

Project Contracts

PMG 323

Prepared by Dr. Asma Abuanzeh

Lecture 7



Contract Terms

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Lecture

Section 1

- Remedies for Breach
- Representations and Warranties
- Limitations/Limitation of Liability
- Indemnification

Section 2

- Insurance
- Modification and Waiver
- Arbitration

Remedies for Breach

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Remedies for Breach

As noted in the previous section, commercial agreements rarely include captions that include the word “Remedies.” This seems largely due to the fact that remedies are often an unpopular subject for at least one of the parties. And although the word “remedies” is found in almost every commercial agreement, it often appears only in very general language limiting or preserving remedies in some way

Remedies for Breach

such as in the following three examples that all preserve the right to “cumulative” remedies:

Except as expressly provided in this Vendor Agreement, any right or remedy hereunder or under applicable law is not exclusive and shall not preclude such party from exercising any other right or remedy that may be available to it. Any and all rights and remedies of Manufacturing Company upon Your breach or other default under this Agreement will be deemed cumulative and not exclusive of any other right or remedy conferred by this Agreement or by law or equity on Manufacturing Company, and the exercise of any one remedy will not preclude the exercise of any other. Nonexclusive Remedy. Except as expressly set forth in this Agreement, the exercise by either Party of any of its remedies under this Agreement will be without prejudice to its other remedies under this Agreement or otherwise.

Remedies for Breach

In fact, the only types of agreements that regularly include clauses captioned *Remedies* or *Remedies for Breach* are traditionally one-sided types of agreements such as banking agreements, loan agreements, leases, and security agreements.

Instead, consequences for breach are often addressed directly or indirectly across a number of interrelated sections of an agreement, including *Obligations*, *Fees*, *Term and Termination*, *Consequences of Termination*, and sometimes under *Limitations* clauses.

Across these sections in an agreement, it might be clear when a party can terminate and on what terms, and it might be clear when a buyer is entitled to a fee reduction or credit, but the issue of *paying* damages for poor performance is rarely directly addressed.

Tailored Remedies

Remedies is simply a difficult topic. Rather than have no agreement at all, negotiating parties often seem willing to simply leave a certain amount of risk allocation unaddressed.

A wise contract negotiator, though, should always try to find a way to weave in language that provides not just reasonable rights of termination and rights to fee reductions, credits, or refunds for poor performance, but also, where appropriate, rights to other forms of compensation directly related to the potential harms that would flow from the other party's breach.

Tailored Remedies

The following example provides for substantial compensation rights without using the terms “breach,” “remedies,” or “damages.”

“In the event that Tax Forms, Inc. fails to deliver the Tax Documentation to Financial Institution’s customers by the Due Date, Financial Institution shall be free to incur all costs as it deems necessary, both internally and externally, to ensure the delivery of all required tax documentation to its customers and Tax Forms, Inc. hereby agrees to reimburse Financial Institution for all such expenses.

In such case, Financial Institution shall provide monthly reports providing reasonable support for all such reimbursable costs and expenses, including receipts and invoices for the procurement of any third party services and reasonable detail regarding the allocation of internal staff and the full costs associated with such staff. Tax Forms, Inc. shall pay all such amounts within twenty days of the receipt of such support documentation from Financial Institution.”

Tailored Remedies

In this case, if the contract also included language elsewhere stating that remedies were cumulative and not exclusive, Financial Institution could be entitled to a refund of any fees paid, recovery of the above described costs and expenses, the right to terminate for breach, and possibly also rights to indemnification from Tax Forms, Inc. in the event of any action by the Internal Revenue Service or harmed customers, all of which would seem perfectly reasonable under the circumstances.

Tailored Remedies

Remedies like those in the above example are extremely difficult to negotiate. Discussions almost invariably become intertwined with counterproposals for liability caps or other types of restrictions. In this case, the service in question is a good candidate for professional liability insurance or errors and omissions insurance. The *Insurance* discussion below will touch on how proposing insurance provisions in a commercial agreement can help move remedies and indemnification discussions forward.

Liquidated Damages

In any situation where a buyer is contracting for critical products or services and the timely delivery of those products or services per the agreed specifications is imperative, and where the buyer has substantial leverage, it should consider imposing additional remedies in the form of *Liquidated Damages* - a predetermined sum of money that must be paid as damages for failure to perform as required under an agreement. Once liquidated damages are included in a contract, though, the non-breaching party will likely be unable to recover actual damages in excess of the specified amount.

Liquidated Damages

a *Liquidated Damages* clause must be drafted with careful reference to

- (i) the facts and circumstances surrounding an agreement,
- (ii)(ii) the harms that would likely flow from a party's nonperformance,
- (iii)and (iii) how the specific damages amount or formula relates to those harms. It is also often necessary to correctly recite that estimating "actual" damages at the time of the contract was inherently difficult and that the liquidated damages represent the parties' best efforts at such an estimate.

Liquidated Damages

A court can invalidate a *Liquidated Damages* clause if it finds it was not a reasonable attempt to estimate the potential losses. To best inoculate a clause from challenge, it is important to use clear language and to avoid jargon and boiler plate.

Liquidated Damages clauses are most common in the construction industry, where it is particularly true that “time is money.” Property owners and developers can incur additional financing costs and penalties and lose substantial profits when projects are late, not to mention incurring other costs such as keeping engineers, project managers, other contractors, and other field or office personnel on site beyond budgeted completion dates.

Key Differences

Aspect	Tailored Remedies	Liquidated Damages
Definition	Custom-designed solutions for breaches	Pre-determined, fixed compensation
Purpose	Flexibility and customization	Certainty and predictability
Flexibility	Highly flexible, can be adjusted	Generally rigid, fixed at contract formation
Legal Enforcement	Based on mutual agreement	Enforced by courts if reasonable
Examples	Repairing work, substituting services	Penalties for delays, breach fines

Representations and Warranties

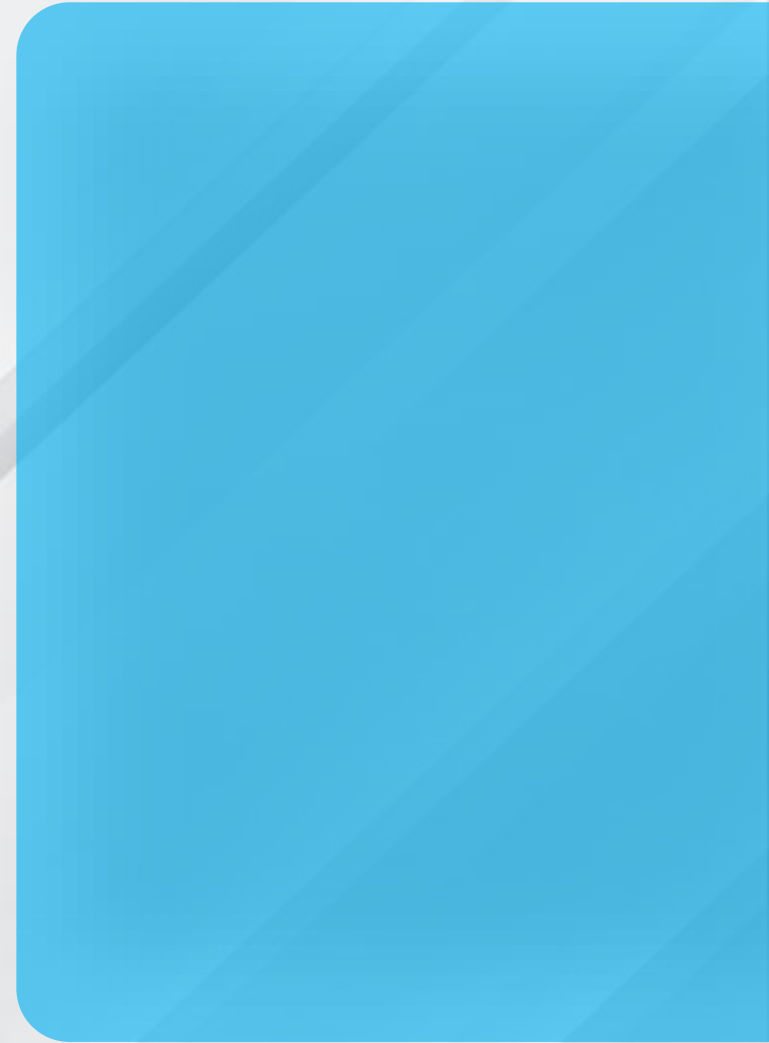
Representations and Warranties

Contract drafters should view Representations and Warranties clauses as important places to clarify expectations and establish standards that can either expand or restrict performance requirements and hence also expand or restrict potential remedies for performance shortcomings.

Representations can be thought of as assurances of specific facts as of the time of an agreement's signing. Warranties are essentially promises regarding the present and the future, possibly covering a stated period of time.

By way of example, an agreement may require a party to “represent” that they are legally permitted and authorized to enter into the agreement.

That same party may also “warrant” that they will perform their duties under the agreement in a manner consistent with the highest standards of the industry.



That said, a party to an agreement could also “warrant” that they are authorized to enter into an agreement and “represent” that the goods delivered thereunder will conform to stated specifications. Representations and warranties are both essentially promises between the parties. No matter what language is used, if the intent is clear, one should expect a court to enforce them in a dispute.

As with consumer product warranties, commercial agreements generally contain specific written or “express” or “limited” warranties that are then whittled back in a later section through legalistic “disclaimers.” And while state and federal laws play a large role in shaping consumer product warranties, in many cases imposing unstated warranties and in other cases invalidating warranty disclaimers, businesses are generally free to negotiate warranties, disclaimers and limitations between themselves without much concern that a court will alter or disregard them.

Note this important caveat, though: in contracts for goods, certain “implied” warranties, like a warranty of “fitness for a particular purpose” may be deemed present in an agreement if not specifically disclaimed between the parties. As noted earlier, sellers of goods should have their sales and distribution template agreements reviewed by UCC counsel.

As a general guide, a buyer of almost any products or services should consider insisting on the following fundamental types of representations and warranties

Products or deliverables will conform to detailed descriptions or specifications provided elsewhere in the agreement.

Any work performed will be performed in a “workmanlike manner consistent with the highest standards/best practices of the industry,” in a “commercially reasonable manner,” “using a commercially reasonable level of skill and care,” or according to other appropriate standards.

As a general guide, a buyer of almost any products or services should consider insisting on the following fundamental types of representations and warranties

The products or services will comply with all applicable laws and regulations.

The products or services will not infringe upon the intellectual property rights of any third party.

In the case of software or software-driven products or services, a warranty against viruses, malware, Trojan horses, and other similar concerns.

As a general guide, a buyer of almost any products or services should consider insisting on the following fundamental types of representations and warranties

Those are some of the most basic types of warranties that any reasonable party should be willing to accept and any resistance should be considered a red flag.

Even where reasonable warranty language is accepted, most sophisticated negotiators will seek to cap their warranty exposures and other liabilities by disclaiming a number of specific warranties and excluding or limiting other types of damages. First we'll discuss disclaimers.

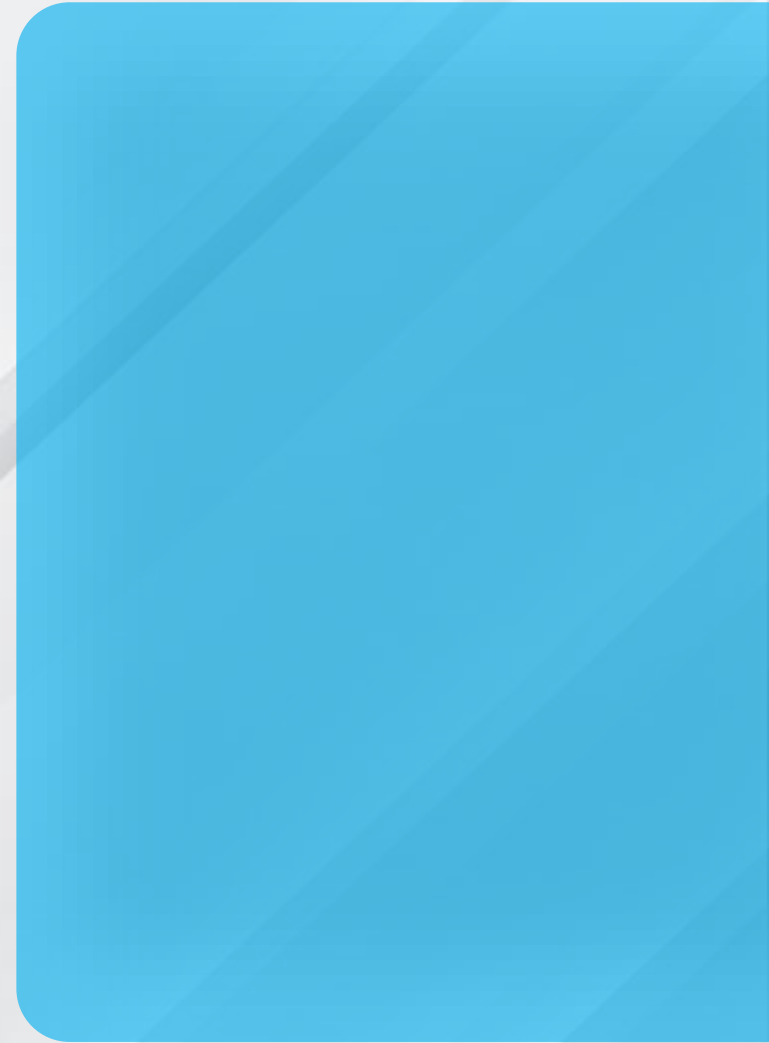
Here is a typical warranty disclaimer paragraph, presented as usual in all capital lettering in order to be “conspicuous,” the standard required for warranty disclaimers under the UCC and certain case law:

Warranty Disclaimer –
EXCEPT FOR THE WARRANTIES SPECIFICALLY PROVIDED HEREIN, EACH PARTY EXPRESSLY DISCLAIMS ALL OTHER WARRANTIES, EXPRESS OR IMPLIED, INCLUDING, BUT NOT LIMITED TO, THE IMPLIED WARRANTIES OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE, AND ANY IMPLIED WARRANTIES ARISING FROM STATUTE, COURSE OF DEALING, COURSE OF PERFORMANCE OR USAGE OF TRADE AS CONTEMPLATED BY THIS AGREEMENT. PARTY A DOES NOT WARRANT THAT THE PROVISION OF SERVICES WILL BE ERROR-FREE.

Notes on the example

Note in this example that the clause “EXCEPT FOR THE WARRANTIES SPECIFICALLY PROVIDED HEREIN...” in the first sentence preserved the explicitly stated warranties in the agreement.

This type of prefatory clause is helpful because, where proper express warranties have been provided elsewhere, it renders the rest of the disclaimer legalese largely irrelevant.



Limitations/Limitation of Liability

Limitations/Limitation of Liability

A party's failure to honor its commitments under an agreement, including its representations and warranties, can potentially lead to liabilities far beyond the fees to be charged or earned under the agreement.

Each party to every agreement, therefore, needs to consider whether and how such other liabilities should be limited by type and amount. Limiting liabilities is a balancing act – limiting them too severely reduces incentives for competent performance and subjects the buyer to potentially unreasonable risks; not permitting reasonable limitations can prevent an otherwise capable provider of products or services from entering into an agreement.

Here is a typical limitation of liability clause:

Limitation of Liability. EXCEPT IN THE CASE OF GROSS NEGLIGENCE OR WILLFUL MISCONDUCT, IN NO EVENT SHALL EITHER PARTY BE LIABLE TO THE OTHER PARTY OR ANY THIRD PARTY FOR ANY SPECIAL, EXEMPLARY, PUNITIVE, CONSEQUENTIAL, INCIDENTAL OR OTHER INDIRECT DAMAGES, INCLUDING WITHOUT LIMITATION, LOST PROFITS, EVEN IF ADVISED OF THE POSSIBILITY OF SUCH DAMAGES, IN ANY MANNER ARISING OUT OF OR IN CONNECTION WITH THIS AGREEMENT OR THE BREACH OF ANY TERM, COVENANT, REPRESENTATION, WARRANTY OR OBLIGATION CONTAINED HEREIN. EXCEPT IN THE CASE OF GROSS NEGLIGENCE OR WILFUL MISCONDUCT, AND EXCEPT FOR EACH PARTY'S INDEMNITY OBLIGATIONS SET FORTH ELSEWHERE HEREIN, IN NO EVENT SHALL EITHER PARTY'S LIABILITY TO THE OTHER OR ANY THIRD PARTY EXCEED THE FEES PAID BY PARTY A TO PARTY B FOR THE THREE MONTH PERIOD PRECEDING THE DATE THE CLAIM AROSE.

Punitive and Exemplary Damages

Let's first discuss some of the legal jargon in this paragraph, Contract Law, "punitive" damages are not allowed in contracts, so limitations on them are generally acceptable.

"Exemplary" damages are essentially the same as punitive damages and generally disallowed, so that term can be disregarded also.

Contract Law, punitive damages can be allowed in a contract dispute where a court also agrees to consider tort claims under the same facts. Since any tort claims may need to arise independently of the contract claims, a Limitations clause like the one above might be found to not restrict damages for tort claims.

Punitive and Exemplary Damages

In the above Limitation of Liability example, it probably helps that this Limitations clause does not specifically disallow “tort claims” or “claims sounding in tort,” language that is sometimes found in Limitations clauses and that might be worth a buyer’s effort to delete.

Direct Damages versus Indirect or Special Damages

The key distinctions to focus on in this Limitations clause and in most others is really between “direct” damages on the one hand and “consequential,” “indirect” or “special” damages on the other, the latter three terms being somewhat interchangeable under the case law.

The battle lines around Limitations clauses are drawn between

(i) direct damages on one hand, for not getting the product or service you paid for and possibly having to replace that product or service,
and (ii) all types of indirect damages on the other hand. Indirect damages include things like the following:

The battle lines around Limitations clauses are drawn between

(i) direct damages on one hand, for not getting the product or service you paid for and possibly having to replace that product or service,
and (ii) all types of indirect damages on the other hand. Indirect damages include things like the following:

- Lost sales or cancelled sales,
- Other types of lost profits,
- Missed opportunities in the market or against competitors, and
- Lost enterprise value from any of the above.

Deleting “Gross” and “Willful”

Staying with the Limitation of Liability example above, as noted, Party A should probably first try to delete the words “special,” “consequential,” “incidental,” and “other indirect damages” from the Limitations clause. This is likely to be met with stiff resistance. If that fails, a good fallback strategy is to delete the words “gross” and “willful” in the phrases words “gross negligence” and “willful misconduct.” These phrases are virtually always used in connection with the word “except,” meaning in this context that they could open the door to “special,” “consequential,” “incidental,” and “other indirect damages.”

To clarify, “negligence” is a much lower standard than “gross negligence,” and “misconduct” is a much lower standard than “willful misconduct.” And while misconduct is an important concept, contractual issues are more likely to involve the critical distinctions between negligence and gross negligence.

Here are excerpted definitions from Black's Law Dictionary:

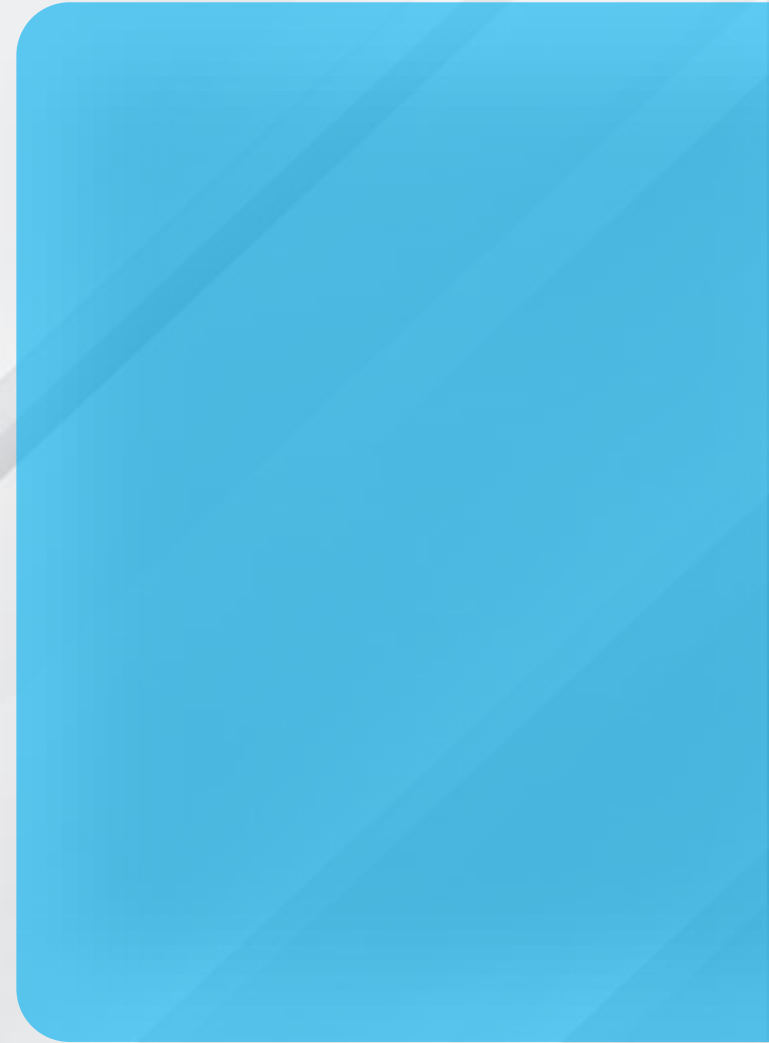
Negligence: Negligence is the failure to use such care as a reasonably prudent and careful person would use under similar circumstances.

Gross Negligence: The intentional failure to perform a manifest duty in reckless disregard of the consequences as affecting the life or property of another. It is materially more want of care than constitutes simple inadvertence.

Here are excerpted definitions from Black's Law Dictionary:

Party A should seek to negotiate away the word “gross” in both places where it appears. Basic negligence is a much easier case to make, increasing the strength of potential indirect damages claims under the “except” clause in the event Party B’s negligent performance. When “gross” is deleted, it makes no sense to not delete “willful,” and not doing so might hand the other side an “interpretation” argument in a dispute.

If both instances of the word “gross” are deleted, Party A would be entitled to any indirect damages resulting from Party B’s negligence and the amount of any recovery also would not be capped at the amount of three months fees.

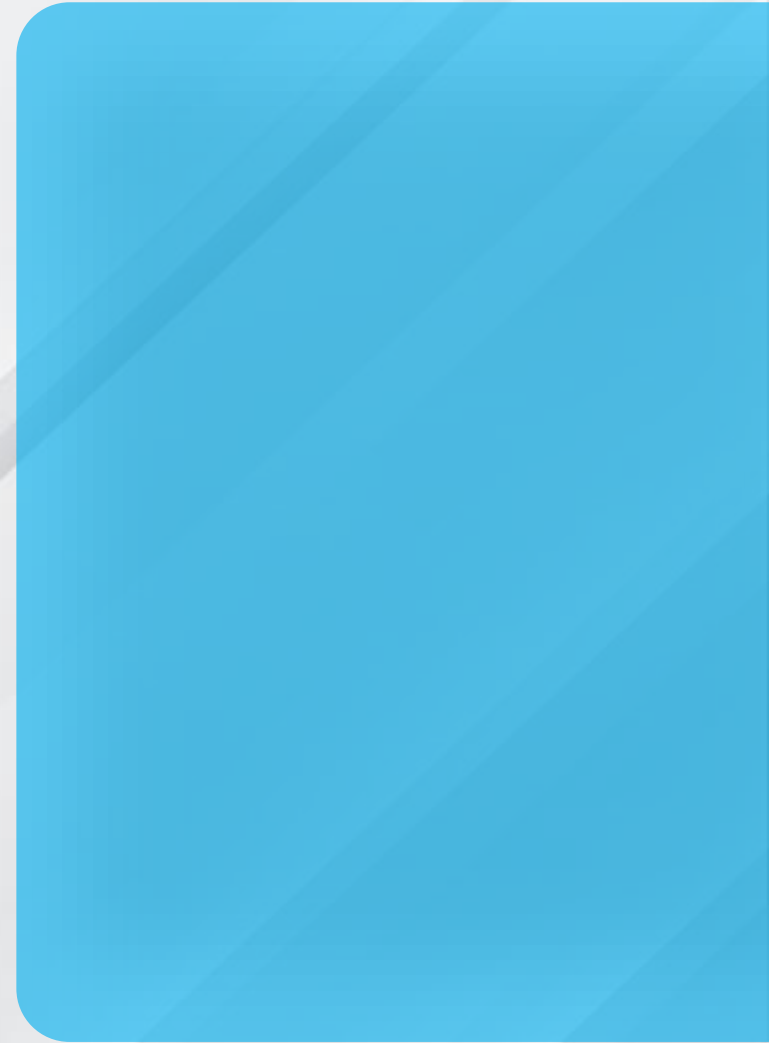


Liability Cap

When a buyer has successfully negotiated reasonable terms under Warranties and Disclaimers, a seller's final sticking points frequently involve Limitations issues like those just discussed, and they often include a proposed maximum liability cap on all damages of all kinds.

At that point, a buyer's goal should be to drive the cap to an appropriately high number by clearly articulating to the other party how its possible non-performance could harm the buyer both directly and indirectly, and how the cap logically ties to those harms.

Raising questions around insurance can help move discussions about liability caps forward by easing concerns about how seller liabilities might actually be funded.



Liability Cap

The interplay among performance obligations, representations and warranties, disclaimers, limitations, and indemnification is like a complex game of whack-a-mole – you fix rights and obligations in one part of an agreement, only to have them cut back or clouded in another part of the agreement.

Liability Cap

Here is a high level summary of how to methodically play this game as a buyer:

- Ensure that the other party's obligations are clear under Obligations.
- Ensure under Representations and Warranties that the other party
- commits to perform its obligations according to an appropriate standard such as "in a commercially reasonable manner consistent with the highest standards in the industry."
- Make sure that the other party does not unreasonably disclaim its performance obligations under Disclaimers; do this by using prefatory language or other caveats that prevent otherwise sweeping warranty disclaimers from applying to the other party's core performance warranties.
- Also under Disclaimers, delete any disclaimers that are clearly illogical in light of your expectations for the other party's performance. In the example above, the disclaimers of any warranty of "title" or "noninfringement" were singled out as overreaching.

Liability Cap

Here is a high level summary of how to methodically play this game as a buyer:

- Negotiate down the threshold protecting the other party from indirect damages in Limitations clauses, as would have been accomplished by deleting the words “gross” and “willful” in the example above.
- Once these drafting goals have been achieved, it is usually a matter of simply agreeing upon an appropriate liability cap, if any. Describing to the other party the types of harms their non-performance could cause
- and how insurance works in such cases can help to get that number higher.

Liability Cap

Regarding the last bullet above, if liability cap discussions get sticky, inquire about the types and amounts of insurance coverage the other party carries. If the other party has a \$2 million or \$5 million “errors and omissions” or “professional liability” policy applicable to their performance, suggest tying the cap to that number, assuming it is a reasonable number based on the potential liability exposures involved.

Indemnification

Indemnification

The word “indemnify” means to compensate for harm or loss. Indemnification clauses generally provide financial protection against lawsuits, government actions, and other third party claims, although sometimes they also cover “first party” claims between the parties, as discussed below. Indemnification clauses differ widely based on the sophistication and negotiating positions of the parties.

Sample Indemnification Clause

Let's first look at a typical, fairly simple Indemnification clause:

Indemnification. Each party shall defend, indemnify and hold harmless the other party and its affiliates, directors, officers and employees from and against any and all suits, actions, penalties, damages, losses, liabilities, costs (including without limitation, reasonable attorneys' fees), and judgments arising as a result of or in connection with any claim relating to the products and services of the indemnifying party or as a result of or in connection with any breach by the indemnifying party of any of its representations and warranties set forth in this Agreement.

Sample Indemnification Clause

It is probably fairly common that a buyer presented with a clause like the one above (i) is comfortable with its vague, open-ended language, (ii) believes the ambiguities might be resolved in the buyer's favor, and (iii) possibly also fears that pushing to address some of the issues discussed below could backfire, resulting in more specific and less advantageous language.

Sample Indemnification Clause

The words “Each party...” mean that it is mutual, applying equally to both parties. As a buyer, offering a mutual Indemnification clause is almost always a good strategy for drawing less attention to the whole issue.

Although a buyer could certainly be hit with indemnification obligations, sellers are generally far more vulnerable to indemnification claims since liabilities usually arise out of products or services provided by sellers.

The list of indemnitees in the above Indemnification example is fairly complete, i.e., “...the other party and its affiliates, directors, officers and employees....”

Sometimes “agents” and “contractors” are also explicitly covered.

Sample Indemnification Clause

The list of covered harms is also fairly complete, i.e., “from and against any and all suits, actions, penalties, damages, losses, liabilities, costs (including without limitation, reasonable attorneys’ fees), and judgments arising as a result of or in connection with any claim relating to the products and services of the indemnifying party or as a result of or in connection with any breach by the indemnifying party of any of its representations and warranties set forth in this Agreement.”

Insurance

INSURANCE

Insurance clauses are not found in every agreement. They are most important where a party's performance or non-performance could result in potential damages and indemnification obligations beyond the indemnifying party's ability to pay, particularly in the event of insolvency or bankruptcy.

When insured risk allocation is important, the Insurance clause should include several key elements, including:

- appropriate coverage amounts,
- appropriate types of coverage,
- correct “additional insured” language, and
- appropriate notification of cancellation provisions.

Here is a clause imposing identical coverage requirements on both parties to a medical device distribution agreement, followed by commentary:

Insurance. Within ten (10) days of execution of the Agreement, and upon request throughout the term of this Agreement, each party will provide the other party with a certificate of insurance evidencing

- the name of a reputable insurance company;
- (ii) the policy number;
- (iii) at least \$2,000,000 of general liability and product liability coverage (to be increased to \$5,000,000 once Reseller has 10,000 Concurrent Users activated);

Here is a clause imposing identical coverage requirements on both parties to a medical device distribution agreement, followed by commentary:

- (iv) that the other party is an additional insured, on a primary basis, for both ongoing operations and completed operations and
- (v) that Company or Reseller, as the case may be, will receive at least thirty (30) days prior written notice of any modification, cancellation or non-renewal of such coverage, but in no case later than three business days of receipt of notice of cancellation, modification or non-renewal from the insurance company.

Certificate of Insurance

If insurance is important, requiring a certificate of insurance can help ensure that the requirement is not ignored. Insurance companies regularly produce these, so it is a reasonable request.

Note in this example that the insurance coverage amount was negotiated to increase as the commercial arrangement evolved. The other party to this agreement originally balked at the higher amount but was willing to accept the phased approach, an excellent negotiating tactic for obtaining higher coverage limits.

Additional Insured, Notice, Primary versus Excess

Here are several key points about the additional insured language shown above:

- First, absent a contractual requirement that a party be made an “additional insured,” that status might not be honored by the insurance carrier in the event of a claim, even if a certificate of insurance states that the party is an additional insured. That is because insurance endorsements to underlying policies usually provide additional insured status only when “required by a written contract.”

Additional Insured, Notice, Primary versus Excess

Here are several key points about the additional insured language shown above:

- Second, make sure the additional insured coverage is “primary,” otherwise it might be on an “excess basis” only, meaning after payouts by the indemnified party’s insurer.
- Third, many potential claims could arrive after an agreement has been terminated; absent language requiring coverage for “completed operations,” coverage for such post-termination claims could be denied.

Coverage Types

Lastly, the sample language above specifically requires product liability coverage. Depending on the nature of the commercial relationship, it is important to require the correct coverage types.

Here are some of the most common:

- General liability coverage is important if a party's employees or agents will be present and performing services or otherwise performing under the agreement at the other party's facilities or inviting the other party's employees or agents to its own facilities.
- Errors and omissions coverage is important if the other party is performing any kind of professional services, including designing, building, hosting or maintaining products, services or systems, or handling customer transactions.

Coverage Types

Lastly, the sample language above specifically requires product liability coverage. Depending on the nature of the commercial relationship, it is important to require the correct coverage types.

Here are some of the most common:

- Privacy and network and data security coverage is important if the other party will be handling or have access to personal data, or designing, building, hosting or maintaining systems handling personal data.
- Media coverage is important if the other party will be serving in any capacity as a publisher, broadcaster, content creator or manager, or otherwise handling media functions.

Coverage Types

Lastly, the sample language above specifically requires product liability coverage. Depending on the nature of the commercial relationship, it is important to require the correct coverage types.

Here are some of the most common:

- Intellectual property coverage is among the most expensive but would be valuable if the other party's products, services or other performance under an agreement could create substantial risk of third party infringement claims.

Modification and Waiver

Modification and Waiver

Modification and waiver are two different but somewhat related concepts. As a result, they are often addressed under the same heading. But not always. Waiver and Modification clauses are rarely sources of concern.

Here is an example of a reasonably robust Modification and Waiver clause:

No failure, delay or other course of conduct on the part of either party in exercising any right, power or remedy under this Agreement shall operate as a waiver of such right, power or remedy, nor shall any single or partial exercise of any such right, power or remedy preclude any other right, power or remedy. Unless otherwise specified, any amendment, supplement or modification of or to any provision of this Agreement, any waiver of any provision of this Agreement and any consent to any departure by the parties from the terms of this Agreement, shall be effective only if it is made or given in writing and signed by authorized signatories from both parties.

The first sentence above deals with “waiver,” or, more accurately, the disclaiming of “waiver.” In this context, waiver means that a party, through its conduct or communications, has forgiven, or “waived,” the other party’s performance shortcomings.

The above fairly standard language allows each party to exercise its best self-interested judgment in the face of the other party’s faltering or failing performance. The injured party does not need to resort to its most strict remedies immediately. Waiver language along these lines is helpful and should always be included in commercial agreements.

Modification

The second sentence in the above example simply clarifies that, once an agreement has been negotiated and signed, any amendment, addendum or other modification should also be negotiated and signed.

This language reduces the possibility that less formal written or oral communications between individuals at varying levels of responsibility in the parties' organizations will later be viewed as amendments to the original agreement.

While this language is common and should be included for both parties' protection, it highlights the importance of ensuring that each party's obligations are clearly and comprehensively described, along with all other rights, remedies and obligations discussed above.

Arbitration

Arbitration

Except in industries like construction, where arbitration clauses are the norm, inclusion of an Arbitration clause is still a matter of personal preference in many situations, or perhaps more accurately, the preference of any counsel involved in drafting or negotiating the agreement in question.

As with any other contractual provision, parties also have broad latitude in drafting arbitration clauses. Some of the biggest issues are whether an Arbitration clause is mandatory or voluntary, appealable or non-appealable, and whether it is applicable to all issues under an agreement or only to certain issues.



Thank You