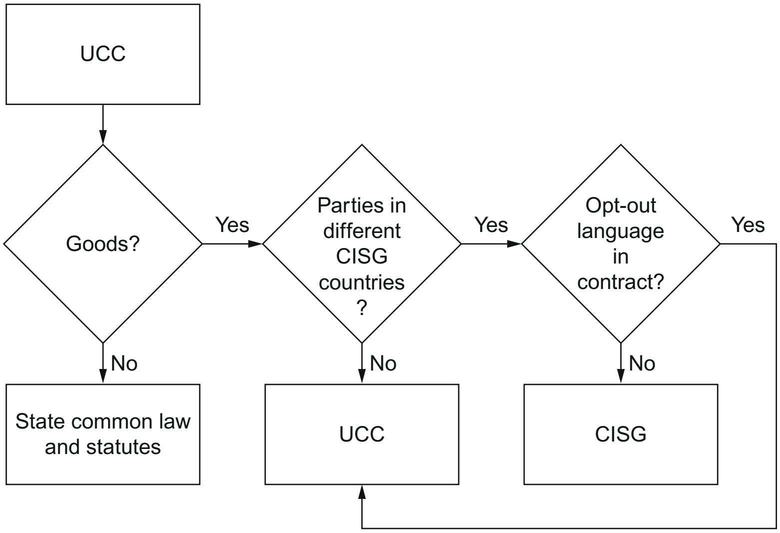

EXHIBIT 11.1
The CISG and UCC relationship.

11.3 CONTRACT FORMATION

To begin to understand the concept of contract formation, the first question to ask is: Has the interaction between two parties created an enforceable contract? Traditionally, the following must take place in order for an agreement between respective parties to create a legally enforceable obligation:

- The parties must have the legal capacity to enter into a contract.
- There must be an offer and an acceptance of that offer.
- There must be consideration to support the contract.
- The subject matter of the contract must be legal and not against public policy.
- There must not be any viable defense, such as mutual mistake, fraud, or duress.

In addition, under certain circumstances, the contract must be reflected by a written instrument.

11.3.1 The offer

The basic foundation of a contract is mutual assent or a meeting of the minds. In order for there to be a meeting of the minds, an offer must be made and that offer accepted. An **offer** is a proposal meeting certain requirements, made by an *offeror* to an *offeree*. In order for a proposal to constitute an offer, it must:

- Identify the person or class of persons (the offeree) to whom it is made
- Be unconditional
- Not require anything from the offeree other than an indication of acceptance

- Indicate an intent to create a contract with the offeree and not a mere invitation for offers (like an advertisement or request for proposals)
- Be objectively reasonable to believe that the person making it is prepared to be bound by the terms if it is accepted, that is, a reasonable person would not consider it a joke or facetious statement
- Provide a basis for determining the essential terms of the proposed agreement. Nonessential terms can be filled in by the court according to a "reasonableness" standard.[7]

The offeree's response to the offer determines whether or not a contract is formed. It can either reject or accept the offer. Rejection can be express (as when the offeree states verbally or in writing that the offer is rejected) or by lapse of time (i.e., the time for accepting the offer has passed). Once rejected, the offer need not be honored or renewed. Generally, only the person to whom an offer was directed may accept an offer. Under common law and the UCC, an acceptance is deemed to be effective when it was mailed, as opposed to when it was received.[8] This is sometimes referred to as the **mailbox rule.** Under the CISG, however, acceptance is not effective until it reaches the offeror.[9]

11.3.2 The Counteroffer

The response to an offer that proposes the parties go forward on different terms than proposed in the offer is a counteroffer. Whether or not a counteroffer constitutes acceptance and forms a contract is a function of the applicable body of law. Unless under the UCC, an acceptance must unequivocally meet and correlate with the offer in every respect in order to be effective. This is referred to as the **mirror image rule.**[10] Even if a response is labeled an acceptance, if it proposes any deviation from the terms of the original offer, it is considered a counteroffer, and a rejection of the original offer.[11] If the counteroffer is not acceptable, the original offeree cannot fall back on the original offer; the original offer need not be honored or renewed.

The mirror image rule does not apply to the sale of goods covered by the UCC.[12] The result is the sometimes difficult and confusing **battle of the forms.** When purchasing goods, a company often sends a preprinted purchase order form containing contract terms and conditions to a vendor. The vendor often responds with its preprinted order-acknowledgment form, containing terms and conditions that are almost always different from those contained in the order or offer.

Under the common law, the vendor's order-acknowledgment form is a counteroffer and the original offer is rejected. No contract would be formed. If, as is often the case, the parties fail to notice or ignore the inconsistencies in preprinted forms, and proceed with the transaction, and there is a dispute, contract law remedies would not be applicable. The parties would have to rely on the judicial doctrine of quasi-contract (discussed below) to prevent unjust enrichment.

Under the UCC, however, any definite and timely expression of acceptance will form a contract regardless of whether it contains different terms—unless acceptance is expressly made conditional on assent to the new terms.[13] Between merchants, the terms of the counteroffer become part of the contract unless:

- The offer expressly limits acceptance to the terms of the offer
- They materially alter the offer
- A notification of objection has already been given or is given within a reasonable time after notice of them is received[14]

A number of issues tend to arise: Which writing between the parties constitutes an offer and which constitutes the acceptance? Does a term proposed in a responsive communication "materially alter" the offer? And, even if the forms are so completely at odds that no written contract is formed, may conduct still form a contract[15]? The issue then becomes: What are the contract terms?

The UCC uniquely assists courts in determining provisions of contracts that are not explicitly spelled out between parties. If parties to a contract go to court to dispute something that was not explicitly spelled out in a written agreement, the court will rely upon the UCC to fill in the missing details. The UCC provides the court with what is known as gap fillers. These are reasonable provisions that are derived from the UCC and that help complete a contract. For example, if a party agrees to provide labor for $100, it may not be spelled out in the contract that U.S. currency is preferred. If a dispute arises because the second party wants to pay in Turkish Lira (a currency that devalues quickly),

MINI-CASE

A Battle of the Forms Can Result in Unwanted Contract Terms

Northrop Corporation sent out a request for proposals soliciting offers to sell Northrop, a particularly complex customized printed wire board. The request stated that any purchase would be made through a Northrop purchase order that would set forth terms and conditions that would override any inconsistent terms in the offer. Litronic had previously done business with Northrop and was familiar with Northrop's purchase order form, but nonetheless responded with an offer that was inconsistent with Northrop's purchase order form. Litronic mailed an offer to sell Northrop four boards for $19,000 apiece, to be delivered within 6 weeks. The offer contained a 90-day warranty stated to be in lieu of any other warranties and provided that the terms of the offer would take precedence over any terms proposed by the buyer. In contradistinction, the purchase order provided for a warranty that contained no time limit.

It was not until 5 or 6 months after delivery that Northrop completed testing of the boards. Finding the boards to be defective, Northrop attempted to return them. Litronic refused to accept the return of the boards, on the ground that its 90-day warranty had lapsed. Northrop's position of course was that it had an unlimited warranty, as stated in the purchase order.

Basically, the offer and acceptance contained materially different terms. There was clearly a contract (if for no other reason, by virtue of the conduct of the parties), but what were the terms of the contract? A lawsuit ensued, revolving around the applicable warranty provision. Did the contract incorporate a 90-day warranty as specified in Litronic's offer or an unlimited warranty as called for in Northrop's purchase order?

The answer was that the contract incorporated neither provision. The transaction was governed by the UCC, as enacted in the state of Illinois. In most states (including Illinois), where the offer and acceptance in a UCC transaction contain materially different terms, a contract is formed based on the terms common to both offer and acceptance, and the discrepant terms are ignored and replaced by a suitable UCC gap filler provision. Accordingly, the divergent warranty terms were both ignored and replaced with a gap filler provision to the effect that nonconforming goods may be rejected within a "reasonable" time from delivery. In this case, the court found that because of the complexity of the required testing, six months was a reasonable time in which to return the boards. Northrop prevailed, even though the warranty provision of its purchase order was discarded.

Significantly, some states (notably California) adopt a different view with respect to the treatment of terms in an acceptance that is materially different from the terms of the offer. According to that view, terms in the acceptance that are materially different from the terms of the offer are ignored. Had the California view been applicable, then Litronic would have prevailed. It was Northrop's good fortune that Illinois law, rather than California law, governed the transaction.

This is a perfect example of unintended (and perhaps serendipitous) consequences resulting from a "battle of the forms."

Source: *Northrop Corporation* versus *Litronic Industries, 29 F.3d 1173 (7th Cir., 1994)*

the first party may go to court, where the court will use gap fillers to determine the *intent* of the offer, acceptance, and consideration.

11.3.3 Acceptance

The **acceptance** is the offeree's assent to the terms of the offer. For example, if the offer to provide labor services was suitable, the party to receive the services would accept the terms. Signing a contract is one way a party may demonstrate assent. Alternatively, an offer consisting of a promise to pay someone if the latter performs certain acts that the latter would not otherwise do (such as repair a vehicle) may be accepted by the requested conduct instead of a promise to do the act. The performance of the requested act indicates objectively the party's assent to the terms of the offer.

The essential requirement is that there must be evidence that the parties had each, from an objective perspective, engaged in conduct indicating their assent. This requirement of an objective perspective is important in cases where a party claims that an offer was not accepted, taking advantage of the performance of the other party. In such cases, courts can apply the test of whether a reasonable bystander would have perceived that the party has impliedly accepted the offer by conduct.

11.3.4 Revocation of Offer or Acceptance

Occasionally, a party will attempt to revoke or retract an offer or an acceptance. If an offer is retracted before it is accepted, or acceptance retracted before it is effective, there is no contract. A revocation is effective when received.[16] An acceptance, under the mailbox rule of the common law and UCC, is effective

MINI-CASE

An Offer or Counteroffer Can Be Revoked Before It Is Accepted

The very day Ms. Miller put her property on the market, she received a written offer from Mr. Normile. The offer contained a provision to the effect that the offer "must be accepted on or before 5:00 p.m." the next day. Ms. Miller responded with a counteroffer, materially changing a number of the terms. Mr. Normile did not immediately respond to the counteroffer, but made statements to the effect that he was not sure that he could accept the modified terms and wanted to "wait a while before he decided what to do with it." In the meantime (at approximately 2:30 a.m. that night), Mr. Siegel made an offer that essentially replicated the terms of Ms. Miller's counteroffer to Mr. Normile. Later that day (at approximately 2:00 p.m.), Mr. Normile was informed that Ms. Miller's counteroffer was revoked and that the property had been sold to Mr. Siegel. After being informed of the revocation, Mr. Normile, but before the 5:00 p.m. deadline set in the original offer, delivered to Ms. Miller a written acceptance of her counteroffer, together with the earnest money required by the counteroffer. The timeline of events is shown in Exhibit 11.2.

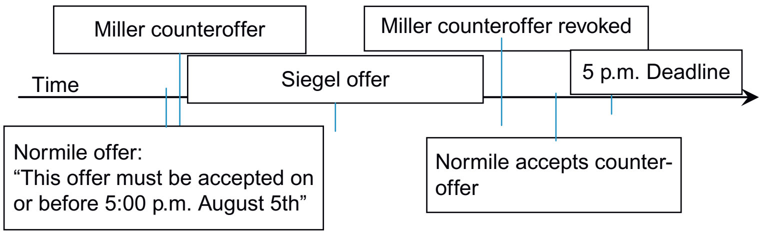

EXHIBIT 11.2
Timeline of Events.

Mr. Normile sued Ms. Miller and Mr. Siegel, seeking a court order requiring sale of the property to Mr. Normile. Mr. Normile argued that the "must be accepted on or before 5:00 p.m." the next day provision in the original offer was imported into Ms. Miller's counteroffer and, in effect, gave him an option on the property precluding revocation of the counteroffer until the 5:00 p.m. deadline.

The court disagreed. In the first place, the "must be accepted on or before" language, is not the same as language to the effect that "the offer shall be held open until" language; it was not a promise or agreement that the offer (or counteroffer) would remain open for a specified period of time. Even more significantly, Ms. Miller's counteroffer was a rejection of Mr. Normile's original offer. Accordingly, no contract was formed on the basis of the original offer. Further, there could be no contract based on Ms. Miller's counteroffer until Mr. Normile accepted it. Accordingly, the acceptance deadline in the original offer, even if imported into the counteroffer, did not create any sort of contractual obligation on Ms. Miller. A counteroffer can be revoked at any time before it is accepted, and once revoked, it cannot be accepted. Accordingly, Ms. Miller prevailed.

on dispatch.[17] Under the CISG, it is effective when it reaches the offeror.[18] If the revocation of an offer reaches the offeree after acceptance is dispatched, but before it is received by the offeror, under the UCC (and common law), the revocation is too late and a contract is formed. Under the CISG, however, there is no contract.

11.3.5 Consideration

Consideration is the bargained-for exchange of an agreement. The adequacy of consideration is irrelevant to the formation of a contract. However, in the absence of consideration, there is generally no enforceable contract. Nevertheless, in some cases, it is reasonable for a person to rely upon a promise. And, if they do so to their detriment, a legal theory known as **promissory estoppel** provides a substitute for consideration and the promise is enforceable.

11.4 DEFENSES AGAINST CONTRACT ENFORCEMENT

In order for there to be an enforceable contract, there must be mutual assent as to the terms of the agreement. Assent, however, can be negated by a **mutual mistake** as to the subject matter of the agreement.[19] If both parties are mistaken as to a basic assumption regarding the contract, the contract may be avoided. For example, assume that an antique seller has agreed to sell what was thought to be an original, 1955 vintage, Berkeley Enterprises GENIAC computer. The purchaser was only interested in buying the item because it was one of the original devices. The seller was aware of this, and received a premium price. If it is later discovered that the item was not in fact an original GENIAC, this would be a mistake of fact material to the transaction—a mutual mistake—and the purchaser would have the right to cancel (rescind) the contract.

On the other hand, a mistake on the part of only one party to a contract, that is, a **unilateral mistake,** is generally not a defense to enforcement of the contract. However, if the nonmistaken party knew or should have known of the mistake, or if it was the result of a misstatement or misleading statement by the nonmistaken party regarding a material element of the contract, the contract may be voidable. In the example given above, if the purchaser mistakenly believed the item to be an original GENIAC and the seller had no reason to know of the mistaken belief and made no representations as to the item's nature, the unilateral mistake by the purchaser would not make the contract voidable.

A contract is unenforceable if the subject matter of the agreement is against public policy or illegal. Examples include:

- Agreements in restraint of trade; for example, an overreaching employee noncompetition agreement may be unenforceable as against public policy
- Gambling contracts (in some states)
- Usurious agreements
- Agreements to commit crimes or torts

An enforceable contract also requires true consent to the terms. If the agreement is entered into as a result of undue duress or coercion, there is no true consent. If the agreement is induced by fraud, e.g., the victim was not aware that the contract was being formed; such **fraud in the inducement** negates true consent and renders the contract voidable.

Under the **statute of frauds**, in the absence of a signed writing, certain contracts are voidable. This concept is incorporated into both common law and the UCC. Significantly, there is no statute of frauds under the CISG.[20] Under the statute of frauds, the following subjects must be in writing:

- Surety contracts that are agreements to pay debt of another
- Promises in consideration of marriage (e.g., "I'll marry you if you'll pay for that surgery I want"—where still enforceable)
- Long-term interests in real property such as the purchase of real estate, mortgages, easements, and leases with the term in excess of one year
- Contracts that by their terms cannot possibly be performed within one year (e.g., five-year employment contract)
- Promises by the executor of an estate to pay the estate debts out of the executor's private funds
- Sale of goods having a value of more than a specified amount, typically $500[21]
- Certain consumer purchases

The writing need not be a formal contract, or even a single document, but must reflect the existence of a contract. The common law requires that the writing includes the identity of parties, subject matter of the agreement, essential terms of the agreement, consideration, and signature of the party against which the contract is to be enforced. Under the UCC, the writing need only be signed by the party to be charged and specify a quantity term.[22] In addition, the UCC also relaxes the signature requirement for transactions between merchants; a timely written confirmation of an existing (oral) contract that has sufficient detail to make the contract enforceable against the merchant sending the confirmation satisfies the writing requirement against the merchant receiving confirmation unless the receiving merchant objects in writing within 10 days of receipt.[23]

11.5 PERFORMANCE AND BREACH

Contracts typically spell out performance requirements for the various parties. For example, a contract to purchase a vehicle from a car dealer specifies that the car will be delivered to the buyer in good quality and in working order. The dealer must perform to these standards to meet its obligations to avoid committing a **breach**. The buyer is obligated to meet payment terms, including a down payment and future monthly payments if the vehicle is financed. **Complete performance** of all of the obligations in the contract fulfills and **discharges** the contract. Anything less than complete performance is a breach.

Essential fulfillment of the obligations but with slight variances from the exact terms, unimportant omissions, and/or minor defects that do not defeat the purpose of the contract is **substantial performance**, but still a breach. (If, in the example above, the contract called for light brown upholstery, and the dealer delivered a car with dark brown upholstery, the dealer would have substantially performed under the agreement). A significant variance from the terms of the contract is considered **inadequate performance** or **nonperformance**. A failure to provide at least substantial performance, that is, inadequate performance or nonperformance, is a **material breach**.[24] (If, in the example above, the dealer failed to deliver a car it would be a material breach). But what are the consequences of less than complete performance? The answer depends upon how close the actual performance comes to being complete and the applicable law.

With respect to UCC transactions the gravity of a breach is no issue. Under the UCC **perfect tender rule**,[25] any deviation from the terms of the agreement (e.g., nonconforming goods) is a material breach and discharges the aggrieved party from performance.

This is not the case, however, as to common law and CISG contracts. A minor breach gives rise to damages, but the aggrieved party is typically still required to perform under the contract. On the other hand, if the breach is material, the aggrieved party can not only obtain damages, but can also stop performing under the contract.[26]

Unfortunately, distinguishing between substantial performance and a material breach can sometimes be difficult. There is no bright-line rule. If the aggrieved party is mistaken with respect to the materiality of a breach and stops performance, it is itself in breach. Fortunately, this issue can be minimized by a well-drafted agreement. The contract can expressly identify certain provisions as material or can provide a right to terminate in the event of any breach (material or not) that is not cured within a reasonable specified time period (Exhibit 11.3).

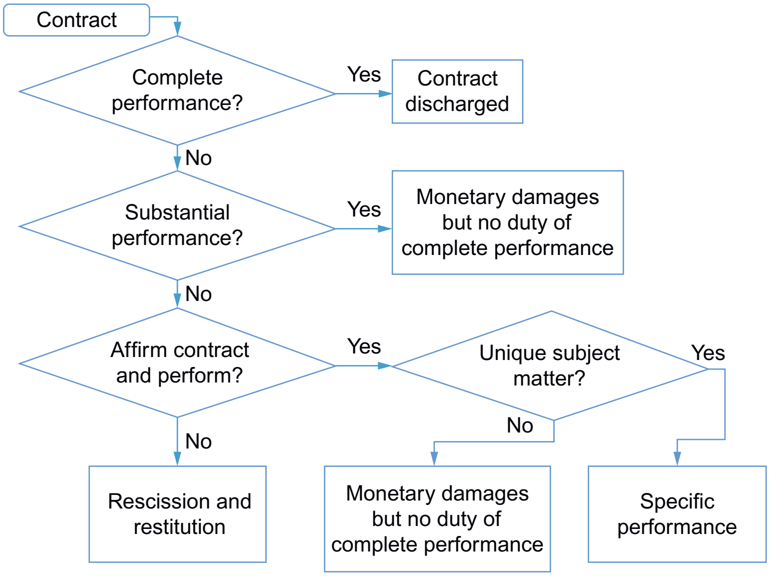

EXHIBIT 11.3
Alternative remedies available to aggrieved party in the event of breach.

11.5.1 Conditions

Performance under a contract can be made conditional on specified events or metrics. Satisfaction of a condition can be a prerequisite for a duty to arise, terminate an existing duty, or change the nature or extent of a duty. Failure to meet a condition is not a breach. Rather, the contract contemplates the possibility of the condition not being met and is carried out or terminated according to its terms.

11.5.2 Excusing Less Than Complete Performance

When one or both parties to a contract failed to provide complete performance, the parties can generally agree to discharge each other's obligations through any one of the following:

- A mutual rescission, whereby both parties are restored to the positions they were in before the contract was entered
- A substituted or amended contract, whereby the original duties are discharged and new duties imposed
- An accord and satisfaction, where a party to the contract agrees to accept a different performance in satisfaction of the existing duty
- A novation, where an amended contract substitutes a third party for one of the original parties to the contract

Occasionally, after an agreement has been entered into, something will occur that renders performance either improper or impossible. In such extraordinary circumstances, the duty to perform will be excused. For instance, if the subject matter of an agreement was legal when the contract was formed, but becomes illegal at a later time, failure to perform is excused.

Circumstances that make performance more difficult or burdensome, however, will typically not excuse contractual duties. However, under a **commercial impracticability test** adopted by many states and the UCC and CISG, performance by a party is excused if it is rendered impracticable by an event that is:

1. Beyond the control of the party
2. Not reasonably foreseeable by the party
3. Contradicts a mutual assumption on which the contract was based

Commercial impracticability requires more than just unexpected hardship or increased cost. It requires extreme and unreasonable difficulty or expense caused by an unforeseeable supervening event. The concept of commercial impracticability is often explicitly written into contracts. Such a provision is often referred to as a **force majeure** clause. Alternatively, an agreement can explicitly call for a party to assume the risk that a certain event may occur, in which case commercial impracticability would not excuse nonperformance.

11.5.3 Damages

In general, the aggrieved party is entitled to all damages that it can show were actually caused by a breach of the contract, as long as the damages were reasonably foreseeable at the time the parties entered into the contract, and are sufficiently certain so as not to be "speculative."[27] Damages arising out of a breach of contract are typically either in the form of compensatory damages or reliance damages. **Punitive damages** are typically not available in breach of contract cases.

Compensatory damages place the injured party in the position it would have been in had there been complete performance under the contract.[28] This includes:

- The loss of value (the difference between the value of the benefits that would have been received and those actually received) less any savings experienced from being excused from any obligations under the contract (the benefit of the bargain)
- Incidental damages directly resulting from the breach (e.g., costs of obtaining substitute performance)
- Consequential damages, also sometimes referred to as "special damages," which include any other damages or losses actually caused by the breach, as long as they are reasonably foreseeable; agreement terms can make clear that certain types of losses are foreseeable

Reliance damages are an alternative to compensatory damages, intended to place the nonbreaching party in the position it would have been in had the contract never been formed. Typical elements include expenses incurred in preparing for, and performing under, the agreement and lost opportunities.

In general, there is a duty to mitigate damages. Damages that could have been avoided with reasonable effort and without undue risk or burden cannot be recovered.[29] The particular acts required to mitigate damages depend upon the circumstances. For example, an aggrieved buyer of goods must **cover** by purchasing substitute goods at a reasonable rate and without unreasonable delay or is foreclosed from receiving any consequential damages that would have been prevented.[30]

Commercial contracts often include provisions purporting to limit liability. Contractual limitation of liability can allocate risk between the parties and be reflected in the consideration paid. If the party limiting liability assumes less risk, the price paid by the other party would be proportionately decreased. The provision thus permits lower charges. This is, of course, totally inapplicable to contracts of adhesion. In general, limitations on liability are not favored by the courts.

11.5.3.1 Rescission and Restitution

Rescission means, in effect, to undo a contract. **Restitution** means to return to the aggrieved party benefits that were unjustly conferred upon another. The aggrieved party is placed in the position it would have been in had the transaction never taken place. Rescission and/or restitution are available:

- As an alternative remedy for a party injured by material breach[31]
- To a party that breaches after partial performance for any benefit conferred in excess of the loss caused by the breach[32]
- When there has been a fault in the formation of a contract or it is otherwise unenforceable or voidable[33]

Restitution may also be pursued in situations where damages are difficult or impossible to prove and to recover specific property.

11.5.3.2 Specific Performance

When monetary damages are inadequate to compensate an aggrieved party, a court may order the breaching party to completely perform under the contract. This is called **specific performance**.[34] For example, money damages are inadequate where the subject matter of the contract is rare or unique (e.g., land or fine art). Under common law, and the UCC, specific performance is not available unless monetary damages are inadequate. However, the parties in international sales transactions under the CISG may obtain specific performance anytime there is a material (fundamental) breach, as long as they have not already resorted to an inconsistent remedy.[35]

11.5.3.3 Quasi-Contract

Even in the absence of an enforceable agreement, a court may construct a fictional contract—a **quasi-contract**—to prevent unjust enrichment. Quasi-contractual recovery is applicable when a party has partially performed in the mistaken belief that a contract had been formed or under a contract that is unenforceable. It permits the party to recover the reasonable value of the partial performance.

11.5.3.4 Reformation

In some cases, a written agreement will not accurately reflect the intentions of the parties. This most often occurs when there has been an error in documentation, a fraud, misrepresentation, or mutual mistake. In those cases, the equitable remedy of **reformation** is employed by the court to effectively rewrite the contract to reflect the actual intentions of the parties.

In other instances, a particular provision of an agreement may be void or unenforceable as **unconscionable**, against public policy, or illegal (due to a change in the law) if interpreted literally. When that occurs, the courts in various jurisdictions will take one of three approaches: (1) hold the entire agreement unenforceable; (2) delete the offending provision and enforce the remainder of the agreement; or (3) effectively rewrite the offending agreement, so that it is valid and enforceable.[36] In some instances, courts can be directed as to which approach to take by an appropriate provision in the contract.

11.6 ANATOMY OF A CONTRACT

Written contracts can take many forms and adopt many formats. As discussed earlier, an enforceable contract can be found even in the absence of a written agreement. However, a comprehensive written agreement can be a tool to ensure good relationships between participants. In this section, we will examine the general structure of a typical negotiated written agreement, and consider the significance of some of the typical provisions. For purposes of illustration, we will refer to a sample development agreement included as Appendix III.

11.6.1 Preamble

The preamble is a vehicle for identifying the parties, establishing the effective date of the agreement and, in many instances, for denominating the agreement for identification purposes.

11.6.2 Recitals

Recitals are a vehicle for ensuring a complete understanding of the party's respective expectations and memorializing any relevant background information and extrinsic considerations. Recitals preferably cover a range of considerations, including:

- Related agreements
- Any third party (3dP, in the example) that may play a role in the performance or that may be a beneficiary
- The relationship between the parties
- The basic premise of the agreement and expectations of the parties
- Any facts or circumstances relevant to the possibility of particular damages (and establishing that such damages were foreseeable)

In the example in Appendix III, the recitals establish that:

- Developer knew one of the reasons that the company engaged it to do the development work under the agreement was that the company understood developer to have special expertise in the subject matter of the agreement. (If the developer did not have that special expertise, it could not be a unilateral mistake on the part of the company).
- Developer's failure to perform under the agreement would cause the company to breach various third party agreements. (Ensuring that the damages resulting from reaching the third party agreements are foreseen and thus recoverable, consequential damages in the event of a breach by developer.)
- A confidentiality agreement exists between the company and 3dP pertaining to some of the information that will be provided to the developer.
- Developer is aware that confidentiality is a significant concern to the company and that an obligation of confidentiality on the part of developer was a prerequisite to the engagement.

11.6.3 Definitions

A well-written agreement will include a definition for each term used that could conceivably be misunderstood. In complex agreements, these definitions are typically included as a separate section either at the beginning or end of the agreement. However, in shorter, simpler agreements, the definitions may be provided in the body of the agreement, as the terms are introduced in context. By convention, defined terms are typically designated within the text of the agreement by capitalization. Explicit definitions are particularly important in international transactions where there are cultural and language differences.

11.6.4 Performance

The provisions of an agreement relating to performance by the parties vary greatly depending upon the subject matter of the agreement. In any event, it is extremely important that all expectations be explicitly reflected in the provisions. A simple rule of thumb: if a detail is not explicitly recited in the agreement, do not expect it to happen.

All deliverables should be precisely and completely defined, including all details that are significant to the parties. Deliverables can be described integrally with the performance events, or in separate provisions. Such descriptions are often provided by reference to a specification or documentation. This is the case in the agreement of Appendix III (see Paragraph 1.1, and Schedule 1, although, examples of the appended documentation are not included in the Exhibit). In fact, as illustrated in Appendix III, one of the initial deliverables can be a specification and development schedule for subsequent deliverables (See Schedule 2 Performance Schedule, Phase 1).

Conditions and contingencies are frequently built into the performance provisions. Use of relative timing (e.g., "Developer will deliver a prototype within 30 days of receiving the specification") rather than absolute dates can be used to expressly make performance conditional on the performance of the other party.

There are myriad ways to specify the performance of the parties. Each performance event can be described with particularity in successive provisions. In the case of the contract of Appendix III performance is defined using a "Performance Schedule" (Paragraph 2.1 and Schedule 2). In a situation where there is considerable interaction between the parties, a performance matrix can be a useful organizational tool, particularly when used in conjunction with a separate detailed description of deliverables. The "Performance Schedule" in Appendix III illustrates a skeletal generic performance matrix. Respective columns are provided for event timing and actions by each of the parties. Each sequential performance event is represented by a successive row. Details with respect to particular performance events can be particularized in the text of the agreement if not clear from the matrix. Please note that Appendix III omits a number of provisions that are often in development agreements: many of the particulars with respect to the cooperation and communications between the parties; specifics as to the expected features of the deliverables, and so on.

11.6.5 Intellectual Property

If performance under the agreement is likely to result in the development of IP, the issue should be dealt with explicitly in the agreement. Ownership of IP resulting from performance under an agreement tends to be highly negotiated. Some considerations include:

- Is the purpose of the contract to develop the IP or is the development ancillary to performance?
- Is the "preexisting" IP of one party being used as the basis for development of the new IP?

- Was the preexisting IP maintained as a trade secret to which the other party would not have access but for the agreement?
- Is the development effort entirely by one party or is it a cooperative effort?
- Is the originator of the new IP being fully compensated for its contribution to the development effort?

It should be recalled that in the absence of an express contractual provision, where independent parties are involved, irrespective of which party pays for development, whichever party actually creates the IP will own it. The circumstances of the agreement may give rise to an implied **license** to use the IP, but it is not good practice to leave the existence and scope of a license to the courts.

Transfers of rights in IP are typically in the form of an **assignment** or a grant of a license. Such transfers are encountered in, for example, agreements setting up a business venture, agreements between a company and its employees, and development/consulting, manufacturing, licensing, technical assistance, joint venture, distributorship, and marketing agreements.

The sample development agreement in Appendix III specifically contemplates the creation of IP during the development process. The developer is required to assign new technology or IP resulting from performance under the agreement ("resultant IP," Paragraph 4.1) to the company, but retains ownership to its preexisting technology. No third party technology or developer's preexisting technology (or any unassigned technology or IP) can be incorporated into the deliverables, unless it is specifically identified (Paragraphs 4.2.1 and 4.2.2) and the company granted a license (of clearly defined scope) to use it (Paragraph 4.3).

It is particularly important that any third party technology, especially software, to be incorporated into the deliverables is identified during the negotiation process. A determination can then be made whether use of the third party technology is acceptable, and if it is, whether or not any necessary licenses from the third parties can be obtained under acceptable terms. Acceptable terms may not always be available, and substitution of other third party technology may sometimes be required. For example, the terms of certain of the prevalent licenses for open source software can have significant repercussions with respect to the ability to maintain exclusivity of certain IP and are not appropriate in some situations.

11.6.6 Consideration

The provisions in an agreement relating to consideration can take a wide variety of forms. In many cases, the consideration is simply a single lump sum payment. In other cases, payment is tied to a milestone. Where a performance matrix is employed, as in Appendix III, such payments are simply reflected as performance events. Other agreements, such as license agreements and distribution agreements, may call for periodic payments, the amounts of which vary on the basis of the marketplace performance, for example, sales of a product. Such agreements might call for quarterly royalty payments or commission payments, in an amount equal to a percentage of gross sales. In those cases, provisions particularizing the computation of the payments, as well as maintenance of accounting records, reporting, and audits of the records, are typically included in the agreement.

11.6.7 Representations and Warranties

Representations are, in essence, a statement of facts relied upon by the parties in entering the agreement. **Warranties** are, in effect, a promise that a product, service, or aspect of performance will meet certain standards or metrics, or do certain things. In many agreements, representations and warranties will be combined ("Developer represents and warrants that …") so that the statement is both a representation upon which the other party relied and a promise.

Representations and warranties are a vehicle for ensuring that the expectations of the parties are understood and met. If something is important to a party, inclusion of a representation or warranty on that point can ensure that there is no misunderstanding as to the party's expectations. The breach of a representation or warranty is also readily made an event that would trigger a right to terminate. Representations are often provided with respect to:

- Authority to enter into the agreement without any third party consents
- The expertise of the parties
- Staffing level to be dedicated to the project
- Level of efforts to go into performance (e.g., "best efforts" or "reasonable commercial efforts")
- Novelty, confidentiality, and/or originality of deliverables
- Absence of pending or threatened claims or proceedings relating to the subject matter of the contract
- Absence of conflicting agreements
- Trade secret status of aspects of the licensed subject matter
- Quality, functionality, and performance characteristics of deliverables
- Completeness and/or accuracy of information provided to the other party

In Appendix III, representations and warranties are provided in Section 5. Representations and warranties may be absolute or qualified. When an exhaustive investigation would be required in order to make a representation, a party can qualify the representation by limiting it to their personal knowledge (e.g., "To the best of Developer's knowledge, the deliverables do not infringe any third party patents").

Warranties that are explicitly stated in the agreement are referred to as **express warranties**. The terms of express warranties are totally in control of the parties.

However, certain other warranties may be implied by law unless explicitly and conspicuously disclaimed in the agreement.[37] In contracts involving goods, both the UCC and the CISG provide for a number of implied warranties, including a:

- Warranty of noninfringement: that the goods sold do not infringe the IP rights of any third party[38]
- Warranty of merchantability: that the product is fit for the ordinary purposes for which it is used[39]
- Warranty of fitness for a particular purpose: that the product is fit for the particular purpose of the buyer[40]

The scope of these **implied warranties** is left open to interpretation of the courts. The better practice is to disclaim the implied warranties and provide express warranties that clearly specify the rights and obligations of the parties.

11.6.8 Indemnity

An **indemnity**, also sometimes referred to as a hold-harmless, is another mechanism for allocating risk between the parties. The indemnitor is obligated to pay for loss or damages incurred by the indemnitee if certain specified events occur. A typical indemnity provision shifts liability to the party who is likely to be more actively or primarily responsible for the events giving rise to the liability. However, negligence or fault is not necessarily a prerequisite for coverage.

For example, indemnifications by the party supplying technology in connection with an agreement against infringement of third-party IP rights are common. The scope of IP indemnifications can vary greatly depending upon the terms of the provision. Frequent areas of negotiation include:

- Choice and participation of counsel and control of litigation
- Reimbursement for attorneys' fees
- Infringement not solely due to the deliverables from the indemnitor, that is, by virtue of additions, modifications, or combinations not provided by the indemnitor
- Remedies in the event of an injunction

An indemnification provision is often used instead of a representation or warranty when the subject matter of the indemnity is beyond the knowledge of the parties. If an event renders a representation false, there is a breach giving rise to liability and perhaps excusing further performance by the nonbreaching party. If, on the other hand, the same event triggered an indemnification, essentially the same liability would accrue, but there would be no breach; the contract simply proceeds according to its terms.

11.6.9 Term and Termination

The **term** of the contract refers to the length of time it remains actively applicable to the parties. When performance involves a single discrete transaction, such as the purchase of goods or the assignment of IP, the duties under the agreement are discharged when the transaction is completed. However, many contracts involve a continuing right or duty, or a series of transactions. In those cases, the term of the agreement should be explicitly stated.

KEY POINT

The Term of an Agreement

There are a number of different approaches to establishing the term of an agreement. The term of an agreement can be:

- For a stated period of time (e.g., "the term shall be for a period of 1 year from the date of this agreement")
- For consecutive periods of stated duration, automatically renewed unless terminated (e.g., "If not earlier terminated, this agreement shall have an initial term of 5 years after the effective date and shall be automatically renewed for successive one-year periods thereafter. Either party may terminate this agreement at or after the end of such initial term upon 90 days written notice.")
- For an indefinite period, but terminable by one or both parties upon the occurrence of specified events ("The term of this agreement shall commence upon the effective date and shall continue until terminated pursuant to this paragraph. This agreement may be terminated: (i) by either party, upon 30 days written notice, at any time after the second anniversary of the effective date; …")

When a contract applies to an indefinite period, the termination trigger events are often crafted to establish an initial period during which the agreement can be terminated only in the event of a breach or failure of condition. Thereafter, the agreement can be terminated by one or both parties upon notice to the other. Termination is typically effected by a written notice, although termination is often not effective until the lapse of a specified time period after the notice.

Certain types of rights and obligations would not be particularly effective if they were terminated or discharged at the same time as the other aspects of an agreement. Confidentiality and indemnification provisions often fall within this category. It is not uncommon for an agreement to expressly state that designated provisions will survive termination of the agreement. (See Appendix III, Paragraph 8)

11.6.10 Miscellaneous Provisions

So-called **boilerplate** provisions typically address various issues of law that are ancillary to actual performance of the agreement. These issues tend to recur in many types of agreements, and over the years, standardized language, the boilerplate, covering the issues has been developed. The issues include:

- Notices: The manner in which formal notices under the contract are to be made
- Waiver: The failure to enforce a right in one instance not constituting a waiver preventing enforcement emulator instances
- Applicable law: Specifying the body of law under which the contract will be interpreted
- Dispute resolution processes: Admission of jurisdiction/exclusive jurisdiction, forum selection,[41] arbitration, mediation
- Integration: Precluding reference to communications not incorporated into the written agreement
- Severability/reformation: Treatment of an enforceable provision
- Assignment: Whether or not assignment of rights and/or delegation of duties are permitted, and any limitations; in the absence of contractual provisions to the contrary, with the exception of personal services, contractual rights can be assigned and duties delegated[42]
- Force majeure: Performance excused if made impracticable by forces outside of the control of the party
- Relationship of the parties: Agreement not creating partnership

11.7 TYPES OF AGREEMENTS ENCOUNTERED

Over its life, a technology venture is likely to encounter a number of different types of agreements. This section will introduce some of the commonly encountered agreements.

11.7.1 Operating Agreements

When a business entity is formed, an operating agreement between the principals is desirable, if not necessary. This is particularly true when the business entity is formed to implement a joint venture between separate business entities. A partnership agreement, Limited Liability Company (LLC) operating agreement, or corporate shareholder's agreement permits the principals to define the internal rules under which the venture will operate and directly or indirectly assign management responsibilities. We discussed these topics in more detail in Chapter 6.

There are limits to the extent to which management can be separated from stock ownership in a corporation, particularly S-corporations. However, a shareholder's agreement can require individual shareholders to vote their stock for particular board members, thus effectively defining the management structure. Partnership agreements and LLC operating agreements are also vehicles for defining how profits and losses will be allocated among the principals. Other considerations often addressed in these agreements include:

- Any special powers to be given to the management
- Contributions of IP by the principals, such as licenses to the venture
- Ownership and use of IP
- Confidentiality
- Services to be rendered on behalf of the venture by individual participants
- Compensation, if any, to principals for services provided to or work done on behalf of the venture
- Transfer restrictions on ownership interests
- Vesting schedules
- Exit procedures, such as repurchase and buy-sell arrangements and processes for dissolution and winding up
- Rights and obligations with respect to further financings and issuance of additional equity interests, such as antidilution provisions and capital contribution provisions
- Indemnifications of the individual principals for actions taken on behalf of the venture
- Special tax allocations

11.7.2 Employment Agreements

Agreements with employees are often essential to obtaining and maintaining rights in IP. In general, such agreements typically require each employee to assign to the company all rights to any IP that relates to the company's business created by the employee during the term of employment. In the absence of provisions in a written agreement to the contrary, the allocation of rights to any inventions made by the employee will depend upon whether the employee was "hired to invent" and when and where the invention was made. The agreement typically also defines an obligation of confidentiality. In some cases, where the employee has access to particularly sensitive information or it is particularly likely that the employee will use proprietary information in connection with other employment, a noncompete provision (discussed below) may be included. Appendix IV provides an example of an employment agreement.

11.7.3 Noncompete Agreements

In the sale of a business, or where particularly critical confidential information is involved, or when an employee is in a crucial position, noncompetition provisions may be appropriate. Noncompetition provisions tend to be very strictly construed and are typically unenforceable if they are not reasonable in scope as to geography, time, and precluded activities. Paragraphs 10 and 11 in

Appendix IV are examples of noncompete provisions premised on maintaining confidentiality.

In other instances where the primary purpose of a noncompetition provision is to prevent the appropriation of the goodwill of the company, by, for example, the sellers of a business or an employee that has been put in a position to establish relationships with customers of the business, the precluded activities tend to be limited to any number of the following:

- A specific geographic area and specific types of positions
- Contact with customers of the employer/sold business
- Certain channels of trade

11.7.4 Confidentiality Agreements

A confidentiality agreement, sometimes also referred to as a nondisclosure agreement (NDA), should be in place before any third party is given access to proprietary know-how outside of the context of a broader agreement already including confidentiality provisions. The NDA precludes disclosure and also limits the use of the information by the recipient to a specific purpose in connection with the business relationship between the parties. The need for written confidentiality agreements in order to establish an obligation of confidentiality to maintain trade secret status of information was discussed in Chapter 5. An example of a generic confidentiality agreement is provided in Appendix I.

In some situations, it is difficult to obtain an executed NDA. For example, in instances where a proposal is being pitched to, a prospective investor who is unfamiliar with the subject matter of the proposal or not yet sure that they are interested in pursuing the proposal, they are likely to be reluctant to take on an obligation of confidentiality.

KEY POINT

Sanitizing the Disclosure as an Alternative to an NDA

Rather than relying on an NDA, technology entrepreneurs can excise sensitive information from the documents they share with potential investors. According to former venture capitalist George Lipper, "The perfect business plan is one that gets mouths watering without giving up the secret sauce."[43]

Some confidentiality agreements impose an obligation of confidentiality for a specified time period. The confidential status of anything disclosed under the agreement is lost at the end of that time period. The time period is typically triggered by disclosure of the confidential information. However, in some NDAs, the obligation runs from the effective date of the agreement irrespective of when the information was disclosed during the course of the agreement. In either case, the time period is arbitrary as it relates to the actual confidentiality of the information. A much better approach is to require confidentiality to be observed with respect to information until such time as the information falls within one of the exclusions to confidentiality status (see Appendix I, Paragraph 4, Appendix III, Paragraph 1.3 and Appendix IV, paragraph 6). This avoids placing an artificial lifetime on confidential status.

11.7.5 Consulting and Development Agreements

In a **consulting agreement**, a consultant (non-employee) is engaged to apply a particular expertise on behalf of the hiring company. The consulting agreement may relate to a particular project or may be more open ended, with the consultant available for any issue involving the consultant's expertise.

A **development agreement** is sometimes considered a species of consulting agreement that specifically contemplates that the consultant will create IP. In many cases, the developer is not intimately involved with the operation of the hiring company and may work on a largely independent basis. A development agreement calling for all IP resulting from the agreement to belong to the hiring company is sometimes referred to as a work-for-hire agreement.

Depending upon the nature and subject matter of the engagement, the agreement may also include provisions precluding the consultant from providing similar services to competitors during the term of the engagement and for a reasonable period after the termination of the agreement. A sample development agreement is provided in Appendix III.

11.7.6 Maintenance and Support Agreements

Maintenance and support agreements cover a wide variety of circumstances, but are most commonly encountered in connection with software products. The agreements often involve the provision of updates and error correction of licensed software. Some of the issues that are commonly addressed in maintenance and support agreements are:

- Ownership of, and the rights of the customer to, new developments
- Availability of updates or error corrections
- Representations by the service persons pertaining to the software
- Criticality of "bugs" and required response times
- The amount and nature of support to be provided

11.7.7 Manufacturing Agreements

Under a **manufacturing agreement**, a company hires a another entity (manufacturer) to manufacture an item according to certain specifications. The arrangement often involves communication of confidential information (e.g., the specification). Appropriate confidentiality provisions and, in some cases, restricted licenses under other types of IP (e.g., patents and know-how) are then included in the agreement. Other areas often addressed in manufacturing agreements include:

- Ordering and delivery procedures
- Quality control and approval procedures
- Ownership of molds and tooling
- Ownership of IP arising out of the agreement
- Representations and warranties as to quality
- Whether or not subcontracting is permitted
- Noncompetition provisions that restrict the manufacturer from manufacturing similar items for competitors or that restricts itself from becoming a competitor

11.7.8 Assignment Agreements

An **assignment agreement** is a document that transfers title to specified IP rights. In most instances, to be effective with respect to a patent, copyright, or trademark, an assignment must be recorded with the patent and trademark or copyright office. In general, there should be a recorded assignment with respect to each patent owned by a company and with respect to each copyright or trademark acquired from outside of the company.

11.7.9 License Agreements

In a **license agreement**, the licensor grants to the licensee certain rights with respect to IP of the licensor. A license is to be distinguished from a sale or an assignment in which substantially all commercial rights and title to the IP are transferred to the assignee. In the case of a license, the licensor retains title to the IP.

Exclusive rights to use IP are the primary sources of competitive advantage in the marketplace (see Chapter 5). Yet, there are a number of reasons why you, as a business venture, might permit others to use your IP. One obvious reason is obtaining a royalty income in consideration for use of the IP. This is particularly so when you are not presently using the technology or are unable or unwilling to meet the demand for products using the IP. For example, you may lack the capital to expand your production facilities or may have other priorities. It may not be practical or economical for you to export product into a particular geographical area or to establish your own manufacturing facilities in that area. Or, you may not have the resources or contacts to develop a necessary distribution system in the area.

Other reasons for licensing IP are not necessarily obvious. For example, having an additional source for a product may increase its market acceptance. In other instances, you might be using the licensed product as a part in another product or sell the licensed product as part of an overall line of products, but find it uneconomical or impractical to manufacture the licensed product yourself. The fact that the product might also be available to your competitors is offset by the compensation paid to you by the licensee.

In other instances, licensing a local entity in a given geographical area to manufacture one product may create a market in that geographical area, or at least increase market acceptance, for others of your products.

The consideration for a license is often a license fee, typically referred to as a **royalty**. The fee can be a single up-front payment, but is often in the form of periodic royalty payments. The periodic royalty payments can be determined upon any number of bases, such as:

- A percentage of a designated royalty base (e.g., gross sales of products employing licensed IP)
- A fixed per-unit fee
- A percentage of savings through use of the licensed IP

The license may also be made conditional upon meeting specified milestones or performance requirements. Milestones can include such things as resources devoted, promotional expenditures, staffing, facilities, and product introduction. Performance requirements could relate to such things as sales level and market penetration. Generally, the conditions are reflected as termination provisions in the agreement.

License agreements often grant rights with respect to more than one type of IP. In many cases, a licensee may be granted rights with respect to both patented technology and unpatented know-how. Many of such licenses also will include a license to use (and sometimes a requirement to use) the licensor's trademark.

11.7.9.1 Patent Licenses

Under a **patent license**, the licensor agrees not to enforce the patent (or certain claims of the patent) against the licensee with respect to certain acts that would otherwise be precluded by the licensor's patent, typically making, using, or selling processes or products covered by the patent. It may be no more than a covenant not to enforce the patent, or it may be coupled with a transfer of know-how or technical assistance. Essentially all countries that have patent systems in place recognize patent licenses.

11.7.9.2 Know-How Licenses

Under a **know-how license**, the licensor permits the licensee to have access to, and use, the licensed know-how. The know-how may be proprietary or non-proprietary. If proprietary know-how is involved, the agreement would include nondisclosure provisions and, typically, provisions restricting the manner in which the know-how can be used. Such provisions are necessary to protect the licensor's proprietary interest in the know-how. Other subjects that tend to be addressed in know-how licenses include:

- The particular mechanism for transferring the know-how
- The nature of deliverables
- A time schedule for the transfer
- The amount and type of technical assistance

11.7.9.3 Trademark Licenses

Under a **trademark license**, the trademark owner permits the licensee to employ the licensed trademark in connection with the licensee's goods or services. It permits the licensee to take advantage of the goodwill associated with the trademark. At the same time, presupposing that the agreement includes the appropriate provisions, the licensor expands its goodwill through, and generates revenue from, the licensee's efforts. Trademark licensing is recognized under the laws of most, but not all, countries. In most instances, however, in order for the trademark owner to retain rights in the mark, the trademark owner must maintain careful quality control over the products of the licensee with which the mark is used.

11.7.9.4 Franchise Agreements

A **franchise agreement** is a specie of license agreement that establishes a close, ongoing relationship between the franchisor and franchisee. Very often, the franchise agreement relates to a turn-key business, including trademark know-how and, sometimes, patent licenses and technical assistance. The franchisor grants the franchisee a license to replicate the business and provides them with the know-how and often other resources to do so. The franchisee then builds a business—that they own—modeled on the successful characteristics of the franchise. The net result is that, as far as the consuming public is concerned, the franchisee is the alter ego of the franchisor.

While franchises tend to be more prevalent for low technology ventures, a number of technology entrepreneurs have successfully leveraged their ventures through franchising. These include franchises in a number of different technologies, including technology consulting; computer products, wireless electronics, Internet marketing, video games, and ink and toner printer cartridges; photo, video, and web services; IT services; digital document storage; cell phone and wireless device accessories; technology education; technology consulting; computer and electronics repairs, services, and sales; and Internet services.

On the other hand, entrepreneurs tend not to be happy as franchisees; a franchisee is working to advance the franchisor's idea, not their own, and must abide by a set of rules standards and controls set by the franchisor. Franchise agreements are closely regulated throughout the United States and in many countries.

11.7.9.5 Technical Services Agreements

Technical assistance or technical services agreements are, in general, hybrid consulting–know-how agreements relating to provisions of know-how, instruction, and training to the receiving party. Proprietary or nonproprietary know-how, or both, may be involved. For example, an entity with special expertise may be engaged to assist in implementing or installing an equipment plant or process and to instruct and train the contracting party in the operation and management of the plant or process.

11.7.9.6 Distribution Agreements

In a **distribution agreement**, the owner of a product (manufacturer and developer) engages a distributor to market the product in substantially unmodified form. In some instances, the distributor may install, service, or customize the product for an end user. Issues often arise with respect to:

- The extent to which, if at all, the distributor is licensed to use the owner's IP internally
- The extent to which, if at all, the distributor is permitted to use the manufacturer/developer's trademarks
- The allocation of risk of liability for infringement of third-party IP rights

In addition, when the product is predominantly software, the distributor agreement typically specifies the manner in which the software is to be marketed by the distributor to the end user. Alternatives include: selling a copy of the software to the end user; acting as an agent for the developer company; acting as a broker for an end-user license agreement between the developer company and the end user; or entering into a sublicense agreement (with specified terms) with the end user. The agreement also typically specifies the origin of copies of software that will be delivered to the end user, for example, provided by the proprietor on an as-ordered basis, provided from an inventory maintained by the distributor, or made by the distributor on an as-needed basis from a “master copy” provided by the proprietor.

11.7.9.7 Value-Added Reseller and Original Equipment Manufacturer Agreements

Value-added reseller (VAR) and **original equipment manufacturer** (OEM) agreements are utilized to permit the VAR or OEM to market the technology or product as part of an overall system or product. OEM and VAR agreements are often distinguished by the extent to which the supplied technology or product retains its separate identity. Where the supplied product is a separate module identified to, or identifiable by, the end user, the agreement is typically characterized as a VAR agreement. Conversely, under an OEM agreement, the supplied technology or product tends to lose its separate identity and becomes an integral part of a product marketed under the OEM's name.

Many of the same IP and compliance issues arise with OEM and VAR agreements that arise with distribution agreements. The agreement, if competently drafted, will also include provisions allocating risks of liability with respect to defects in the products and provisions relating to the infringement of third-party IP rights. Such provisions are particularly significant in VAR and OEM agreements, and even more so where the VAR or OEM is permitted to modify the supplied product. Indemnity provisions often make the owner liable to infringement claims as to unmodified product, and run to his or her benefit to the extent that infringement claims relate to modifications of the product by the VAR or OEM.

11.7.9.8 Purchase Agreements

In general, a **purchase agreement** is an agreement under which a vendor (supplier) transfers the title to a product to a purchaser (customer). The UCC and/or CISG are typically applicable to purchase agreements, and terms of the purchase agreement are often established by preprinted forms: purchase order and order-acknowledgement or confirmation forms. Issues tend to arise as to the precise terms of the agreement when the terms in the purchase order conflict with those of the confirmation or acknowledgment form. This is the "battle of the forms" discussed earlier.

11.8 CHAPTER SUMMARY

This chapter has explored in detail both the legal underpinning for contracts and some of the many different types of contracts that technology ventures may encounter. In general, a contract between respective parties serves to define the rights and obligations of the parties and/or the rules under which they operate for the duration of the contract. Within broad legal limits, the parties are free to agree upon whatever terms they see fit. Inadvertently creating a contract, or failing to form a valid contract when a contract is intended, can be catastrophic to a business.

There are various sources of contract law, and it is important to identify which body of law will control the transaction. The common law—the multifarious precedential decisions that have been handed down by judges at all levels for decades—provides the basic foundation, and, in general, still governs contracts other than those for the sale of goods. Where the sale of goods is involved, either the UCC—one form or another of which has been adopted in essentially all of the United States—or the United Nations Convention on CISG will control. In many cases the particular law that applies can make a difference in whether or not a contract exists, and if so, the terms of that agreement.

In general, contract formation requires the basic ingredients of offer, acceptance, and consideration. The offer is a proposal, an attempt, by an offeror directed to an offeree, to initiate a meeting of minds. In order for a proposal to qualify as an offer it must meet certain requirements, for example, identify the offeree, be unconditional, and establish the essential terms of the proposed agreement.

The offeree's response to an offer determines whether or not a contract is formed. If the offeree unequivocally accepts all of the terms of the offer a contract is formed on those terms. Conversely, if the offeree unequivocally and totally rejects the offer, no contract is formed. However, the response to an offer is often a counteroffer, a proposal that the parties go forward on terms different than those of the original offer. Whether or not the counteroffer results in formation of a contract, and if so, the terms of the contract, depend upon the applicable law. Under the common law, and the CISG, no contract is formed unless the acceptance mirrors the offer—unequivocal acceptance of all of the terms of the offer, without any additional terms. However, that is not the case under the UCC, often resulting in the so-called battle of the forms where a contract is formed, but the particular terms of the contract can require considerable analysis. The other necessary ingredient for a contract is consideration—an exchange of something of value—that signifies a transaction has occurred.

This chapter also explored various defenses against contract enforcement. For example, if there was a mutual mistake—both parties were mistaken—as to a basic assumption regarding the contract, the contract can be avoided. Likewise, if it can be shown that one party caused the other party to be mistaken, or knew the other party was mistaken, the mistaken party can avoid the contract. However, a unilateral mistake, strictly by one party, where the other party is not at fault, does not make a contract voidable. A contract is also unenforceable if its subject matter is illegal or against public policy, consent was provided under duress or as a result of fraud, or, with respect to certain types of agreements, it is not in writing.

Once a contract is formed, the parties must perform according to the terms of the contract. Failure to completely perform is a breach. The consequences of a breach (and whether or not the nonbreaching party can cease performance under the contract) depend upon the terms of the contract (which can dictate the consequences), the severity of the breach, and the applicable law.

A comprehensive written agreement can be a tool to avoid misunderstandings and ensure good relationships between participants. Terminology should be carefully and precisely defined, and all items of importance to the parties should be explicitly and unambiguously stated in the agreement. An attempt should be made to deal with all contingencies. Addressing future problems does not imply any particular expectation that the problems will arise, nor does a complete and unambiguous contract imply lack of trust. A comprehensive written agreement goes a long way to ensure that the parties have a complete understanding of each other's expectations. A minimalist agreement, on the other hand, leaves too much room for misunderstanding.

While contracts can take many forms and adopt many formats, there is a common anatomy to most contracts. We examined the general structure of a typical negotiated written agreement and considered the significance of some of the typical provisions, with context provided by the sample agreements of Appendix III and IV. We also reviewed some of the types of agreements commonly encountered by technology entrepreneurs. These discussions should give you the basic grounding in contracts necessary to be a successful technology entrepreneur.

KEYTERMS

Acceptance An unqualified expression of assent to the terms of an offer.

Assignment Transfer of all rights, essentially a sale.

Assignment agreement An agreement transferring title to specified intellectual property rights from the assignor to an assignee.

Boilerplate Standard provisions that address issues of law ancillary to actual performance of the agreement.

Breach An unexcused failure to perform in accordance with the terms of a contract.

Contracts for the International Sale of Goods (CISG) A UN-sponsored multilateral convention establishing rules applying to the sale of **goods** between parties in different CISG countries.

Commercial impracticability The legal doctrine whereby performance under a contract is excused where an unexpected event, for which risk is not assigned by the contract (or custom), makes performance extremely and unreasonably difficult or expensive.

Compensatory damages A sum of money intended to place the aggrieved party in the position it would have been in had there been complete performance under the contract.

Complete performance Completely fulfilling all obligations under the contract in accordance with its terms.

Consideration The bargained-for exchange of an agreement.

Consulting agreement An agreement where a consultant is engaged to apply a particular expertise on behalf of the hiring company.

Contract An agreement between two or more parties that is legally binding and enforceable in a court of law.

Counteroffer A response to an offer that proposes the parties go forward on different terms than proposed in the offer.

Cover Under the UCC as a prerequisite to consequential damages for an aggrieved buyer, the good faith purchase of substitute goods, at a reasonable rate and without unreasonable delay.

Development agreement An agreement where a developer, typically having particular expertise or resources, is engaged to create technology and/or intellectual property for the hiring company.

Discharge of a contract The termination of a contractual duty.

Distribution agreement An agreement through which the owner of a product (manufacturer, developer) engages a distributor to market the product in substantially unmodified form.

Express warranty A warranty expressly stated in a contract.

Force majeure clause A contractual provision which excuses (for suspends) performance under the contract in the event performance is rendered impracticable by events outside of the control of the parties.

Franchise agreement A species of license agreement that establishes a close, ongoing relationship between the franchisor and franchisee, with the franchisee granted a license to, in effect, replicate a franchise business. Typically trademarks and know-how, and sometimes patents, are licensed.

Fraud in the inducement What occurs when the victim is not aware that the contract was being formed.

Goods Under the UCC, anything that is movable at the time of identification to a contract for a sale.

Implied warranty A warranty that is implied by law in certain contracts unless explicitly disclaimed in the contract.

Inadequate performance A significant variance from the terms of the contract.

Indemnity A promise by an indemnitor to pay for the liability, loss, and/or costs incurred by the indemnitee if specified events occur.

Know-how license An agreement whereby the licensor permits the licensee to have access to, and use, specified know-how.

License A grant of a right to use the licensed subject matter for a specified period of time, analogous to a rental of real property.

License agreement An agreement whereby a licensor having certain intellectual property grants certain rights with respect to the intellectual property to a licensee.

Manufacturing agreement An agreement whereby a company hires another entity to manufacture an item according to certain specifications.

Material breach Failure to provide at least substantial performance under a contract and generally depriving the aggrieved party of reasonably expected benefits from the contract.

Mirror image rule The concept that in order for a response to an offer to be an acceptance, the response must accept every aspect of the offer, without modification, addition, or condition.

Offer A proposal made by an offeror to an offeree.

Original equipment manufacturer (OEM) agreement An agreement by which the owner of a technology or product licenses an OEM to market the technology or product as part of an overall system or product, where the supplied product is fully integrated into the system and is not identifiable as being a product of the technology owner.

Patent license An agreement whereby the licensor agrees not to enforce a patent (or certain claims of the patent) against the licensee with respect to certain acts that would otherwise be precluded by the licensor's patent.

Perfect tender rule A UCC provision (UCC §2-601 et seq) such that any deviation from the terms of the agreement is a material breach and discharges the aggrieved party from performance.

Promissory estoppel An equitable doctrine that makes a promise enforceable by law, even though there is no consideration for the promise when the entity to which the promise is made, reasonably relying on the promise, changes its position to its detriment.

Punitive damages A sum of money not directly corresponding to losses incurred by the aggrieved party, but intended to punish and act as a deterrent to egregious activities.

Purchase agreement An agreement under which a vendor (supplier) transfers the title to a product to a purchaser (customer).

Quasi-contract An equitable doctrine where in the absence of a legally enforceable contract the court creates a fictional contract to prevent one person from being unjustly enriched through retaining money or benefits that in fairness belong to another.

Reliance damages A sum of money intended to place the aggrieved party in the position it would have been had the contract never been formed.
Representation A statement of facts relied upon by parties in entering an agreement.
Rescission Abrogation of a contract, effective from its inception, restoring the parties to the positions that they would have been in had no contract been formed.
Restitution Returning the benefits unjustly conferred upon another to the aggrieved party.
Royalties Consideration paid for in return for the grant of a license.
Specific performance Where a court orders complete performance under a contract.
Statute of frauds A law requiring certain types of contracts to be evidenced in writing.
Substantial performance Essential fulfillment of the obligations but with slight variances from the exact terms, unimportant omissions, and/or minor defects that do not defeat the purpose of the contract.
Term of a contract The length of time the contract remains actively applicable to the parties.
Trademark license An agreement whereby the trademark owner (licensor) permits a licensee to employ a specified licensed trademark in connection with certain goods or services of the licensee.
Unconscionable A contract provision so egregiously one-sided that a court will refuse to enforce it.
Uniform Commercial Code A relatively comprehensive set of laws relating to business and commercial transactions in the United States.
Value-added-reseller (VAR) agreement An agreement by which the owner of a technology or product licenses an OEM to market the technology or product as part of an overall system, but the supplied product is a separate module identified to, or identifiable by, the end user as being that of the technology owner.
Warranty A promise that a product, service, or aspect of performance will meet certain standards or metrics, or do certain things.

ADDITIONAL READING

Bloom, B., Contracts, Wolters Kluwer Law & Business, New York, New York.

Emerson, R., 2009. Business Law, fifth ed. Barron's Educational Series, Inc., Hauppauge, NY.

Ferriell, J., 2009. Understanding Contracts. second ed. LexisNexis, New York, NY.

Lechter, M., 2014. Protecting Your #1 Asset: Leveraging Intellectual Property, second ed. TechPress Inc., Phoenix Arizona.

WEB RESOURCES

http://www.cisg.law.pace.edu: This website is a case law database for the United Nations Convention on Contracts for the International Sale of Goods (CISG).

http://www.expertlaw.com/library/business/contract_law.html This site is an excellent introduction to contract law, covering many topics relevant to the launch and growth of technology ventures.

http://www.law.cornell.edu/ This website provides a searchable database of case law, statutes, and articles on law.

http://smallbusiness.findlaw.com/business-contracts-forms.html This website provides an overview of contract law and the different types of contracts and forms commonly used by businesses.

http://www.law.cornell.edu/ucc This site provides a searchable copy of the Uniform Commercial Code (UCC).

ENDNOTES

1 Louisiana is an exception. Its law is based on a civil code, rather than the precedent of judicial decisions.

2 UCC Article 2. The UCC also includes articles covering, among other things, Negotiable Instruments (Article 3), Bank Deposit (Article 4), Letters of Credit (Article 5), Bulk Transfers (Article 6), Documents of Title (Article 7), Investment Securities (Article 8), and Secured Transactions (Article 9).

3 UCC § 2–103.(1) (k).

4 There are a number of exclusions from the CISG, including “goods bought for personal, family, or household use.” CISG Art. 2(a).

5 http://treaties.un.org/pages/ViewDetails.aspx?src=TREATY&mtdsg_no=X-10&chapter=10&lang=en

6 CISG Article 11. But see, Forestal Guarani, S.A. v. Daros International, Inc. 2008 U.S. Dist. LEXIS 79734, (D. NJ, 7 October 2008), Zhejiang Shaoxing Yongli Printing & Dyeing Co., v. Microflock Textile Group Corp., 2008 U.S. Dist. LEXIS 40418, 2008 WL 2098062 (S.D. Fla. May 19, 2008), Chateau des Charmes Wines Ltd. v. Sabat é USA, Sabat é S.A 328 F.3d 528 (9th Cir 2003).

7 See UCC §204C. For example, price is not an essential term. UCC §305 See also CISG Art 14(1).

8 See Restatement (Second) of Contracts §63, UCC §206(1).

9 CISG Art 18(2).

10 Restatement (2d) Contracts §59. CISG Art 19. CISG Art 19(2) indicates that additional or different terms that do not materially alter the terms of the constitutes an acceptance and, unless objected to without undue delay, become part of the agreement. However, CISG Art 19(3) denominates most relevant terms as material, including: “terms relating, among other things, to the price, payment, quality and quantity of the goods, place and time of delivery, extent of one party’s liability to the other or the settlement of disputes.”

11 See Janky v. Batistatos, 86 USPQ2d 1585 (N.D. Ind. 2008).

12 UCC §2-207 See *Architectural Metal Systems, Inc.*, 58 F.3d 1227, 1230 (7th Cir. 1995), Janky v. Batistatos, 86 USPQ2d 1585 (N.D. Ind. 2008), Uniroyal, Inc. v. Chambers Gasket and Mfg. Co., 380 N.E.2d 571, 575 (Ind. Ct. App. 1978).

13 UCC §2-207(A).

14 UCC §2-207(B).

15 UCC §2-207(C).

16 See Restatement (Second) of Contracts §42, CISG Art 22.

17 See Restatement (Second) of Contracts §63, UCC §206(1).

18 CISG Art 18(2).

19 See Restatement (Second) of Contracts §§17, 20.

20 CISG Art 11.

21 UCC §2-201.

22 UCC §2-201.

23 UCC §2-201(2)

24 The CISG defines a breach as "fundamental" if it "results in such detriment to the other party as substantially to deprive him of what he is entitled to expect under the contract, unless the party in breach did not foresee and a reasonable person of the same kind in the same circumstances would not have foreseen such a result." CISG Art 25, Art 49

25 See UCC §2-601 et seq.

26 See Restatement (Second) of Contracts §§237, 373, CISG Art 49

27 Restatement (Second) of Contracts §352.

28 See Restatement (Second) of Contracts §344, UCC 1–106, CISG Art 74.

29 See Restatement (Second) of Contracts §350, UCC §2-715(2)(a), CISG Art 77.

30 UCC §2-715(2)(a).

31 See Restatement (Second) of Contracts §373.

32 See Restatement (Second) of Contracts §374.

33 See Restatement (Second) of Contracts §376.

34 See Restatement (Second) of Contracts §359, UCC §2-716.

35 See CISG Art 46, Art 62. See also CISG Art 28.

36 See Restatement (Second) of Contracts §184.

37 See UCC §§2-312, 2–314, and 2–315, CISG Art 35(2). Under the UCC, the disclaimer must be conspicuous. UCC §2-316.

38 UCC §2-312, CISG Articles 42 – 44.

39 UCC §2-2-314, CISG Articles 35(2)(a).

40 UCC §2-2-315, CISG Articles 35(2)(b).

41 See, Atlantic Marine Construction Co. v. United States District Court for the Western District of Texas, 571 U. S. ____ (2013), Slip Opinion No. 12–929 decided December 3, 2013

42 see, e.g., UCC §2-210

43 Herbert M. Confidentially Speaking. *Inc*. April 2005; 27 (4): 50.