

Ten Things – How to Read a Contract

(from the blog series “Ten Things You Need to Know as In-House Counsel”)

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August 28, 2019

I recently heard from someone I worked with when I was General Counsel of Travelocity. She was on the business side and worked on a lot of contracts. She reached out because she remembered an article I had written and posted on the legal department intranet site about “how to read contracts.” It was something I wrote for the business so they would be better prepared to work with my team on contracts. Apparently, she still used it over ten years later! But, she had lost her only copy and wanted to share it with some of her team at her new company so she could coach them up. She reached out to ask me if I still had a copy that I could share with her. I did and sent it over to her. Now she is teaching a new generation of her sales team how to read contracts. Reading back through it, however, got me thinking about the fact that not all in-house lawyers have a good understanding of how to read a contract – though we would all hate to admit it. It is not a skill they teach in law school (or at least they didn’t when I was there, i.e., I never saw an actual contract until I started working at a law firm). Instead, law schools focus more on contract theory and stuff like that. Which is all well and good until you’re faced with your first 50-page agreement and realize all that theory isn’t going to help you much as you start to wade through something that reads like a map written in ancient Greek.

I decided to dust it off and revamp it a bit for the readers of this blog.^[1] This edition of “Ten Things” will teach you a few tricks about how contracts are structured and how to look at them so you can understand what’s going on. As an in-house lawyer, it is vital that you understand how to read contracts – they are the lifeblood of any company and working on them is, in my opinion, the highest and best use of the legal department. Even if you don’t work on contracts every day, it’s an important skill to develop and it will help you with your day-to-day work because at some point someone will slide a contract over to you to look over for some purpose – yes, even the litigators kept chained to the wall down in the basement waiting to be unleashed. Moreover, you might want to share a version of this with your business colleagues as the more they understand about contracts (including being willing to actually read them) the better you can serve them and the faster deals can get turned around. Finally, these tips generally apply wherever you are located on the planet, not just the USA. So, let’s get started:

1. Contract structure. Contracts are a different type of animal and are unlike any other type of writing you have ever seen before, e.g., books, memos, articles, essays, and newspapers. Those formats are structured with the intent that you read them front to back, sequentially, with introductions, transitions, summaries, etc. Contracts, on the other hand, are structured to collect certain related provisions together, with all sorts of cross-references and other tricky stuff in there (including the use of defined terms and documents

incorporated by reference). This structure is not intuitive, which means that your head will explode like that guy in the movie “Scanners” if you try to read a complex contract carefully, from front to back, and expect to understand it on just the first read-through. That’s wishful thinking (and potentially very messy). Instead, think of contracts like a nice big, juicy algebra problem. And, like algebra, it takes a little practice to get it down.

2. Get a hard copy. Seriously. Time to fire up the printer. If you try to read a complex contract online only then see my reference to the “Scanners” guy above. Most contracts require you to flip around a lot, especially when you’re dealing with lots of defined terms. So, step one is to printout a hard copy of the contract. Then make a separate copy of the defined terms and use it as a glossary. Trust me, this is much easier than trying to read the contract on a computer screen or continually flipping back to the definitions page.

3. What is all this stuff? All commercial contracts generally have the same basic categories of “stuff.” Typically:

- Preamble: Gives the name the contract (e.g., Master Services Agreement), the names of the parties and the date entered into.
- Recitals: These “background” sections are supposed to provide context for the contract (though rarely do so in any useful manner — but where the hell else will you ever see the word “Whereas” unless you’re a member of Congress or Parliament?). I typically like to just get rid of recitals but the other side usually wants them because they feel they are “supposed” to be there. If so, spend some time making sure the recitals set out the background correctly and, if you think they are important to your deal, add a provision stating they are part of the operative terms of the agreement. Otherwise, courts tend to view recitals as subordinate to the operative provisions of the agreement, or worse, not part of the contract at all.
- Defined terms: Think of these like formulas you will need for your algebra equation. The written meaning of a defined term (usually capitalized words in a contract) tells you what that term means for purposes of the contract. For example, “cost of production” may have a customary meaning in the industry your company operates but what is written as the definition in the contract controls what that term *actually* means in your deal. Consequently, the guts of any complex deal usually turn on the defined terms and you need to understand them and make sure they are correct for your purposes. Moreover, defined terms, like those Russian “nesting dolls,” often rest within lots of other defined terms, and have carve-outs for other defined terms. When this happens you move from algebra to calculus!

- ♦ Term and termination: How long does the contract last? Under what circumstances can it be extended or terminated early? Often the stated term will be in one section and the early termination provisions will be in another section. As to the later, one thing that is typically important to most companies is “how do we get out of this deal if it sucks?” So, this is a place you’re going to want to wallow in the details. Also, watch out for ambiguity around dates/times (termination, notice, etc.). For example, if a contract terminates on the 21st is that Midnight of when the 20th becomes the 21st or Midnight when the 21st becomes the 22nd? I could never keep that straight in my mind. I liked to make it simple and would state something like “this agreement terminates at 11:59 pm Central Standard Time on October 21st, 2019”). This way, the time and date of the action are crystal clear.
- ♦ Representations and warranties: These are promises that certain statements of fact in the contract are true. Make sure what you promise as true in a contract is a promise you can keep. Regarding warranties, parties typically set out expressly what they will warrant about the product or service and then expressly disclaim any other warranties (including implied warranties) to the extent permitted by law.
- ♦ Covenants: These are promises made by each party about what they *will do under* the contract. For example, a vendor typically agrees to provide services or goods. Their customer generally agrees to pay. You should generally look to the business folks to know they can deliver what is promised – but if you ever have doubts take steps to confirm that the company can indeed deliver.
- ♦ Conditions: These aren’t promises about facts or about what the parties will do. Instead, they are qualifiers. For example, a contract may have conditions that, if not satisfied by a given date, result in termination of the contract.
- ♦ Payment: Typically, there is a section for the payment provisions. Look closely at what happens if payment is late or is missed. And if your company is one getting paid, be sure the contract addresses what happens if payment is late or missed (especially around termination rights and the ability to recoup the cost to collect what’s owed)!
- ♦ Risk allocation: Typically, one of the most important sections in a contract. Indemnification, for example, is an allocation between contract parties about which one of them bears the risk of specified third-party claims. Other ways risk is allocated between the parties include waivers of certain types of damages (e.g., punitive, lost profits, consequential, etc.), limits on liability (e.g., the value of the contract or some multiple thereof), mandated insurance coverages, and hold harmless clauses (clauses that release and hold harmless one of the parties from liability to the other). As a lawyer, you need to carefully read – and understand – the risk allocation provisions because if something goes wrong these provisions will limit recovery to some extent.

- **Boilerplate:** These are the standard legal provisions, such as governing law, choice of forum, dispute resolution processes, notice, assignment, confidentiality, Force Majeure, etc. Many lawyers make the mistake of thinking they can gloss over the “boilerplate.” Wrong. There are actually a lot of traps for the unwary here. For more on this, see my prior post on boilerplate language.[2]
- **Exhibits and schedules:** Crucial information, such as the description of services, service level agreements or pricing, is often tucked away in exhibits and schedules to the contract.

4. The “three passes” approach. One of the best tricks my friend ever taught me was the “three phases” approach to reading a contract. The next time you read a commercial contract, try approaching it in three passes, where you dive deeper into the material with each pass:

- **First Pass:** This should be a high-level scan of the document. Don’t read too carefully – just get a good sense of how the contract is structured and where all the “stuff” (outlined above) is located.
- **Second Pass:** Now go through the contract more carefully. Start with the defined terms and read them carefully once through. Then make your careful second pass through the contract. When a defined term uses another defined term, stop at that place in the sentence and flip to the other defined term. If necessary, use some scratch paper to diagram relationships among defined terms and take notes. Understanding defined terms is often crucial to understanding the contract. Keep your “glossary” of defined terms handy. As you read the rest of the contract, if the use of a defined term in a sentence doesn’t seem to make sense, check your glossary. Keep making notes on observations and questions as you read.
- **Third Pass:** Skim back through the defined terms now that you have read the contract more carefully and see if your understanding of any of them has changed. Find the term and termination provisions and make sure they make sense and fit your deal. Next, focus on the payment provisions (same drill). Then make a pass through the balance of the provisions in whatever order makes sense to you.

Now you are ready to discuss the contract with others. You will come to that discussion with questions as contracts *always* have ambiguity, early drafts *always* have mistakes, and *all* contracts ultimately require interpretation. But you will come to the discussion prepared and with a view.

5. What’s missing? This can be tricky, like trying to prove a negative, but it’s important to watch out for what’s *missing* from the contract as you read through it. This gets easier with more experience, especially as in-house lawyers become more well-versed in the details of the business. One thing that can help a lot is a [checklist](#), either one you create on your own or one in use generally by the legal department (and if you don’t have one consider creating one). This list should contain key deal terms your company needs to see (or *not* see) in every

contract. Another trick is simply to stop and think about all the things that can go wrong, no matter how improbable, and whether there are provisions that deal with that list of horrors. Alternatively, there may be a section that purports to deal with an issue but the discussion is incomplete. You may need to fix it. Part of your goal when reading a contract is to think through any such provisions and ensure they get edited to get the job done the way you/the company want it done.

6. Danger Zone! As you read through the contract, watch out for some big potential viper-pits or what Sterling Archer calls – The Danger Zone:

- ♦ Most Favored Nations clause: a MFN basically requires a party to offer the same services, products, prices, or whatever on the same terms and conditions they offer it to any other party or category of parties. Watch out for anyone trying to impose such a requirement on your company or, if your offering one, that the company is truly prepared to give it and understands the repercussions. At one company I worked for, our delegations of authority required that the CEO of the company had to approve accepting or giving an MFN. That solved a lot of problems.
- ♦ Exclusivity: Does the contract require exclusivity on the part of one party/both parties? Is the company truly prepared to do that? Is there any whiff of [competition law problems with exclusivity](#) (same for MFNs)? Bells should go off if you see exclusivity requirements in a contract.
- ♦ Liquidated damages: I always paused whenever I saw a [liquidated damages](#) provision in a contract I was reviewing. These clauses provided for a set amount of damages for breach (or the agreement or some specific term). I would agree to them only in rare circumstances.
- ♦ Sub-Contractors: Does the contract permit or prohibit sub-contractors? Depending on how your company operates, this can be an issue. If sub-contracting is permitted, be sure you protect the company in the event the sub-contractor fails to perform properly.
- ♦ Service levels: Finally, does the contract require or lack service levels, i.e., metrics of performance where failure to meet them results in a penalty of some nature? Again, it depends on whether you are giving or getting them but, regardless of which side you are on, ensure that any contract containing [a SLA](#) provides for service levels you can live with along with acceptable remedies in the event the levels are not met.

7. Don't shoot blanks. A lot of contracts you will read start out as form agreements. This means there are likely blanks to fill in. As you read, watch for those and make sure you note them and that they are properly completed when the time comes. There's little more painful than, for example, having a dispute with the other party and going back through a contract after it's signed to find key provisions contain blanks. While usually not fatal, it can be very problematic.

8. “Other” documents. Just when you think reading the contract cannot get any more painful, you need to watch out for documents and other agreements incorporated by reference. A lot of contracts also include hyperlinks to webpages. So, the bad news is you need to gather up these documents and read through the relevant webpages to ensure you understand how they embellish and impact the contract you are reading. Skipping this step is simply not an option. And watch out for language that gives the other side the right to unilaterally change the incorporated documents (e.g., terms and conditions incorporated via a hyperlink). At a minimum, give yourself a termination right if any such changes would materially impact the company’s benefits or obligations under the core contract.

9. Are the parties right? Initially, getting parties right sounds like fun. But, I am talking about the parties to the contract and not the other kind. Seriously, it is deadly important to make sure the parties signing the contract are the parties who will provide or accept/pay for the services, goods, or whatever (or, if not, that the contract clearly spells out the relationships). This includes not only the preamble but, more importantly, the signature block. This is particularly important when one party ends up in a potential bankruptcy situation or there is trouble and litigation is brewing – when having the right parties on the hook really matters. If there is doubt about the stability of a party to a contract, you can seek a personal guarantee or have a related company guarantee performance of their subsidiary or sister company. And, regarding signatures, start thinking about who in your company is authorized to sign the contract you are reviewing. As mentioned above, sometimes there are delegations of authority or other policies that dictate who can sign what. You don’t want to be minutes away from signing and then realize you don’t have the right person engaged to sign it.

10. Other tips. Here are some other things to watch out for as you read through a contract:

- Whenever you see the phrase “provided, however” or “provided,” this flags that you are about to read an exception to the contract rule you just finished reading.
- If you see a phrase “notwithstanding the foregoing” or “notwithstanding any provision to the contrary,” this flags that you are about to read a rule that trumps all other contract rules on that topic.
- The phrase “for the avoidance of doubt,” means the contract author really, really, really wants to make sure there is absolutely and emphatically no confusion on whatever comes next.
- Watch out for double negatives! Sometimes it helps to diagram these to make sure you understand exactly what the contract says. Ultimately, you may want to rewrite the sentence with the double negative so the meaning is clear.
- If you think a sentence is ambiguous, ask yourself whether that ambiguity helps the company or hurts the company. If it hurts the company, ask yourself whether you have the leverage to clarify it in negotiations. If not, don’t raise the issue in negotiations because, if you do, it will only get clarified against you.

- Contract sentences can be long. Dreadfully long. So, mark the logical breaks in long sentences, and work section-by-section. Then put the sentence back together as you read back through it.

As you can see, there's a lot that goes into reading a contract properly. And like most work for in-house counsel, the devil is in the details. Half-assing a contract review is almost always a path to problems down the road. If a contract lands on your desk, grab a big mug of coffee and clear some time to do a proper reading. Take the time to do it correctly. Everyone will be glad you did, especially you.

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August 28, 2019

I have started working on book number six which will deal with productivity and will come out in 2023. But, my fifth book, [*Showing the Value of the Legal Department: More Than Just a Cost Center*](#) is available now, including as an eBook! As the ABA says, "Buy this book or suffer the consequences!" I know this is a bit vague but the ABA is serious so just buy a copy of the book and not risk it (whatever it is). You can buy it [HERE](#).

Two of my books, [*Ten Things You Need to Know as In-House Counsel – Practical Advice and Successful Strategies*](#) and [*Ten \(More\) Things You Need to Know as In-House Counsel – Practical Advice and Successful Strategies Volume 2*](#), are on sale now at the ABA website (including as e-books).

I have published two other books: [*The Evolution of Professional Football*](#), and [*The Slow-Cooker Savant*](#). I am also available for speaking engagements, webinars/CLEs, coaching, training, and consulting.

Connect with me on Twitter [@10ThingsLegal](#) and on [LinkedIn](#) where I post articles and stories of interest to in-house counsel frequently.

"Ten Things" is not legal advice nor legal opinion and represents my views only. It is intended to provide practical tips and references to the busy in-house practitioner and other readers. If you have questions or comments, or ideas for a post, please contact me at sterling.miller@sbcglobal.net, or if you would like a CLE for your in-house legal team on this or any topic in the blog, contact me at smiller@hilgersgraben.com

[1] I need to acknowledge my good friend Jeff Everett, one of the best contract lawyers I have ever met, who worked for me and helped me write the original article. Jeff was a great teacher and fun to work with. We did a lot of deals together over the years and I always learned something new from him when we did.

[2] [*I Know It's Only Boilerplate \(But I Like It\)!*](#)