

## Common Risks in Contracts

Contracts inherently involve risks that can lead to disputes and negative financial consequences if not properly addressed. Key risks include:

- **Misinterpretation, Ambiguity, and Uncertainty:** A contract is "ripe for dispute" if it is unclear. Ambiguity occurs when a provision can reasonably be understood in more than one way. This can stem from various sources, including imprecise language, conflicting clauses, or a failure to address an issue entirely. Specific types of ambiguity include lexical (meaning of a word, e.g., "chicken") and syntactic (word order). Vagueness, where a concept allows for borderline cases (e.g., "reasonable efforts"), is another source of uncertainty.
- **Non-performance or Breach:** Contracts establish future performance obligations. A party's failure to perform can lead to legal claims. A breach of a fundamental "condition" can allow the other party to terminate the contract, while a breach of a less fundamental "warranty" typically only entitles monetary compensation.
- **Unforeseen Problems:** Business transactions are inherently risky, and a well-drafted contract anticipates potential future problems like market fluctuations, regulatory changes, or a party's inability to perform.
- **Unreasonable Risk Allocation:** Without careful attention, a contract can unintentionally place an unreasonable amount of risk on one party.
- **Disputes and Litigation:** The ultimate goal of a well-drafted contract is to be so clear and comprehensive that it prevents disputes from escalating to legal action.
- **Tort Claims:** Parties may attempt to bypass contractual limitations on liability by asserting tort-based claims, such as misrepresentation or fraud.

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## Allocating and Minimizing Risks Through Careful Drafting

Careful drafting is a multi-faceted process that involves understanding the deal, selecting appropriate contractual "building blocks," and adhering to principles of clarity and precision.

### 1. Risk Allocation through Contractual Provisions

Contracts use specific types of clauses to distribute and manage identified risks:

- **Representations and Warranties:** These clauses are fundamental tools for allocating risk related to existing facts or conditions.
  - A party making a representation or warranty assumes the risk if the stated fact proves false.
  - Qualifiers can adjust this risk. "Flat" representations are absolute, placing full risk on the maker, while "qualified" representations (e.g., "to the best of Seller's knowledge") limit this risk, shifting some burden to the recipient. Materiality qualifiers further limit the scope to only "material" facts, preventing breaches for insignificant inaccuracies.

- Using the phrase "represents and warrants" strategically maximizes the client's potential remedies, allowing claims for misrepresentation (under the Contract Act, 1872) or breach of warranty (analogous to the Sale of Goods Act, 1930).
- **Covenants:** These detail promises for future actions and performance obligations. They are crucial for risk allocation through the precision of the performance standard. Different degrees of obligation, such as "absolute obligation," "best efforts," or "reasonable efforts," significantly alter a party's risk exposure.
- **Conditions (Contingent Contracts):** Conditions specify that one party's obligation to perform depends on a prior event or state of affairs. This allocates risk by making certain performances contingent upon specific triggers.
- **Indemnity Clauses:** An indemnity clause is a promise by one party (the indemnitor) to compensate the other (the indemnitee) for specific types of losses or damages. This allocates risk for:
  - Losses arising from external events or circumstances not fully controlled by the indemnifying party.
  - Losses caused by claims from non-parties.
  - Ensuring losses are covered even if other provisions exclude certain types of damages.
  - Allowing for recovery of legal costs, like attorneys' fees, which are often not recoverable by default in common law jurisdictions.
- **Termination Clauses:** These clauses define the specific events or conditions under which a contract can be brought to an end, whether amicably or due to a dispute. They are critical for managing the "endgame" of a contractual relationship and its financial consequences.
- **Dispute Resolution Mechanisms:** Contracts should clearly outline the methods for resolving disputes, such as negotiation, mediation, or litigation. Incorporating arbitration features can offer a less expensive and quicker alternative to court proceedings for settling potential disputes.

## 2. Minimizing Risks through Drafting Techniques and Principles

Beyond specific clauses, the overall quality and approach to drafting significantly reduce risk:

- **Clarity and Precision in Language:**
  - **Plain Language:** Using clear, simple language and avoiding unnecessary jargon, archaic words (like "hereinafter" or "witnesseth"), and redundant phrases ("null and void") is paramount for clarity and reducing misinterpretation.
  - **Precision and Consistency:** Contracts must be precise and comprehensive, leaving no room for misinterpretation. Consistency in language and terminology is also vital to avoid unintended differences in meaning.
  - **Active Voice:** Employing the active voice makes the actor and action clear, preventing ambiguity about who is responsible for what.

- **"Shall" for Duty, "May" for Discretion:** Using "shall" exclusively to denote a binding obligation and "may" for discretionary authority helps prevent significant ambiguity.
- **Defined Terms:** A dedicated "Definitions" section acts as a private dictionary for the contract, ensuring that key terms are understood consistently by all parties and a court if needed. This is a primary defense against challenges of uncertainty.
- **Effective Structure and Organization:**
  - **Logical Hierarchy:** Breaking the contract into logically numbered articles, sections, and subsections with descriptive headings provides a clear roadmap for the reader.
  - **Tabulation and Sentence Structure:** Using bullet points or numbered lists for complex sentences improves readability. Keeping sentences short and direct, with the subject and verb placed early, also enhances clarity.
  - **Strategic Placement of Information:** Placing lengthy or detailed information in schedules attached to the agreement, and incorporating it by reference, keeps the main body of the contract clean and readable.
- **Thorough Preparation and Review:**
  - **Understand the Purpose and Deal:** The drafting process begins with a deep understanding of the contract's objectives, the client's business, and the specific commercial terms involved.
  - **Legal Compliance:** Researching relevant laws and regulations is necessary to ensure the contract is legally compliant and enforceable within the governing legal framework.
  - **Anticipate Issues:** Analytical thinking and foresight enable drafters to anticipate potential risks and incorporate preventative measures.
  - **Iterative Process:** Drafting is an iterative process that involves multiple rounds of revision and refinement, including careful proofreading for consistency and accuracy, and seeking feedback from legal practitioners and stakeholders. Critical analysis of precedents is also important.
  - **Negotiation Strategy:** Effective contract negotiation, which precedes drafting, also minimizes risks by clarifying expectations, identifying issues early, and striving for mutually beneficial outcomes. This includes establishing trust, listening actively, and having backup positions.