

# CONTRACTS AND LEGAL ISSUES





# Overview – Contracts

---

- What is a Contract?
- Contract: An agreement between two or more persons which creates a legal obligation to perform or not perform some action such as work, or a purchase and sale of goods; a legal enforceable promise.



# Contracts – Elements, Terms, Definitions

---

- Elements of a Contract
  - Mutual obligations
  - Consideration
  - Mutual agreement
    - Goods
    - Services
    - In writing?
    - “Agreement” vs. “contract”



# Contracts – Elements, Terms, Definitions

---

## Uniform Commercial Code (UCC)

- Article 2 of the Uniform Commercial Code: A set of uniform laws governing the sale of goods in all states.

Under the UCC, a contract may exist where terms have been left open, such as price.



# Contracts – Elements, Terms, Definitions

---

- Elements of Formation of a Contract:
  - Offer: An expression of willingness to enter into a bargain or contract, an offer gives someone else the power to accept.
  - Acceptance: An indication of agreement to be bound by the terms of the offer that is given in a method required by the offer. The acceptance must be communicated to the offeror.
    - Example: Jack tells Lisa that she can buy his piano for \$300. Lisa says “Okay” or “You’ve got a deal.”
  - Consideration: The cause, motive, price, or influence which induces a contracting party to enter into a contract.
    - Anything of value is consideration (employment, services, forbearance, money, property)



# Contracts – Elements, Terms, Definitions

---

- Consideration: For example: if A promises to pay B \$100 in exchange for B's merchandise, the transfer and delivery of the merchandise to A are consideration for A's promise.



# Contracts – Elements, Terms, Definitions

---

- Contract Enforceability – Concepts:
  - Written contract: A contract that states all of the terms in writing. Also referred to as a formal contract.
  - Oral contract: A potentially enforceable contract that is not in writing or is only partially in writing,
  - The UCC provides that any contract for the sale of goods for a price of \$5,000 or more must be in writing. (2-201)
  - “Battle of the Forms:” Term used to describe the effect of multitude of forms exchanged by buyers and sellers in connection with the same transaction.



# Contracts – Elements, Terms, Definitions

---

- Actions of the parties (course of dealing/course of performance)
  - Course of Dealing
  - Course of Performance
  - Waiver
  - Trade Usage





# Contracts – Elements, Terms, Definitions

---

- Course of Dealing – Conduct between the parties regularly over time which evidences a common basis of understanding and which occurred prior to formation of present contract
  - Example – Purchase of resin from Dow by COMPANY over last 10 years.



# Contracts – Elements, Terms, Definitions

---

- Course of Performance – Where contract invites repeated occasions for performance, each occasion is relevant to determining meaning of contract.
  - Example – Payment is made monthly for all shipments invoiced during the month. Acceptance of monthly batched payments is evidence that Seller agreed to accept this payment method.

# Contracts – Elements, Terms, Definitions



---

- Waiver – Repeated acceptance of non-conforming goods or behavior could lead to waiver of obligation to adhere to contract.
  - Example:
    - Contract calls for purchase of 1 million widgets a month.
    - For 12 months we have ordered and paid for 500,000 widgets each month. Seller cannot suddenly require us to purchase 1 million widgets in month 13 (unless there is a “non-waiver clause”!)



# Contracts – Elements, Terms, Definitions

---

- Trade Usage – A practice within a particular industry or at a particular place which occurs on a regular basis such that a reasonable person entering into a transaction would assume that the practice was part of the basis of the bargain.

The trade usage will be used in interpreting the agreement as to that part of the performance which may be in dispute or unclear.



# Defense, Indemnity & Insurance

---

- Separate defense & indemnity clause
- Vendor must defend COMPANY, its subsidiaries, officers, directors, employees, licensees, agents, distributors and independent contractors.
- Claims covered:
  - Intellectual property infringement
  - Product liability claims
  - Violation of law because of unlawful manufacture, possession, sale or use
  - Defect in goods (including packaging, tagging, labeling, packing, shipping and invoicing)
  - Failure to warn or inadequate warnings or instructions



# Applicable Law and Jurisdiction

---

- Illinois law applies
- Illinois courts have jurisdiction
  - Other States?
    - NY
    - DE
  - Other Countries?

# Commonly Used Terms & Trends: Covenants, Representations, and Warranties



---

- Covenant – ongoing promise by one party to take or not to take certain actions
- Representation – a statement of fact upon which another party is expected to rely
  - Must demonstrate materiality
- Warranty – a party's assurance as to a particular fact
  - Per se material



# Commonly Used Terms & Trends: Warranties

---

- How long?
- What warranties do you want? What do you want this to do?
- Remedies
- Disclaimers



# Commonly Used Terms & Trends:

## Type of Warranties

---

- Quality of Services / Goods - no defects (fitness for specific use)
- Merchantability
- Performance of good or technology
- No Sunset – If you are going to Sunset, give us notice and opportunity to buy spare parts (CMD)
- Sufficient title
- Conformity to RFP / Specifications – who provides?
- Financial condition
- Non-infringement



# Commonly Used Terms & Trends: Levels of Effort

---

- Reasonable efforts
- Diligent efforts
- Good faith efforts
- Commercially reasonable efforts
- Best efforts – could require use of all company's \$ and all personnel
- Best commercially reasonable efforts?



# Commonly Used Terms & Trends: Payment Terms and Fees

---

- How is price determined?
  - Fixed rate
  - Time and materials price
  - Caps
- When is price paid?
- Incentives to key vendor employees
- Out-of-pocket expenses
  - Trend: Marking-up fees to include out-of-pocket expenses
  - Consider: Is lowest expense policy beneficial to the deal?
- Trend: Lower (no) interest on late payments
- Trend: All fees clause – avoid calls to legal to see if included



# Commonly Used Terms & Trends: Personnel - Services

---

- Identify the vendor's key personnel
- Limits on vendor's ability to replace
  - Trend: Scarcity of good employees
- Trend: Background and security checks
- Trend: Cell phone numbers
- Pre-qualification – if so, how?
- Right to interview
- Right to replace
- Non-solicitation clauses (AVOID: Non-hire clauses)
- Key third party contractors



# Commonly Used Terms & Trends: Related Services

---

- Scope of work
- When scope of work isn't enough
  - May update through change orders
  - Avoid informality of updates by oral agreement



# Commonly Used Terms & Trends: Force Majeure

---

- A force majeure event excuses a party's failure to perform
  - When failure results from some circumstance beyond a party's reasonable control (be careful of "shortages of labor and goods")
  - Party's obligation to perform is "suspended"
- Trend: Additional force majeure events (e.g., acts of terrorism)



# Commonly Used Terms & Trends: Term and Termination

---

- Match term to business needs
  - Initial term
  - Term renewals
  - Term extensions
- Termination rights
  - What constitutes a “material breach”?
  - Bankruptcy
  - Convenience
- What terminates? Some clauses should continue
  - Confidentiality
  - Indemnity
  - Warranty



# Commonly Used Terms & Trends: Disengagement

---

- Exit Strategy
- Disengagement Process
  - Time or events that will trigger disentanglement
  - Mechanics of disentanglement
  - Transition services to be provided
  - Price for resources to be reconveyed
- Transition Plan





# Commonly Used Terms & Trends: Indemnification

---

- Infringement of intellectual property
- Trend: Watch out for customer costs to assist vendor
  - Indemnatee will be paid for its costs of helping
- Bodily injury and property damage
- Use of data, modifications, inventions
- Limitations:
  - All costs as incurred vs. final judgment
  - Procedures
  - Subject to limitation of liability – baskets, caps, and termination provisions
  - Remedies



# Commonly Used Terms & Trends: Damages

---

- Compensatory Damages (aka “actual”)
  - All damages other than punitive, exemplary, and nominal damages
- General Damages
  - Damages that normally and necessarily occur in the normal course as a result of a particular type of breach
- Consequential Damages (aka “special”)
  - Losses that result from special or unusual circumstances peculiar to the non-breaching party, provided that the breaching party must have had reason, at the time of making the contract, to know of the other party’s special circumstances; and personal injuries and property damage that result directly from the breach (lost profits, opportunity costs)
- Incidental Damages
  - Expenses of ascertaining and dealing with the breach
- Cost of Cover; Direct or Consequential?



# Commonly Used Terms & Trends: Liquidated Damages

---

- Unenforceable penalty unless:
  - Damages from breach difficult to compute
  - Liquidated damages are good faith estimate
- Liquidated damages provision specifying that damages are difficult to compute and the specified liquidated damages are a “good faith estimate”
  - Courts will look to substance rather than form



# Commonly Used Terms & Trends: Other Clauses to Consider

---

- Assignment
- Amendments
- Change of control
- Non-solicitation / non-competition
- Order of precedence



# DANGER! Proceed with Caution – A List of Warning Signs

---

## 1. Long Duration

- More than 2 years
- Magnifies problems
- Escape valve
  - Termination for convenience
  - Market pricing/performance



# DANGER! Proceed with Caution - A List of Warning Signs

---

2. Exclusives/Percentages of Total Requirements
  - Carve out for acquisitions
  - Hard to administer – we're too big
    - Exception bucket to cover mistakes and unanticipated items



# DANGER! Proceed with Caution - A List of Warning Signs

---

## 3. Minimums

- Absolute minimums vs. price advantage if minimums
- Distinguish between requiring capacity vs. requiring purchases



# DANGER! Proceed with Caution - A List of Warning Signs

---

4. Convoluted/Complex Business Terms
  - Somebody/everybody is playing a game
  - KISS
  
5. Paying for Source's Capital Investment





# DANGER! Proceed with Caution - A List of Warning Signs

---

## 6. Not Owning Product/Patent/Copyright When We Are Creating the Value

- Hot product / Competitive advantage
- Commitments to our customer

## 7. Single Sources

- Market pressure = value



# DANGER! Proceed with Caution - A List of Warning Signs

---

8. Commencing Business Before Contract is Signed/Agreement to Agree on Key Terms
  - Time waster
  - Use Purchase Order



# DANGER! Proceed with Caution - A List of Warning Signs

---

9. Don't Use Their Form Contract
  - It's not just "meaningless Boiler plate"
  
10. Covenants Not to Compete / Non-Hire Provisions



# Drafting a Purchasing Contract

---





# Top 10 Reason Why You Can't Get the Contract Done on Time

---

10. My computer crashed because I have 5000 urgent contract requests and your draft was erased.
9. You haven't sent me the deal terms because you expect that I will figure them out from the vendor proposal you sent me.
8. I was unable to access Filetrail to pull existing contracts since the system has been down for a week.
7. You gave me the draft created from a 20-year old form that was written by the vendor and never had legal review.
6. You took what the vendor sent and, without reading it, brought it to me for approval (while you waited).
5. You have been negotiating and changing the draft for over a month before you realized that I need to approve changes to the contract. Now, it needs to be signed this afternoon.
4. You insisted that the vendor would not accept changes, so I did not initial the contract because it was highly unfavorable to COMPANY. Your manager told you that he wouldn't sign the contract without legal approval. Now, the vendor is willing to negotiate, but their lawyer is on vacation.
3. The vendor has been our sole source supplier for 15 years without a contract and we are seeking a 20% cost reduction.
2. I have been called by the Board to negotiate a highly secretive transaction. Unfortunately, this means that I have been in the Cayman Islands for the past six weeks.
1. You waited until the Friday afternoon at 2:30 pm before the vendor meeting (scheduled for the Tuesday after Memorial Day) to send me the contract for review!



# Drafting a Purchasing Contract

---

## Step 1:

- Determine business structure of the Vendor.  
Is the vendor a:
  - Corporation
  - Subsidiary or division of a corporation
  - Limited Liability Partnership; Partnership or Limited Liability Company
  - Operating under an assumed name (i.e., d/b/a)
  - Sole proprietor
- Include correct and full name and address of vendor on any contract document.



# Drafting a Purchasing Contract

---

## Step 2:

- Sign a Confidentiality Agreement, if applicable
  - Mutual
  - One-Way



# Drafting a Purchasing Contract

---

## Step 3:

- Develop operational information about the vendor:
  - History
  - Management team and principals
  - Source of labor
  - Significant customers, bank references, independent accounts/auditors/D&B, etc.





# Drafting a Purchasing Contract

---

- Additional background issues:
  - Has the vendor ever conducted business with COMPANY in the past (or under different names)?
  - Are any of the principals of the vendor organization current or former employees of COMPANY or do they have family members who are current or former COMPANY employees? (Statement of Business Principles)
  - Have the vendor or any of its principals ever declared bankruptcy?
  - What is the vendor's litigation history?



# Drafting A Purchasing Contract

---

## Step 4:

- Utilize COMPANY's standard forms
  - Don't go to a prior contract (unless we have one with this vendor)
  - Call Legal if confused about which form to use



# Drafting A Purchasing Contract

---

## Step 5:

- If vendor demands changes to the standard forms
  - Scope/Importance of project
  - Are there alternate vendors?
  - Business vs. “Legal” Provisions
    - Price vs. Indemnity, Warranty, Non-Hire, Compliance
  - Send to Legal for Review
    - Provide description of deal and timing
    - May take from 24 hours to 2 weeks



# Drafting A Purchasing Contract

---

## Step 6:

- Verify that a Certificate of Insurance evidencing that the required insurance coverage has been obtained.

## Step 7:

- Have an authorized person sign the contract.



# Drafting Issues: Precision and Time References

---

- Precision:
  - Draft contracts to precisely reflect the agreements and intentions of the parties
  - Avoid unnecessary “legalese”
    - If you don’t understand it, don’t sign it!
- Time references:
  - Specify dates
  - Date based
  - Promptly



# Drafting Issues:

## Use of Formulas and Materiality

---

- Use of formulas:
  - Make sure they work!
  - Written algebraically
- Materiality:
  - What does it mean?
  - Subjective concept

# Drafting Issues:

## Words to Scrutinize Carefully

---

- Solely
  - Means 100% (not 99%)
- Estimate
- Shall vs. may (“Will usually means the same as “Shall”)
- Goal
  - Word like estimate (absent fraud, merely an aspiration)



# Drafting Tools: Technology

---

- Avoid Parallel Drafts – One document goes back and forth
- Track changes:
  - Corruption
  - Complicated
  - User-friendliness
  - Control





# Drafting Tools: Internal Tools

---

- Checklist
  - What isn't there that needs to be there
- Precedent files
  - Be sure to distinguish between standard provisions and provisions previously negotiated
- Update checklists and precedent files frequently to:
  - Keep current
  - Reflect industry standards and industry trends



# Some “Level Setting”

---

- The counter party:
  - The other party is not your enemy but they are also not your friend
  - Does not get his paycheck from COMPANY
  - Will always time box you and threaten the “imaginary price increase” next quarter (or next day), so;
    - Never disclose financial or budget information; it becomes “the price”
    - Never disclose that they are your favorite; competition is good – better terms and price is the goal. Use RFP’s and let everyone know the race is on



# Some “Level Setting” (cont’d.)

---

- Last deal points are:
  - Price
  - Indemnities
  - Warranties
  - Ownership of deliverables
  - Limitations of liability



# Forms on COMPANY SITE

---

- Confidentiality Agreement
  - Mutual
  - One-Way
- Purchase Agreements
  - Facilities Services
  - Products and Services
- Consulting
  - Consultants Agreement
  - Professional Services Agreement
    - IT
    - Non-IT



# Forms on COMPANY SITE (cont'd.)

---

- Terms and Conditions
  - PO – for Goods
  - Services
- Other: Sale of Used Equipment, RFP Template, Software License, Training Services



# Forms on COMPANY SITE (cont'd.)

---

- Call Your Lawyer!
- No Forms For:
  - Significant Manufacturing (Toll Manufacturing)
  - Long term, key supply (Specialty resins, inks)
  - Strategic Alliances (Licensing, Joint Development)