



**Annual Meeting 2011**  
DENVER OCT 23-26  
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# *Dealing with Change in Your Contracts*



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# *Recognizing change will happen*





## Dealing with Change in Your Contracts

- Overview:
  - Part 1—**Recognizing the types of changes** that could occur
  - Part 2—**Addressing these changes** as part of contract negotiations:
    - By contract provisions
    - By processes
    - Deciding when to be specific versus general
    - Learning from the master---insights from Government contracting
  - Part 3—**Parting thoughts....**



## Anticipating Changes

- When a change is anticipated, it is usually addressed as part of contract negotiations with the other side
- Parties often agree to contract language that specifically addresses the impact of these changes
  - Example: Language recognizing the effect of a contemplated merger with a third party
- Anticipated changes also may be addressed by:
  - Specifying alternative obligations if the change occurs
  - Conditions to performance
  - Pre-agreed adjustments (price, equity interests)



## Dealing with Unanticipated Change

- A change may occur that neither party anticipates during the contract negotiations that has a profound impact on performance of the contract.
- The adverse impact of a change may be lessened by addressing typical changes that may have an impact on the contract, through means such as:
  - Force Majeure provisions
  - Business continuity/disaster recovery planning
  - Representations
  - Change Order provisions
  - Material adverse change clauses
  - Termination Provisions



## Dealing with Unanticipated Change

- In some cases, a change may be anticipated by one Party but not by the other Party
  - When should you tell a Counterparty about a change that could impact a transaction with them?
- May be ethical issues
- Representations and warranties may force the issue
- Loan agreements often have ongoing notice requirements to address this



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# *Addressing different types of changes*





## **Recognizing the Different Types of Changes that can Impact a Contract**

- **Changes in the Counterparty:**
  - Changes in the identity of the Counterparty
  - Counterparty's financial condition becomes worse
- **Changes in the Work or how it is performed:**
  - Change in key business objectives
  - Loss of key personnel or a key supplier
  - Changes in product offerings
  - Disruption at a manufacturing facility
- **Changes External to the Contract:**
  - Changes in law or regulation
  - Changes in political climate
- **Changes in the Market: Most Favored Nations**





## Dealing with a Change in the Identity of the Counterparty

- **Name change:**
  - Notice provision
  - Perfecting security interest
- **Assignments by Operation of Law:**
  - Mergers/consolidations, court orders, marital dissolutions
  - If intend to impose limits on this, be specific



## Dealing with a Change in the Identity of the Counterparty

- **Assignment clauses:**
  - Prohibition on assignment
  - Permit only with prior approval
  - Prohibit except where between affiliated entities
- **If you are the party seeking flexibility:**
  - “Permitted Assignee” safe harbors
  - Assignments for financing purposes



## **Dealing with a Change in the Identity of the Counterparty**

### **– Assignments—Other Considerations:**

- Drag along/tag along rights
- Rights of first offer/rights of first refusal
- Confidentiality provisions
  - practical effect on a Party's ability to shop its interest
- Regulatory considerations
- Tax considerations



## Dealing with Changes in the Financial Condition of a Party

- **Require “adequate assurance of performance” in defined cases**
  - Consider bankruptcy issues (e.g., rules for setting aside preferences)
  - UCC 2-609 may govern some transactions (contracts for sale of goods)
  - Some industries have standard forms with well defined credit support standards (e.g., ISDA swap agreements, EEl power sales agreements)
- **Possible types of performance assurance**
  - Letters of credit, guarantees
  - Prepayment, cash deposits, other collateral



## Dealing Generally with Changes in the Work

- Use exhibits to describe the Work
  - Establish a base-line technical specification for the Work
  - Use functional specification, not technical specification
- Establish a process to address technological changes and to maintain compatibility with legacy systems.
- Consider authorizing the Work in Phases  
Downside: loss of price certainty



## Dealing with Specific Changes in the Work:

- **Change in key business objectives:**
  - Reopen contract for good faith negotiations to amend
  - Terminate for convenience
- **Loss of key personnel:**
  - Identify key personnel and subcontractors
  - If important to you, secure right to approve replacements
- **Loss of key supplier/disruption of manufacturing:**
  - Business continuity/disaster plan may be triggered
- **Changes in product offerings:**
  - If contract refers to current offers, no amendment needed
  - If contract refers to offers as of execution date, amendment or separate contract needed



## Dealing with Impossibility of Performance or Frustration of Purpose

- High standard: not just unforeseen difficulty or expense
- May result in non-performance being excused and/or restitution of benefits
- UCC 2-615 may govern some transactions (contracts for sale of goods)
- Not usually addressed expressly by contract language, but may be indirectly addressed through force majeure clauses.



## Dealing with Changes in Laws or Regulation

- **Responsibility for compliance with laws**
  - Who should be identified as responsible?
  - And who should bear the costs of compliance (or fines and penalties for non-compliance)?
- **“Applicable Laws” definition:**
  - Should it be: “as of effective date” or “as changed”?
- **Options for dealing with change in law**
  - Address through a Change Order process (future debate over who should pay is likely)
  - Address as a force majeure event
  - Allocate between the parties





# Dealing with a Force Majeure Event

- **Definition is often key:**
  - an “Act of God”
  - an event “outside the reasonable control of a Party”
  - Specific events to think about and include or exclude:
    - Changes in law/regulation
    - Strikes, loss of key supplier
    - Failure of third party to perform its obligations
    - Other industry-specific events?
  - May also want to specifically identify what is not a Force Majeure
- Practice Tip: In a service contract, be careful to exclude delays that are associated with your other business operations that could affect performance of the Work—these delays are typically ones that should be accommodated by the suppliers.



## Dealing with Force Majeure Events

- **Typical conditions for treatment as a Force Majeure Event :**
  - Prompt **notice** of event must be given
  - Qualification of event as **within the definition** of a force majeure event must occur
  - Efforts must be made to **mitigate** the force majeure event (and activities unaffected by force majeure event must **continue** without change)



## Dealing with Force Majeure Events

- **Short-Term Impacts From a Force Majeure Event**
  - Failure to perform is excused (i.e., to the extent the party is unable to perform)
  - Performance must resume as soon as it can.
- **Additional provisions may also be triggered:**
  - Day-for-day schedule extension
  - Compensation paid to ramp up and down impacted activities



## Dealing with Force Majeure Events

- **Impact of a Prolonged Force Majeure Event**
  - Where the Force Majeure is prolonged, may trigger suspension or termination for convenience rights
  - Avoid this by specific language that addresses a prolonged force majeure event:
    - Termination fees less likely for Force Majeure termination than for termination for convenience
    - Force Majeure termination may include additional rights to take control of the Work or engage a third party to complete the Work
- Practice Tip: consider how force majeure provisions track across related contracts



## Use of Business Continuity Plans and Disaster Recovery Plans

- May help where **critical supplier is lost** or **political instability** experienced
- Supplier's plan **should anticipate** a range of potential events and should describe specific actions in **response** to them
- Purchaser may want to develop contingency plans to deal with **gaps** in the Supplier's plans and obtain contract rights to implement these plans, such as:
  - Rights to manufacture thru a third party where the Supplier is unable to manufacture units
  - Most favored nation's rights to component parts
  - Right to store product in Supplier's warehouses, at no cost.



## **Checklist for addressing Business Continuity Plans and/or Disaster Plans**

- Consider **what the plan needs** to contain
  - Support for services and facilities provided by Supplier?
  - Protection for critical technology and infrastructure?
  - Risk controls to allow performance in case of a disaster?
- Require the plan be submitted and implemented **by specified date**
- Provide for **notice of non-compliance**
- Address **impacts from non-compliance**
- **Review** adequacy of the plans at set intervals
- Consider **coordinating** your own plans with those of Supplier



## Representations, Warranties and Certifications to Avoid Surprises

- In addition to the typical provisions, you may wish to **customize** these to address your specific transaction.
- For a service contract, might focus on:
  - How the work has been performed.
    - Without copying or plagiarism
    - Without infringement or misappropriation of third party rights
    - With disclosure of third party rights that have been used
  - What rights are being granted to the work. Example:
    - No one else have been given the rights you received
- In some cases, you may want to require annual certification of compliance with certain requirements (such as ethics or safety standards)



## **Examples of topics you could address by a Representation, Warranty or Certifications**

- Efficient and Cost Effective Performance of All Assigned Tasks
- Compliance with Applicable Laws
- Use of Skilled and Qualified Personnel
- Use of Due Diligence
- Status of Technology Provided
- Non-Infringement
- Authorization and Other Contracts
- Inducements
- No viruses or inclusion of disabling code





## **Use of MFN Provisions to address market uncertainty**

- **Indexes rates and/or other material terms in a contract to those of contracts for similar good/services entered into at a later date.**
  - Usually restrictions on triggering an MFN
  - Can attach limitations to accepting an MFN offer (link with other terms and conditions)
  - Compliance monitored by requiring certification; sometimes backed by audit rights
- **Useful in reaching agreement when market rate is not established and one party is hesitant to overpay or lead the market in a long term agreement**



## Use of Change Orders

- **Commonly used** in large fixed price procurement contracts as a way to change commercial terms
  - May also be used as a way to amend terms and conditions
- Provision is of great importance to Suppliers
- Typically, however, **Buyer's issue** Change Orders
- Change Orders are typically effective when written acceptance or "**deemed acceptance**"

Practice Tip: Often desirable to replace "deemed acceptance" with a specific limit on the time the Buyer has to accept



## **Change Order Clauses – Additional Considerations**

- Who can initiate? Under what circumstances?
- Can certain types of events be pre-agreed as justifying a change order?
  - Examples: discovery of historical artifacts, unforeseen subsurface conditions, hazardous waste
- Consider additional requirements:
  - Threshold dollar amount for price change requests
  - Time limit for requesting change order
- What happens while parties are negotiating terms of a change order? Typically: exchange information, continue work, preserve the status quo



## **Suggestions to Provide Specificity in Change Order Provisions**

- Create a unilateral right to direct a change in the work that does not depend on agreement as to the compensation that will be paid when a change is directed. If possible, include a default compensation formula (such as use of pre-agreed time and material rates)
- Establish factors that will be considered in determining what compensation for a change is equitable: Whether the cost of making the change can be spread to other customers
  - Whether the change is required in order to continue in business or simply to provide unique services to a specific customer.
  - Which Party has the greatest negotiation leverage?
- Foreclose the Supplier from using the Change Order clause to obtain additional compensation for mistakes or carelessness in submitting a bid



## Use of a Material Adverse Change Clause

- **In M&A context:**
  - May give a Buyer a right to back out if a MAC has occurred after signing but prior to closing
  - May trigger a price re-opener
  - Seller should consider possible MAC scenarios and pre-negotiate contingent terms (buckets, price change formulas or caps, etc.) or process to keep the deal on track
- **In lending context:**
  - May give the lender a right to terminate a loan commitment
  - May trigger “market flex” (change to price or terms)
  - May be an event of default



## Use of a Material Adverse Change Clause

- **Drafting considerations:**
  - Seller/Borrower will want MAC clause narrowly drawn; Buyer/Lender will want it broad and forward-looking
  - Consider use of quantitative guidelines (if none, a “reasonable purchaser” standard will be inferred)
  - Consider including specific triggers and carve-outs tailored to your industry
  - Consider how to address pre-existing adverse circumstances, if any, which may continue or worsen
  - Consider how to address general industry changes
  - Some MAC events can be handled as closing conditions



## **Notification versus Amendment**

- **May be easier to administer if changes take effect by notification and without requiring an amendment**
  - Change in notification (name/address)
  - Changes in published price lists
  - Change in standard business terms and conditions (use of internet guides)
- **Is Internet posting of price lists and price guides adequate notice?**



## Use of a Governance Structure

- Identify types of changes that require review and approval
- Determine requirements for review or approval
- Monitor to assure process is being used and working as intended
- Consider how structure should work with the dispute resolution processes in the Agreement.





## Termination Rights

- **Types of termination rights:**
  - Convenience
  - Cause (i.e., default or breach)
    - Question, does it matter whether you identify the termination rights as being for default, breach or cause??
  - Other specific triggers, e.g., failure to obtain regulatory approval
- **Conditions on the exercise of a termination right:**
  - Prior notice
  - Payment of termination fees or costs



## Termination for “Cause” v. “Convenience”

- **In deciding which to use, consider:**
  - Termination for convenience often has a neutral impact on the business relationship
  - Termination for convenience usually requires you make the other side “whole”, which can be costly
  - A wrongful termination for cause may result in a counterclaim of wrongful termination
    - may wish to address this possibility in your contract language: “If requirements for termination for default are not met, then termination shall be treated as a termination for convenience.”



## Termination for “Cause”

- May be **triggered by** a material breach or specific actions, such as:
  - False/misleading reps
  - Dissolution or ceasing to conduct business in the normal course
  - Mergers without surviving entity assuming obligations of the transferor
  - Unauthorized assignment



## Other drafting issues for termination provisions

- Is termination automatic upon notice or should the other side have an **opportunity to cure** its default?
  - Duration of cure period? Should it be extended?
  - What about when the default is not able to be cured?
  - What if there are multiple events of the same type of default (or lots of separate defaults)?
  - What if the nature of the default means giving a cure right would significantly increase the impact from the original default (such as safety or ethics violations)
- What type of **transitional assistance** do you need from the other side if you terminate?
  - Do you have a right to require assignment of subcontractor agreements and could the subcontractors complete the work?



## Addressing Unexpected Problems

- **Tools may include:**
  - Root cause analysis (by Supplier or with third party)
  - Audits and other independent assessments of a situation
  - Implementation of a correction plan
- **Who should pay** for the related costs??
- What **assistance or cooperation** is required from you or others?
- What **effect**, if any, should evoking these provisions have **on other contract remedies**?



## Contract Duration and Importance

- **How long do you expect this contract to last? (original term + potential extension)**
  - With a very short term, many concerns about the potential for changes may disappear
  - With a very long term, it becomes difficult to specifically anticipate all the changes that could impact you
- **How important is this contract to you?** (if inexpensive commercial product, may just terminate and then go elsewhere)
- **Do you need to request information from your Counterparty to monitor and plan for future events?**



## Moving forward in the face of uncertainty

- **When you are unable to get agreement to address potential “what ifs” in advance, what should you do?**
  - Consider how bad the consequences of a “what if” might be for you
  - Think about the easiest path to address the situation in the future, if you decide to wait:
    - Amendments versus agreed-upon processes for updating contract language
    - Dispute resolution process
    - Termination rights



## And moving forward with your eyes open....

- **Rapid pace of technological change can suddenly render contracts ineffective**
  - Technical descriptions in contracts of how goods or services are delivered or what rights are granted can fall short of current technology or practices
  - Long terms may not allow for renegotiation when technology advances develop quickly
- **Drafting rights licenses or grants requires consideration of whether narrow drafting or broad descriptions best serve your business goal**
- **Consider whether shorter term or non-exclusive agreement will allow you to respond to a period of rapid change in technology**

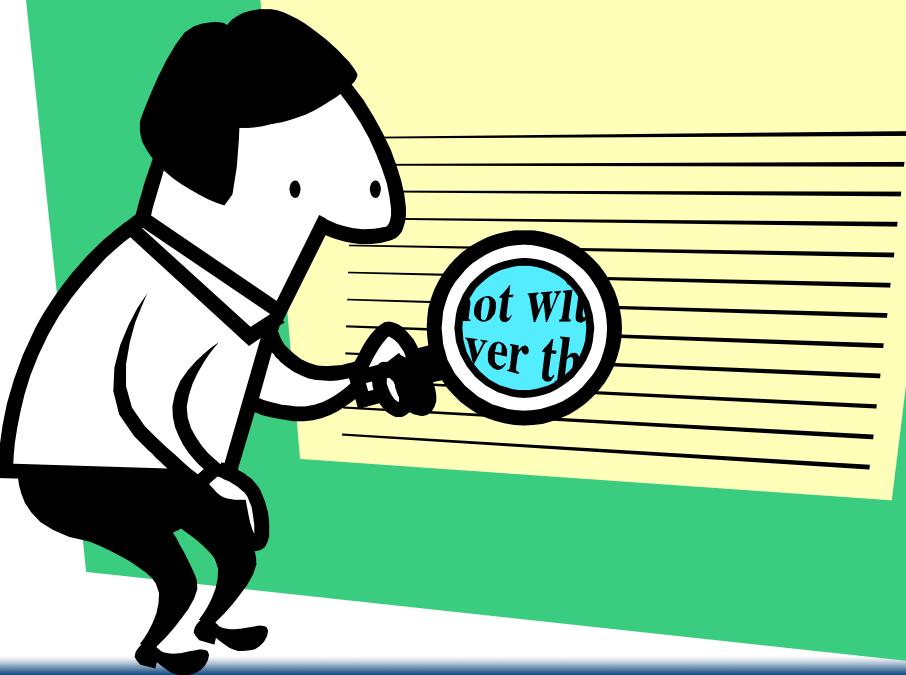




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# *Insight From Government Contracts*





## How Uncle Deals with Change

- **U.S. Government constantly works with changes to its programs and the contracts that support them, such as:**
  - funding issues
  - changes in military threats
  - Contractors in trouble
  - tech developments
  - company mergers
  - program and cost growth
  - unexpected barriers to contract success
- **Some of these are similar or the same as the problems that private businesses deal with too.**



# Federal Acquisition Regulation (FAR) as a Resource in Responding to Changes

- **What is the FAR?**
  - A collection of contract clauses and instructions on how to use them created by the Federal Government
  - Designed to help Federal Government procurement personnel perform their jobs.
- In dealing with the federal government, an understanding of the FAR is key
  - And in dealing with entities that contract using the FAR as a reference point (such as munis or defense contractors), an understanding of the FAR also is very valuable
- **Can your company enhance its commercial flexibility by looking to US Govt contract techniques and remedies as possible models?**



## **PROTECTING CONTRACT RIGHTS AND VALUES IN A “UNILATERAL” ENVIRONMENT**

- Customer-Exercised Contract Changes, Terminations and Options
- U.S. Government Procurement Models; Possible Adaptations for Private Sector Work
- Protecting Rights and Interests of the Party not Holding Unilateral Powers:
  - Bargaining for Equal or Parallel Treatment for Subordinate Party
  - Constructing Non-or-Pre-Litigation Dispute Resolution Systems



## First US Gov't "Changes" Clause?

### 1818 Contract with Asa Waters for supply of 10,000 muskets:

It is further agreed, that if the Ordnance Department should so far change the model of the muskets manufactured at the national armories, as to direct the barrels and bayonets to be finished of a brown color, after the manner commonly used, and direct the locks to be finished without polishing, the said Asa Waters will conform to the directions which may be issued from the Ordnance Department to that effect, without claiming any extra compensation therefor; it being fully understood that the muskets contracted for by the said Asa Waters shall be, in all respects, of a uniform pattern with those which may be made at the United States' armory. Should any alterations or pattern other than above mentioned, be decreed by the Ordnance Department, the said Asa Waters will be entitled to compensation for any extra expenses occasioned by such alterations.



# The Changes Clauses in the FAR -- Salient Characteristics

- **Allows the Government to unilaterally change its contracts**
- **Provides relief for "Constructive Changes"**
  - Constructive changes are ones caused by informal acts or inaction of Government officials
  - Supplier/Contractor to the Government may be entitled to an "equitable adjustment" of the contract price and/or duration provided notice is promptly given



# Pros and Cons of Constructive Changes

## – Advantage to Government:

- Constructive change claims will be submitted through the same administrative remedies system used for formal changes, and without the necessity for the contractor to contend that a breach of contract has occurred.

## – Advantage to Counterparty:

- Cheaper route to relief than suing for breach;
- Contractor can still push the matter through the Disputes system and ultimately into litigation.



## Typical Prime / Sub Positions re: Exercise of Options

**(Note: Options are Typically Used to Extend Performance into Subsequent Periods or Authorize Additional Quantities)**

**Prime:** Flow prime contract clause down virtually intact – preserve prime's discretion to cut off sub's work and select different subcontractor.

**Subcontractor:** If Government (or other ultimate customer) exercises options in prime contract, prime should exercise corresponding options in subcontracts accordingly, at least where subcontract still exists and sub is not in default.

CAUTION: Some Government clauses use stupid language to describe the period in which Government (or prime contractor) can exercise the option to extend: e.g., "A" may exercise the option by written notice to "B" **within** \_\_\_ days prior to expiration of the initial contract term. Could be six seconds! Better: "at least \_\_\_ days **prior** to expiration ....".





## Protection of Workforce

- **Sub or other non-dominant party is removed from project by prime's termination of subcontract or non-exercise of option**
- **Can prime now actively solicit Sub's key employees?**

Likely "YES" in absence of a non-solicitation clause

If non-solicitation clause, likely to restrict for term of subcontract plus one or two additional years following conclusion of the subcontract.



## **Termination for Convenience of the Government**

- **U.S. Power to Terminate Recognized:  
U.S. v. Corliss Steam-Engine Co., 91 U.S. 321  
(1875)**
- Decision recognizes the Government's power to compensate Contractor for partial performance, where the Government exercises a termination for convenience right.



## **Termination for Convenience -- Similar Question:**

Can prime contractor terminate subcontractor at will even if the highest entity [Government, project owner, etc.] does NOT terminate the prime?

Prime: Yes -- good clause. We like it!

Sub: Terrible idea; why should I work hard to support you if you are going to dump me even though your customer is happy with you and with all of my work?

Prime: Requirements change, you know. And we don't like your hat.

Does Sub have enough clout to secure a promise of longevity if prime contract is not terminated?



## **STANDARD DEFAULT CLAUSE (BASIC PART)**

### **FAR 52.249-8 (APR 1984)**

*(a)(1) The Government may, subject to paragraphs (c) and (d) of this clause, by written notice of default to the Contractor, terminate this contract in whole or in part if the Contractor fails to-*

*(i) Deliver the supplies or to perform the services within the time specified in this contract or any extension;*

*(ii) Make progress, so as to endanger performance of this contract (but see paragraph (a)(2) of this clause); or*

*(iii) Perform any of the other provisions of this contract (but see paragraph (a)(2) of this clause).*

*(2) The Government's right to terminate this contract under subdivisions (a)(1)(ii) and (1)(iii) of this clause, may be exercised if the Contractor does not cure such failure within 10 days (or more if authorized in writing by the Contracting Officer) after receipt of the notice from the Contracting Officer specifying the failure.*



## **FAR 52.233-1: DISPUTES (synopsis)**

- If grievances not informally resolved, contractor submits written claim asserting rights to equitable adjustments or other relief under Changes, Termination or other clauses of contract. Right of appeal to "Boards" or suit in US Court of Federal Claims.
- Contractor must continue performance while claim is evaluated and responded to by Govt if the issue is redressable under a remedy-granting clause (e.g., "Changes; "Differing Site Conditions"); if not [i.e., a "breach" claim], contractor can stop work and pursue breach remedies unless Disputes clause has special alternative provision requiring work continuance regardless of claimed breach.
- System is widely employed or adapted for use in prime-subcontractor disputes and in numerous purely commercial company contracts.



# *Almost done....*





## Parting Thoughts

- **Practice tips for service contracts:**
  - Use a close out process to resolve open change orders
  - Keeping a log of change requests
  - Governance processes to deal with non-material, routine changes
- **Other considerations:**
  - Know your contracts and how they work together
  - Beware of informal amendments, “apparent authority” issues
  - Beware of waiver/estoppel/detrimental reliance issues
  - Learn from litigation! Revise contract forms regularly
  - Relationships with counterparties are key



# Thought Provokers



- Why isn't there more litigation over contracts, given all the things that can go wrong??
- When do changes result in contract litigation?
- How does the type of contract influence whether a change clause is needed (and the language in the change clause)?