# 308 - Best Practices in Contract Negotiation, Drafting, & Administration

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# Faculty Biographies

**Don Butler**

Don Butler is senior counsel and secretary of Seneca Resources Corporation in Houston. He handles a complete range of upstream and downstream contractual matters both domestic and international with an emphasis on operational risk management that integrates safety, contractual provisions, and insurance. He also manages energy litigation.

He has held in-house positions with several independent producers, including his current employer, Seneca Resources Corporation, a wholly owned subsidiary of National Fuel Gas Corporations, as well as law firm positions, including ,Vinson & Elkins in its general litigation section and Fulbright & Jaworski in its energy & environmental litigation section. These positions have involved both domestic and international oil and gas law, transactions, and litigation.

Mr. Butler is a past president and currently a director of ACC's Houston Chapter. He has been an adjunct professor of law at the University of Houston Law Center teaching oil and gas law. He is also certified by the Texas Board of Legal Specialization in oil, gas and mineral law.

He graduated second in his class from the University of Houston Law Center and was on the *Houston Law Review*.

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Irene Kosturakis is chief intellectual property counsel at BMC Software, Inc., in Houston. She is responsible for all intellectual property matters for the company, including patent acquisition, development and maintenance of the patent and trademark portfolios, patent litigation, copyrights, intellectual property transactions, and industry standards-setting efforts.

Ms. Kosturakis arrived at BMC with my years of experience handling intellectual property issues at the Hewlett-Packard Company and Compaq Computer Corporation. At HP, she performed in the role of IP transactions attorney. While at Compaq, Ms. Kosturakis went through the two largest IT industry mergers at the time: Compaq/Digital Equipment and HP/Compaq. During the Compaq/DEC merger, Ms. Kosturakis successfully merged the patent portfolios of the two companies. At Compaq, she managed the company's patent portfolio, establishing strategy and processes for growing it into an assertable and valuable patent portfolio.

Ms. Kosturakis is currently president of the ACC's Houston Chapter and an adjunct professor at South Texas College of Law for the international business transactions problem course. She is a registered patent attorney. She is the chairperson of the state bar's business law section e-commerce committee. Ms. Kosturakis is also a member of the Houston Intellectual Property Lawyers Association (HIPLA). She is also a Houston Volunteer Lawyer assisting indigent bilingual and handicapped clients on simple family law matters, including divorces.

Ms. Kosturakis has a B.S. from the University of Texas at El Paso, a Masters from the University of Houston, a J.D. from South Texas College of Law, and a Masters of Law from the University of Houston.

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# A FRAMEWORK FOR NEGOTIATING LIMITATION OF LIABILITY CLAUSES AND INDEMNITY OBLIGATIONS IN BUSINESS AGREEMENTS

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## Executive Summary

This outline discussed limitation of liability and indemnification clauses. Both clauses commonly arise in contractual negotiations and are among the most difficult to negotiate and have great impact on the outcome of a future contractual dispute. The successful outcome of many disputes will depend on you, as the practitioner who drafts, negotiates and finalizes a contract, having thought through the consequences of including these clauses and their precise language.

The first part of this outline discusses limitation of liability clauses. You can limit liability by eliminating the obligation or duty all together by negating fiduciary duties, implied warranties, and the duty of care. Doing away with the duty means there is no need to limit damages. There cannot be any.

Some duties will be impossible to eliminate completely, of course, and you then must limit ensuing damages with the appropriate clause. The most frequently used clause to limit damages by far relates to consequential damages, but there are many other ways to limit the amount of damages, such as, for example eliminating punitive damages, providing for no damage where there is a force majeure event, stating that there is "no damages for delay," providing an exclusive contractual remedy, having a liquidated damages clause, imposing a financial cap on damages, having a "net" damages (such as limiting damages to insurance recovery), and eliminating subrogation rights where you have exposure to the party having the right of subrogation, typically insurance companies. You can also reinforce some affirmative defenses in your agreement by imposing a contractual duty to mitigate and providing for a contractual statute of limitation.

The second part of this outline discusses indemnity provisions in agreements. There is a discussion of why indemnities are useful. Four types of indemnities are discussed: (a) the "covenant reinforcement" indemnity; (b) the "fault-based" indemnity; (c) the "activity-based" indemnity, and (d) the "control-based" indemnity. The "covenant reinforcement" indemnity simply restates a covenant in terms of an indemnity: "you will return my equipment in good condition and you will indemnify me if it is not returned in good condition." The "fault-based" indemnity simply restates a legal obligation in terms of an indemnity: "you promise to perform the operation with care and skill, and you will indemnify me if you don't exercise due care." The "activity-based" indemnity and the "control-based" indemnity are often mutual indemnities: "I will indemnify you while you have my car, and you will indemnify me while I have your car." Control often follows ownership or responsibility: "I will be responsible for my property, which I have insured, even if you cause the damage, but you will be responsible for your property, which you insured, even if I am responsible, and we'll get our insurers to waive the right of subrogation."





## I. A Framework for Limitation of Liability Clauses

### A. Eliminating Risks

#### 1. Eliminate Duties

#### (a) Fiduciary Duties

The common law imposes fiduciary duties in business relationships, such as partnerships, joint ventures, and agencies. Such fiduciary duties are inappropriate where the parties to the relationship are sophisticated and prefer to deal at arms' length, expressly stating each party's rights, duties, and remedies in a written agreement. Because the law imposes fiduciary duties, contracts must clearly negate them.

#### (b) Duty of Care

The common law imposes a duty of care in virtually all relationships, including business ones, but sometimes that duty of care imposes liabilities and associated costs on one party to a business transaction, while in some transactions, the other party is sophisticated enough to the point that it does not need the protection, preferring, for example, to buy property "as is" rather than not have the property at all.

### B. Eliminating Warranties

#### 1. Implied Warranties

The common law imposes certain implied warranties; however, the parties often desire to write their own warranty obligations in a written agreement. Because the common law imposes implied warranties, the contract must clearly negate them so that the implied warranties do not interfere with the express ones. The ones most commonly eliminated are the implied warranties of merchantability, fitness for purpose, and habitability.

#### 2. Statutory Warranties

Even though the legislatures have imposed certain statutory warranties, the parties often desire to write their own express warranty obligations in a written agreement. Because the legislature has imposed the statutory warranties, however, the contract must clearly negate them where legally permissible so that they do not interfere with the express warranties.

### C. Eliminating Damages

It is the rare contract that does not impose at least some duties and obligations, such as to meet a workmanlike standard, adhere to a schedule, use of new materials, conform to specifications, conform to codes, and correct defects. Therefore, one of the most popular methods of eliminating risks is to eliminate certain types of damages that would, but for the restriction, otherwise be available, the most common being consequential damages and punitive damages.

**1. Consequential Damages**

**(a) Direct and Indirect Damages Have Same Requirements**

Direct damages are losses which flow naturally from the breach, while indirect damages are damages that do not flow directly from a wrong or injurious act but, rather, indirectly. Consequential damages are indirect damages and are the single most important source of "upside" in commercial litigation. Consequential damages are actual damages. Whether direct or indirect, however, the requirements for receiving damages are the same: damages (a) must be proximately caused by the actionable wrong, (b) must have been within the reasonable contemplation of the parties, and (c) must be shown with reasonable certainty, *i.e.*, not be speculative. Because consequential damages are more likely to be speculative, contracting parties usually try to eliminate them. See the below example, which is an excerpt from an SEC filing.

> Disputes have arisen between a subsidiary of Fluor Daniel and its client, Anaconda Nickel, over the Murrin Murrin Nickel Cobalt project located in Western Australia. Both parties have initiated the dispute resolution process under the contract. Anaconda's primary contention is that the process design, through which pressurized and super heated metal slurry flows through a series of depressurization flash vessels, is defective and incapable of proper operation. Anaconda also contends that it has suffered other consequential losses, such as loss of profit, for which it seeks payment from New Fluor. *Anaconda contends that New Fluor is liable to Anaconda in the total amount of A$1 billion, A$800 million of which is alleged consequential damages.* [emphasis added]
>
> New Fluor vigorously disputes and denies Anaconda's allegations. Among other things, New Fluor contends that Anaconda has and continues to improperly operate the facility causing the flash vessels to fail. When Anaconda complied with the written operating procedures, the flash vessels operated properly and continuously. Moreover, New Fluor contends that Anaconda has failed to supply the contractually guaranteed feedstock, adversely affecting the performance of the facility. New Fluor rejects Anaconda's claim of loss of profit, since New Fluor has complied with the applicable standards of care in the industry and otherwise, *the contract between New Fluor and Anaconda contains a waiver of consequential damages, such as loss of profit.* [emphasis added]

**(b) The Distinction Between Direct and Indirect Damages (Or A Picture Is Worth A Thousand Words)**

These examples are from Crichton, Sha-shana N.L., Distinguishing Between Direct and Consequential Damages Under New York Law in Breach of Service Contract Cases, 45 How. L.J. 597 (2002).

**The Classic Direct Damage Example**
**(Pay Me What You Owe Me)**

> [T]he Court of Appeals classified lost profits as direct damages in American List Corp., v. U.S. News and World Report, Inc., because American List Corp. ("ALC") sought only to recover money that U.S. News and World Report ("U.S. News") assumed a definite obligation to pay under the contract. U.S. News agreed to rent mailing lists of the names of college students that ALC would compile over a ten-year period. U.S. News cancelled the contract after one year. The trial court found U.S. News liable for breach of contract and awarded ALC $1,449,344 in damages for the remaining nine years of the contract, reduced to its present value. U.S. News appealed and ALC cross-appealed. U.S. News argued that the trial court erred in awarding ALC lost profits damages which were consequential damages and not compensable absent a showing that they were



> foreseeable, and that liability for such damages was contemplated by U.S. News and ALC at the time they entered the contract.
>
> The Court of Appeals reasoned that ALC's lost profits damages were direct damages which U.S. News was obligated to pay to ALC under the contract and which resulted as a natural and probable consequence of U.S. News' premature cancellation of the contract. The contract required U.S. News to pay ALC a fixed sum for a fixed period and ALC sought only to recover lost profits damages for the balance owed to ALC under the contract. Although the Court of Appeals categorized ALC's lost profits damages as direct damages that did not require proof that liability was contemplated at the time of contracting, the court nonetheless noted that ALC's lost profits damages were "unquestionably within the contemplation of the parties" at the time of contracting because U.S. News drafted the contract and expressly stated in an appended schedule that it would pay ALC $3,027,500 over a period of ten years to provide a specific number of names.

**The Classic Indirect Damage Example**
**(If You Had Built It, Then They Would Have Come)**

> The Court of Appeals considered lost profits as consequential damages in Kenford Co., Inc. v. County of Erie. In this case, Kenford Company, Inc. ("Kenford") and Dome Stadium, Inc. ("DSI") entered into a twenty-year contract with the County of Erie ("County") for the construction and operation of a new dome stadium. The County failed to begin construction as scheduled in the contract. DSI sued the County for breach of contract. DSI requested damages for the profits they anticipated earning from related business opportunities, including a baseball franchise for the stadium. The trial court awarded DSI lost profits damages. The County appealed. The Appellate Division reversed the award on the grounds that the statistical projections used to prove the amount of damages were insufficient as a matter of law to support an award for lost profits. The Court of Appeals affirmed the Appellate Court's decision, but on different grounds. The Court of Appeals reasoned that DSI's evidence was legally insufficient to warrant an award for lost profits damages, because DSI failed to demonstrate that the parties contemplated liability for lost profits over the length of the contract at the time of contracting, and also failed to prove the existence and amount of lost profits with reasonable certainty.

**Now The Thousand Words –**

This is from the Association of International Petroleum Negotiators Guidance Notes for its Model Well Service Contract. Considerable effort was made by this Association to research the issues, resulting in probably no better brief summary of consequential damages. That section, which is quoted below, is complete with English spellings.

> The provisions in the Model Contract dealing with liability for damages attempt to spell out the specific kinds of damages that the Parties intend to exclude. Courts in different jurisdictions may interpret differently words such as "direct" or "consequential" damage. Depending upon the context in which the relevant words are used within the contract, different interpretations may well be given to these words by the courts in the same jurisdiction.
>
> From decisions of English courts the following general principles can be extracted:
>
> The term "consequential damages" within exclusion clauses has been generally interpreted as being synonymous with "indirect" damages.
>
> Consequential or indirect damages have generally been regarded as those which do not flow directly from a wrong or injurious act but, rather, indirectly.

Direct damages are losses which flow naturally from the breach without an intervening cause and independent of any special circumstances.

Direct damages arise naturally from a breach and are dependent upon the knowledge that a reasonable businessman in the same position of the parties is assumed to have.

Exclusion clauses that only preclude liability for indirect or consequential damages have been held not to exclude liability for direct damages or losses suffered by a plaintiff.

In characterising damages as being either direct or consequential, the Courts have relied upon the two branches of damages established in *Hadley v. Baxendale* (1854) 9 Ex. 341 with respect to remoteness of damages, which are

> imputed knowledge on the part of the defendant for damages which a reasonable businessman would or ought to have foreseen as the likely or probable consequence of the breach (objective test); and
>
> knowledge of special circumstances or particular consequences which may go beyond what was ordinarily foreseeable but nevertheless is recoverable as being within the "reasonable contemplation" of the parties by virtue of the defendant's knowledge of the special circumstances (subjective test).

The two branches of damages in the *Hadley v. Baxendale* test have been relied upon to distinguish between direct and indirect damages.

By way of example the English Court of Appeal considered the meaning of "consequential" loss in the case of *British Sugar plc v. NEI Power Projects Limited and Another 87* Build LR 42. The main judgment was given by Lord Justice Waller. This was an appeal from a judgment on a preliminary issue concerned with words in a contract that were seeking to place a limitation on liability for damages in relation to "consequential" loss. It was successfully argued at first instance that a loss that flowed directly and naturally from a breach of contract was not caught by a limitation on liability imposed on "consequential loss". It was suggested by the appellant that any reasonable businessman would understand that, for example, loss of profits would be "consequential". The appellant relied upon an analysis contained within a leading text book (McGregor on Damages) where the editor seeks to draw distinction between "normal" and "consequential" damages in that normal loss is the loss that every plaintiff in a like situation will suffer and consequential loss being the loss which is special to the circumstances of the particular plaintiff. Waller LJ found that in two other cases the Court of Appeal had in very similar contexts found that the word "consequential" did not cover any loss which directly and naturally resulted in the ordinary course of events.

The Court of Appeal agreed with the judge at first instance decision that on the true construction of that contract, the parties simply agreed to limit the defendant's liability for loss and damage not directly and naturally resulting from the defendant's breach of contract to an amount equal to the value of the contract.

The test applied by the court was what would the reasonable businessman understand from the contract. The principles which a court should use to come to a decision as to the understanding of the reasonable businessman were set out by Lord Hoffman in the case of *Investors Compensation Scheme Ltd v. West Bromich Building Society* (No 1) [1998] WLR 896 (HL), Lord Hoffman's summary of the principles being:

> Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.



The background was famously referred to by Lord Wilberforce as the 'matrix of fact', but this phrase is, if anything, an understated description of what the background may include. Subject to the requirement that it should have been reasonably available to the parties and to the exception to be mentioned next, it includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man.

The law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent. They are admissible only in an action for rectification. The law makes this distinction for reasons of practical policy and, in this respect only, legal interpretation differs from the way we would interpret utterances in ordinary life. The boundaries of this exception are in some respects unclear. But this is not the occasion on which to explore them.

The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean. The background may not merely enable the reasonable man to choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax (see: *Mannai Investment Co Ltd v. Eagle Star Life Assurance Co Ltd* [1997] 3 All ER 352, [1997] 2 WLR 945).

The 'rule' that words should be given their 'natural and ordinary meaning' reflects the commonsense proposition that we do not easily accept that people have made mistakes, particularly in formal documents. On the other hand, if one would nevertheless conclude from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had. Lord Diplock made this point more vigorously when he said in *Antaios Cia Naviera SA v. Salen Rederierna AB, The Antaios* [1984] 3 ALL ER 229 at 233, [1985] AC 191 at 201:

> …if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business common sense, it must be made to yield to business common sense.

In summary, *the interpretation given by an English court to words used to limit or exclude damages will depend upon the context in which the words are used and will be interpreted against the contract as a whole. It is therefore advisable to take advice from someone suitably qualified as to the effect of the limitation or exclusion provision* contained within Article 13. [emphasis added]

The AIPN Well Service Agreement on Consequential Damages

As you can tell from the above summary, consequential damages has no precise meaning. A search on EDGAR, however, resulted in the following examples of what corporations consider to be consequential damages in contracts filed with the Securities and Exchange Commission:

Items Lawyers Have Listed as Consequential Damages

1. Loss of earnings, profits, or revenue from collateral or ancillary transactions (loss of earnings, profits, or revenue from the transaction that is the subject of the agreement may be considered direct damages because they do not depend on the actions of a third party).

2. Loss of use of an asset.

3. Loss of business, reputation, or goodwill.

4. Loss of business opportunity, lost sales, or lost contracts.

5. Loss of management or employee productivity.

6. Wage or salary increase or other inflationary cost of labor.

7. Increase in financing costs, cost of capital, administrative fees, legal fees, or overhead or failure to realize expected savings.

8. Business interruption.

9. Unavailability of facilities.

10. Claims of customers.

11. Shutdowns or service interruptions.

12. Inventory or use charges.

13. Cost of obtaining substitute goods or services.

14. Lost data or information.

15. Loss of product or oil production, oil reservoir damage, loss of drilling hole, or damage due to well blowout or drill hole cratering.

**2. Punitive Damages**

An award for punitive damages, *i.e.* exemplary damages, require very special circumstances, such as the breach of a fiduciary duty, gross negligence, or abuse of a confidential relationship. If awarded, exemplary damages may be very large, and are not as readily available as consequential damages.

**3. No Damages In Certain Situations**

**(a) Force Majeure Clauses**

The law will not imply a force majeure clause. It must be expressly stated in a contract.

> Practice Note: *Include in the listing of force majeure events "acts of terrorism and sabotage" as well as any special circumstances that your party may experience due to geographic location. For example, include "hurricanes and flooding," if your party's performance will be in the Southeast Gulf coast region of the U.S.*

**(b) No Damages for Delay Clauses**

No "damages for delay" clauses are common in construction and other work-related contracts because the risk of delay is high, and the damages are usually consequential, but there is



often a desire on the part of the party performing to address the topic to avoid direct as well as indirect damages.

**D. Exclusive Contractual Remedy**

One of the most common forms of limitation of liability clauses is to make the contractual remedy the exclusive one, such as limiting the buyer's options for defective products to repair or replace of the product.

**E. Liquidated Damages**

Liquidated damages do not seem to be as popular as financial caps. Liquidated damage clauses require a reasonable pre-estimate of the actual damages. This is a consistent with the requirement that the liquidated damages not be a "penalty." Because the liquidated damages are a substitution for actual damages, however, a liquidated damages clause is used when the actual damages are difficult to ascertain.

**F. Financial Caps**

Unlike liquidated damages, financial caps require that actual damages be proven. The caps can take many forms: a dollar cap, a cap based on insurance, or a cap tied to the value of an asset, such as where one party agrees to have recourse only against certain property of the other party.

**G. "Net" Damages Only**

Similar to a financial cap is net damages. Where the party who is liable may reduce the payment by any number of items, most often one or more of the following:

**(a) Insurance Recovery**

**(b) Third-Party Recovery**

**(c) Tax Benefit of Loss**

**H. Subrogation Rights**

This is similar to a third-party recovery. The recovery, however, is done by the party having to make the payment for damages. Having paid, the paying party may require that it be subrogated to any rights the paid party may have against third parties.

**I. Contractual Duty to Mitigate Damages**

Even though there may be no other protection, such as caps, a party may write in a contractual duty to mitigate damages so that losses are not exacerbated by the other party's inaction.

**J. Contractual "Statutes of Limitation"**

Strict requirements as to the time in which a claim may be brought that are far less than the law allows is one way to limit damages. This can be quite sophisticated, such as where the parties provide by contract that the discovery rule will not apply.

## II. A Framework for Indemnity Clauses

### A. The Broader Context of Indemnities and Risk

An indemnity is a promise by one party to protect the other party from unfavorable events that may occur during the performance of the contract they are negotiating. Since indemnities expressly shift foreseeable, even if unlikely, risks, the indemnities are often the most contested part of a contract's "boilerplate." Risk allocation, however, does influence the price, with companies feeling compelled to charge more depending on the risks assumed and the cost of the insurance products to cover the risks. In some cases, a company may lose business to competitors willing to accept certain risks that the company is reluctant accept. Especially intractable are indemnity negotiations over potential losses that cannot be shifted to the insurance industry, indemnity negotiations of any kind with self-insuring entities, and indemnity negotiations touching jurisdictions with anti-indemnity laws.

> Practice Note: *Since an indemnity is part of the written contract, the negotiator must identify possible unfavorable events or risks before the negotiation concludes. The negotiator must consult with others in the negotiating group to determine the nature of those risks, their likelihood under the contract under negotiation, and how such risks might be managed either through the current contract negotiations or in some other way, including, but not limited to insurance. The "boilerplate" issues are more important in master service agreement negotiations than in the negotiations of a construction or other one-time contracts. In master service agreement negotiations, scope of work, price, quality, completion date, service, and warranties dominate. What is very important in a master service agreement negotiation is strictly second tier in most other negotiations. That does not mean those considerations are unimportant in other types of contracts, but only that they are dealt with after the first tier or business terms are essentially agreed, usually in a "term sheet," "heads of agreement," or other "preliminary" memorandum. In the master service agreement, the job, the price, and the dates are part of the "order" after the "boilerplate" is agreed upon.*

An indemnity is simply one risk management tool. If a risk is manageable to the indemnifying party by other means (such as insurance coverage), the promise to indemnify may be the knife that cuts through the "contractual fog" – the other side's uncertainties, inexperience, or vague fears – to a reach agreement. If the risk is unmanageable by any means, the promise to indemnify may be the contractual equivalent of slashing one's own wrists. An indemnity is neither good nor bad, but is always a business decision.

Within the same agreement, a negotiator may sometimes be negotiating as the "indemnified party" and sometimes as the "indemnifying party." Since only a mother could separate the twin phrases "indemnified party" and "indemnifying party," the term "protected party" will hereafter be used for "indemnified party." Remember, however, what is one party's "protection" is another party's "liability."



Negotiators may be receiving indemnities because they are in a "contractual fog." Sometimes negotiators may be giving indemnities because their counterpart is in a "contractual fog." These tranquilizing indemnities are "unilateral." Although a fog might be dispelled in many ways, these tranquilizing indemnities are an effective method where the "contractual fog" is on a "side" issue.

> Practice Note: *The negotiator relying on an indemnity must understand that the indemnity is only as good as the creditworthiness of the indemnifying party. The credit concern applies not only to small businesses, but also to large corporations. Sophisticated companies incorporate subsidiaries to limit their liability. Through complex corporate structures, some foreign entities can make it so difficult and therefore costly to demand the payment of indemnification amounts that the protected party may as well not try. If the indemnities relate to insurable risks, then one solution is requiring insurance to "back-up" the indemnity obligations from a creditworthy insurer. If the protected party is using the indemnifying party's insurance to secure the indemnity obligation, then the insurance must be arranged so that the insurance obligations follow the indemnity obligations and cannot be unraveled by the insurance company through the insurer's exercise of its subrogation rights. Subrogation is the insurer's right, after paying under the policy, to pursue all the claims that its insured may have. Subrogation claims are one way insurance companies reduce their losses after they occur. On the other hand, if the indemnities relate to uninsurable risks or risks that can be insured only at great cost, some other form of credit protection may be necessary. The most common form is a parent company guaranty. Where the parent company has suspect credit, then a letter of credit, an escrow arrangement, or other financial source to meet the indemnity obligation may be necessary. As a footnote, subrogation rights are not just for insurance companies. Other parties may use such rights where payments are made without insurance being involved. In such cases, such as self-insurance, an express assignment of the cause of action is made at the same time the compensating payment is made.*

### B. Intellectual Property Indemnities

#### 1. Unilateral Intellectual Property Indemnities

"Intellectual property" indemnities are examples of "tranquilizing" indemnities. In the course of performing, a party may provide technology or materials that another may have patented or that were copied or misappropriated from another. Because anyone who makes, uses, or sells the technology or distributes the materials may be sued for infringement or misappropriation, the customer may be concerned that it can be sued along with the customer, especially because suing the contractor's customers is the best way to pressure the contractor into taking a license. The customer will therefore desire and request an intellectual property indemnity from the contractor.

Because the customer has no control over the design of the technology or materials provided and no practical, cost effective way of verifying the contractor's rights to the patented, copyright, or trade secret items, which are solely under the control of the contractor, the

contractor will agree to give the customer an indemnification against intellectual property infringement or misappropriation.

**2. Mutual Intellectual Property Indemnities**

This indemnity is truly "unilateral," but it might be "mutual" in certain circumstances. In addition to the "unilateral" indemnities, the negotiators often use "mutual" indemnities to allocate responsibilities. In the "mutual" indemnity, each party gives the other an indemnity for its share of the allocated duties. Often an allocation is made concerning different aspects of the same potential adverse event, with one side taking some duties and the other side taking other duties.

For example, in some cases, the customer may provide to the contractor its own technology or "trade secret" sauce that the contractor will embed into the technology or materials that the contractor will provide back to the customer. Or, the customer may request a specific customization of the contractor's standard offering, which the contractor can not guarantee will not infringe. The customer may combine the contractor's technology with other products that may result in the infringement, or, the customer may use the technology in ways in which the contractor did not intend, both of which may result in the infringement of a third party's intellectual property. In such cases, it is the contractor who will require an IP indemnification from the customer. Finally, the contractor may require indemnification in the event that the customer modifies the technology resulting in the infringement.

> *Practice Note: The customer clauses described above are typically drafted in complex "but for" construction. A simple provision is: "Customer agrees to defend, indemnify and hold contractor harmless from all actions, damages, and costs, including attorneys' fees, resulting from third-party claims of intellectual property infringement arising from (i) customer-required customizations of the deliverables (ii) customer's combination of the deliverables with items not provided by the contractor, (iii) customer's technology included in the deliverables, (iv) customer's use of the deliverables in a way not intended by contractor, and (v) customer's modification of the deliverables, if but for such customizations, combination, inclusion of customer technology, use of the deliverables in an unintended way, or modification, the infringement would not have occurred."*

If the negotiator does not master the indemnity tool, the benefits at the contract's core – the desired item or work, the price, the completion date, the quality, the warranty, and the service – will be lost either by failing to agree on indemnities or by agreeing to imprudent indemnities. In addition, where a "mutual" indemnity allocates risk, the negotiator must use the indemnity tool to obtain a fair, or to at least avoid an unfair, allocation of responsibility. In most such negotiations, "fair" usually involves appealing to the tradition of "treating equals equally, and treating unequals unequally, but only in proportion to their inequality" as an objective standard.

**C. Four Common Types of Indemnities**

Indemnities defy precise classification because the contractual language is the king of the indemnity jungle, but four broad common language patterns do exist. These are not exclusive, but they are common in contracts.



**1. The "Covenant Reinforcement" Indemnity**

Some indemnities relate to the promises made in the agreement. These indemnities simply reinforce the promise being made, and they may be unnecessary legally, but they may be, however, necessary psychologically.

In the "covenant reinforcement" indemnity, one of the parties makes a promise, and then the promise is restated as an indemnity: "The company shall return the rental equipment in good working order with only normal wear and tear excepted, and the company shall indemnify the rental agency from any loss or damage resulting from the failure to return the rental equipment in such condition."

This indemnity is probably not necessary. The breach of the promise to "return the rental equipment in good working order with only normal wear and tear excepted," will entitle the injured parties to damages. These damages are not changed by the indemnity. One does not get one set of damages for breaching the covenant and another for breaching the indemnity.

Why is the indemnity added? It's necessary psychologically. The drafter probably wants to emphasize that this promise is particularly important, and no excuses will be heard. The reason this is unnecessary legally is that a contractual promise must be performed. To enforce the promise it is not necessary to show that the party making the promise was negligent or at fault. All contractual covenants are on a no-fault basis. If the party making the promise wants to make an excuse, it must provide for it in the agreement. A good example of this is the force majeure clause in most agreements.

> *Practice Note: The core mutual promises in the contract should not be complicated with the use of indemnity clauses that do not add any meaningful legal rights. The indemnities, while important, are better left to the "boilerplate," somewhere after the basic business terms have been stated.*

**2. The "Fault-Based" Indemnity**

Some indemnities relate to fault only. This is similar to the "covenant reinforcement" indemnity. Both reinforce existing law, and they may be unnecessary legally, but they both may be necessary psychologically.

In this "fault-based" indemnity, the indemnifying party indemnifies the protected party for any loss that is caused by the indemnifying party's negligence, strict liability, or other fault. Of course, these are duties the indemnifying party has at all times, not just under a contract. They are there whenever one drives a car. If only one party is indemnifying, the indemnity is "unilateral." If both parties are indemnifying each other, the indemnity is "mutual." As anyone in an automobile accident knows, courts exist to find fault. Therefore, this "fault-based" indemnity does not add much to a party's legal rights; however, the following two practice notes indicate why some want them anyway.

> *Practice Note: If the "fault-based" indemnity is worded to include the "duty to defend" as well as an "obligation to indemnify," it may defray attorneys' fees and other litigation costs. Generally, attorneys' fees and litigation costs cannot be recovered, even in victory, unless authorized by a contract or a statute.*

*<u>Practice Note</u>: There may be a practical reason for including a "fault-based" indemnity. If the beneficiary of the indemnity, which in this case would be the person not at fault (the "innocent" party), is also under the typical master service agreement an additional insured under the "negligent" party's liability insurance policy, then the innocent party may sue the "negligent" party's insurance company directly. Although the "innocent" party is only named as an additional insured on the "negligent" party's insurance policy "to the extent of the 'negligent' party's assumed obligations," the "negligent" party has in this "fault-based" indemnity assumed its "tort" obligations in the contract. Therefore, the "innocent" party as beneficiary of the "fault-based" indemnity can require the "negligent" party's insurer to pay by making a direct appeal or threat. If this "fault-based" indemnity were omitted, then the "innocent" party could pressure the "negligent" party's insurer only by putting pressure on the "negligent" party to pursue its insurance claim with its insurer. This may be especially important where the "negligent" party is not around, gone under, skipped the country, or, for any reason, is uncooperative.*

**3. The "Activity-Based" Indemnity**

Third, some indemnities relate to "activities." In these indemnities, one party indemnifies another party for any loss that is caused by the indemnifying party's "activities." The "activities" are always described, such as "the fraternity agrees to indemnify the hotel from all activities in connection with the annual beer bust." Unlike the previous two indemnities – "covenant reinforcement" and "fault" – these are probably intended to be on a "no fault" or "without regard to fault" basis, but the parties frequently fail to state this. Under strict construction, they run the risk of not having their subjective intent be reflected in the contract language.

**(a) Unilateral Activity**

In the typical "unilateral" case, one party is granting to another a right to engage in the activity, with little or no consideration paid. Thus, the authorizing party wants the user to indemnify it from any harm associated with the authorized, but gratuitous or at least unprofitable, activity. In the oil and gas business, examples are found in boarding, access, easement, production handling, or facility interconnect agreements.

*<u>Practice Note</u>: The "unilateral activity" indemnity is a good place to illustrate the use and misuse of the phrase "including, but not limited to." An indemnity that refers to "all student activities, including, but not limited to, skydiving from any plane" is arguably too broad from the students' point of view. The students probably realize they are giving up any rights if their parachutes do not open, but they probably do not realize that they are giving up any rights if the skydiving school's mini-van tips over on the way to the airfield. The phrase "all student activities" is open ended. "Skydiving" is the only named "activity," but it is only an "example." The better phrase from the students' point of view is an indemnity for "skydiving from any plane, including, but not limited to, being sliced by the propeller,*



*the parachute not opening, and/or the reserve parachute not opening." The indemnity covers not only "skydiving," but also all other related activities and not simply the serious ones that have been specifically listed. This is an appropriate use of the "including, but not limited, to" phrase. It will protect the skydiving school, for example, if all the chutes do open, but the skydiving school plops the skydiving students in a lake rather than in an open field. It will protect the students if the mini-van tips over.*

**(b) Mutual Activity**

These "activity based" indemnities may also be "mutual." In the typical "mutual" case, the parties are allocating responsibilities for these activities in some manner, often over time. In this indemnity, one party indemnifies the other party for a certain period of time, such as for "all activities associated with the use of the property prior to the effective date of sale." The other party then indemnifies for "all activities associated with the use of the property after the effective date of sale."

**(c) "Fault-Based Activity" Indemnity**

In "activity-based" indemnities, the parties may indicate their intention that this indemnity shall apply "whether or not any negligence or other fault was present." This nudges this indemnity closer to a "without regard to fault" indemnity. If this intention is unexpressed, then this nudges this indemnity closer to the "fault-based" indemnity. The courts will defend their "fault" turf unless the parties clearly state otherwise, it is therefore wise to include an expression of the "without regard to fault indemnity" lest all doubts be resolved in favor of a "fault-based activity" indemnity. A "fault-based activity" indemnity, as typically written, does not expand the parties' pre-contractual rights and duties in any material way.

*<u>Practice Note</u>: The "fault-based activity" indemnity is often a source of confusion. As a practical matter, many contracts are concluded with even the parties realizing at the time that some of the agreement is confusing. It is important to know how such provisions will be enforced. It will help determine how to prioritize the clauses that need more clarity and allocate the available negotiating resources accordingly. Remember that the "intent" in a courtroom is not what the parties think they were accomplishing. It is "objective intent." "Objective intent" is first determined by looking at the contractual words and the words only. If that leaves two equally possible interpretations, then the court will apply certain rules of construction. (The court is still not interested in the parties' "subjective" intent). If two equally possible interpretations exist after all applicable rules of construction have been applied, the court may consider what the parties have to say about their "subjective" intent along with industry custom and practices. "Intent" now ceases to be a legal matter and becomes a factual one to be determined by a jury or a judge, if tried without a jury. Getting to "subjective intent" (and, therefore, a trial) has several hurdles that cannot be cleared simply because the parties disagree on what the indemnity means and even because they agree that the indemnity is confusing. Those factors do not make the agreement ambiguous. The court must find an ambiguity exists*

> *after it has reviewed the actual words for intent as seen through those words and applied all appropriate rules of construction to those words. There are two such rules of constructionng. First, the courts will strictly construe an agreement where one party is indemnified for its own negligence. Second, the courts will liberally construe an insurance policy to find coverage.*

**4. "Control-Based" Indemnities**

Some indemnities allocate risks based on some standard other than "fault" and other than some "activity." The "without regard to fault" indemnity is the primary one used in contracts involving any kind of physical labor. For example, because farming is a dangerous occupation, a great deal of focus has been given to indemnity and insurance language in contracts relating to farming activity.

In the "without regard to fault" indemnities, the parties allocate risks, not on "fault" and not on "activity," but on "control." In this indemnity, one party assumes responsibility for its "property" and its "people," even if the other party is negligent, strictly liable, or otherwise at fault.

The theory is that "its property" and "its people" are within the responsible party's "control." Safety concerns should be addressed and insurance provided by the party in "control." Many of the risks associated with the physical labor associated with tending to business assets can be covered by insurance, such as liability insurance, worker's compensation insurance, physical damage to property insurance, business interruption insurance, and builder's risk insurance.

If only one party has control, the indemnity is "unilateral." It is very onerous to have one party pay for any loss that it suffers to "its property" and "its people" and at the same time pay for any loss the other party suffers to "their property" and "their people," all without regard to the fault of any party, including without regard to the fault of the other, protected party. Thus, one party receives a "double" benefit and the other a "double" burden. Because it is so burdensome, this "unilateral" indemnity is also referred to as a "hardcore indemnity" or a "cram down indemnity." Only those with significant bargaining power can impose it on another party and then only because that party still finds the contract worth entering into even though it will have to pay for everything: there is no "going dutch."

Since such one-sided contracts are unappealing to most companies, the "mutual" indemnity predominates. A particularly "fair" mutual indemnity is known as the "knock-for-knock, without regard to fault" clause. The "knock-for-knock" is short hand for a "mirror-image" indemnity protection, *i.e.*, "going dutch," "what's sauce for the goose is sauce for the gander," "tit for tat," or any other phrase supporting equal treatment. As previously discussed, the "mutual" indemnity allocates responsibilities for people and property based on "control" rather than on "fault" so that each side has different, but "mirror-image" responsibilities. "Ownership" is one aspect of "control," but not the only one. For example, leased equipment is one area where "ownership" and "control" are separated. In contracts where physical work is being done, the key element in such split situations is "custody" on the ground. At this point, the tie-in to insurance concerning coverage for property of another if in one's "care, custody, and control" will creep into the discussions.

## III. Conclusion

Limitation of liability and indemnification clauses go hand in hand with each other. In fact, what the indemnification clause provides can be entirely taken away by the limitation of



liability clause. For example, a robust indemnification provision can be easily undone by a limitation of liability clause that reads as follows, "In no event will [the indemnifying party] be liable for any direct, indirect, incidental, special, consequential, or punitive damages under this Agreement," or by "[indemnifying party]'s liability under this Agreement shall be limited to the amount that the [indemnifying party] pays under this Agreement," where the indemnifying party has no payment obligations. Practitioners are forewarned to pay especially close attention to both indemnification and limitation of liability clauses.

# Negotiations

## 12 Ways to Speed Up Negotiations

12. Manage like a project
11. Process vs. outcome
10. Use projector
9. Timestamp all drafts
8. Term sheet
7. Playbook approach
6. Reasonable positions
5. Accept redlines
4. Comment bubbles or footnotes
3. Small agreements early
2. Editable documents
1. Collaborative mindset
0. *Audience?*

- How to deal with Jerky Boy
- How to not let Jerky Boy get to you and make you jerky
- How to change Jerky Boy into a nicer guy to deal with
- Audience?

## Contract as Business Plan

- Who should (or might) make what happen?
- "What ifs" in the business relationship lifecycle:
  - Startup
  - Normal operations
  - Trouble
  - Big trouble
  - Termination

## Contract Negotiation Life Cycle

- Contract Team
  - Negotiation of business terms
  - Negotiation of legal terms
  - Concerns if negotiating with foreign party
- Final points
  - How to come to closure

## Letters of Intent

- Should you use?
- How to make non-binding
- Expressly disclaim enforceability
- Disclaim “good faith negotiation”?
- Include NDA provisions, or separate NDA?
- Include freedom-of-action clauses?
- Audience comments?

## Contract Forms

## Contract Drafting: Overall Tone

- Hardball
  - Eventually get more of what you want?
  - Negotiation time
- Reasonable for both parties?
  - E.g., mutuality of provisions
  - Less time to negotiate (can be important!)
  - Sets a tone for relationship
  - Better impression on execs, judge, jury?
- Audience?

## 5 Key Clauses to Consider

- Sunset clauses (e.g., for pricing rights)
- Warranties for deliverables
- Indemnities for actions
- Termination rights – “out” clauses
- Assignability
- *Audience?*

## Problem Clauses

- Fuzzy warranties, no liability limits
- No assignment w/out consent
- Most favored nation / customer
- "Naked" caps on price increases
- Promises for future deliverables
- "All you can eat" clauses
- "Gross negligence," "willful misconduct" deliverables

# Particular Situations

## Request for Propsoal Responses: 3 Points

- Beware of "binding" language in RFP
  - Confidentiality
  - Response incorporated in contract (warranties?)
  - Contract T&Cs
- Disclaimers in response
- Intellectual property issues
- *Audience: RFP problems you've had?*

## NDA Forms

- Can be crucial document
- Paper trail requirement - specificity
- Match up with term of agreement?
- Confidentiality period?
- Freedom-to-operate clauses?
- Residuals clause?
- PACTIX NDA (www.pactix.org)

## Indemnity Agreements

- Four types:
  - "Covenant reinforcement" indemnity
    - Reinforces a covenant already in the agreement
  - "Fault-Based" Indemnity
    - Reinforces a common law legal obligation
  - "Activity-Based" Indemnity
    - Makes person "performing" the activity responsible
  - "Control-Based" Indemnity
    - Makes person "owning" the item responsible

## Revenue Recognitions Issues

- "Coupons" – guaranteed future pricing
- Future deliverables
- Renegotiating the contract
- And don't forget:
  - Secret side letters / channel-stuffing
  - Backdating contract documents

## In the Back of Your Mind ….

- Document retention (for later disputes)
- 8-K filing requirements?
- Export controls (include “deemed exports”)
- FCPA provisions
- Special meaning to “common” contract terms, e.g., force majeure

## Limitation of Liability - Eliminate the Duty

- If you eliminate the duty, there will be no damages
- In certain situations consider negating:
  - Fiduciary duties
  - Implied and statutory warranties
  - Duty of care

## Limitation of Liability - Eliminate the Damages

In certain situations consider eliminating:

- Consequential damages
- Punitive damages
- Damages during force majeure
- Damages caused by project delay

## For Duties, Eliminate the Damages

In certain situations consider crafting one’s own damage measure:

- Create an exclusive contractual remedy
- Provide for liquidated damages
- Cap damages

## For Duties, Reinforce Affirmative Defenses

In certain situations consider reinforcing:

- One's affirmative defense:
  - Create a contractual duty to mitigate
  - Create a contractual statute of limitation

## IP Indemnification Clauses

- Indemnify, hold harmless, defend
  - Claims, causes of action
  - Judgments, settlement amounts, attorneys fees
  - Infringement of 3rd party IP, misappropriation, and breach of warranty of title
  - If used as intended
  - Except out
    - Unintended uses
    - Combinations with other items not provided
    - Modification
    - Required customizations
    - Inclusion of customer technology

# Issues to Think About Tracking

*(with future M&A in mind)*

## Some Things to Consider Tracking

- Clauses w/ operational restrictions on, e.g.:
  - Pricing (lock-ins; most-favored-customer)
  - Business scope
  - Geographical area
  - Customers
  - Suppliers
  - Employee hiring / solicitation

## Some Things to Consider Tracking

- Indemnification
- Contract disputes and their resolutions
- Contracts not terminable at will
- On-going payment obligations (purchases, royalties, profit-sharing, etc.)
- Non-assignability clauses

## Some Things to Consider Tracking

- Employment agreements with special obligations
- Settlements, releases
- Tax-related contracts

## Some Things to Consider Tracking

- Supply-chain agreements
  - Reseller
  - Distributor
  - VAR
  - Partner
  - Supplier
- NDAs
- License agreements (inbound & outbound)

## Some Things to Consider Tracking

- Clauses triggered by Event X (e.g., time passing; merger; more-favorable deal to other)
  - Notification requirement
  - Consent requirement
  - Termination option
  - New / additional rights
  - Acceleration; etc.
  - Loan covenants, other financing documents