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Preface

As lawyers, we are often asked to represent clients as they enter into agreements with others. We sometimes must draft the controlling documents; at other times, we must review the documents drafted by other counsel. This one-volume edition of Drafting Business Contracts: Principles, Techniques & Forms can sit on every attorney's desk to assist in these tasks.

CEB gratefully acknowledges the work of the 18 attorneys who wrote one or more chapters for this book. Their names appear on the contents pages and on the first page of the chapter or chapters to which each contributed.

Chapter manuscripts were reviewed by practicing attorneys throughout California, who contributed many helpful suggestions to the text. Their names are listed under "Acknowledgments" on page xiii.

This book contains useful features designed to make the contents more easily accessible, the forms more useful, and the practitioner's work more efficient. These features, as well as the organization of the book, are discussed in the section "About This Book" on page xv.

Wendy L. Brown was the editor of chapters 1-3, 5-6, 8, 11, 13-14, 16, and 18-20, and as project supervisor reviewed all other chapters. David Peyerwold was the editor of chapters 4, 7, 9-10, 12, 15, 17, 21-23 and the Appendixes.

Cinda Ely was responsible for copyediting and production of this volume. Legal research analysis was provided by Elizabeth Allen, Elliot Cohen, Duane De Joie, Maria Donohoe, Alan Flatt, Sue Homer, Lucinda Igarashi, Bonnie J. Lamb, Kenneth E. Scudder, Mindy Spatt, Martin Weis, Amy E. Wheat, and Tova L. Zeff. The index was prepared by Robert W. Burke, Jr., and composition was performed by CEB's Electronic Publishing Staff. Cheryl Ventimiglia designed the book.

CEB plans to supplement this book on a regular basis. We solicit your suggestions and comments to help us keep it accurate and up to date.

September 2009 Update

CEB would like to thank the authors of the September 2009 update: Justene M. Adamec, Pumilia & Adamec LLP, Los Angeles; David C. Burgess, Business Law Group, San Jose; James K. Dawson, Koppel, Patrick, Heybl & Dawson, Thousand Oaks; Brenda T. Dieck, O'Melveny & Myers LLP, Los Angeles; James F. Fotenos, Greene Radovsky Maloney Share & Hennigh LLP, San Francisco; Victor Hsu, Fulbright & Jaworski LLP, Los Angeles; Brian J. Philpott, Koppel, Patrick, Heybl & Dawson, Thousand Oaks; Michael J. Ram, Koppel, Patrick, Heybl & Dawson, Thousand Oaks; and Pauline M. Stevens, Morrison & Foerster LLP, Los Angeles.

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About This Book

Lawyers are constantly called on to represent clients when they enter into agreements with others. These agreements may launch new business relationships, settle disputes, clarify personal transactions, or touch on almost any aspect of the client's existence or operations. When properly drafted, these agreements accurately define and help strengthen the parties' relationship, allow the parties' expectations to be met, minimize later disputes, and preserve legal rights.

Unlike many other practice manuals, this book contains only a few forms for complete agreements. Instead, it presents a library of provisions, arranged by topic. They have been edited for consistency of substance and style. The forms in this book provide the core of most agreements. Counsel can draft the required agreement by starting with these provisions, adding other language as necessary to document the parties' intent and to tailor the agreement to the facts of a particular transaction.

In preparing agreements, no two legal drafters work in precisely the same manner. Some lawyers prefer to work from an existing form that more or less fits the current need, modifying it as necessary. Others like to prepare totally customized agreements, using a checklist to pull clauses from various sources and then reviewing and editing the result. This book should assist with both methods of drafting.

The attorney analyzing a transaction must first decide whether it is appropriate to document the transaction. If so, counsel must decide what form the agreement should take and what provisions should be included. Chapters 1 and 2 provide general information on drafting, together with suggestions for preparing documents in the most efficient manner. Chapters 3 and 4 address legal and factual issues that the attorney must consider before preparing the first draft of an agreement.

Once counsel has decided on the form and overall content of the agreement, this book will be a valuable drafting resource. Provisions that profoundly affect a client's interests are sometimes included in agreements without much thought or inquiry on the part of the drafter. Chapters 5 through 18 and 19 analyze the provisions that are commonly incorporated into documents, discussing their use and their advantages and disadvantages, and provide one or more alternative forms. If the chapter does not include a form for a desired provision, the discussions in the chapter enable the attorney to custom draft necessary language.

Chapter 18A addresses the rapidly developing world of electronic contracting, including a review of the federal Electronic Signatures in Global and National Commerce Act (E-SIGN), 15 USC §§7001-7031.

Chapters 20 through 23 present forms and explanations for some frequently used agreements: letters of intent, notes, guaranties, and powers of attorney.

Drafting Business Contracts: Principles, Techniques & Forms incorporates several features to help the practitioner use the information and forms more easily and efficiently. These features include:

Checklists: Each chapter begins with a checklist of information that the attorney must elicit from the client or the case file, and then consider, in order to draft provisions dealing with the subject matter of that chapter. These checklists can also be used by more experienced attorneys to assure that a necessary provision is not forgotten.

Forms: This book presents forms for many different provisions. Generally, the forms appear in a separate section following the discussion of their importance and use. Comments are provided for forms when the information is necessary for use of the form.

Sample Provisions: In addition to forms that can be completed by supplying information in the blanks, we have occasionally used sample provisions based on specific fact situations if a form requires too much case-specific information to be useful otherwise. These sample provisions can be easily modified to meet the client's needs.

Notes, Practice Advice, and Warnings: This book highlights certain material in the text for quick reference, helping the attorney to better represent the client and avoid problems.

Discussions of Ethics: The ethical issues involved in the drafting process are discussed in chapters 2 and 4. In addition, ethical considerations are highlighted when they appear elsewhere in the text.

Word Choice Charts: Alternative word choices are included in chapter 2 to enable the reader to avoid sexist and legalistic terms and to quickly select more appropriate terms.

Sample Agreement Organizational Outlines: The appendixes provide sample outlines for specific types of agreements to enable the attorney to organize the desired provisions into an effective agreement.

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Selected Developments

September 2009 Update

The rule that a nonexistent business entity may be a party to a contract if, after forming, it expressly or impliedly ratifies or adopts the contract applies to LLCs as well as corporations. *02 Dev., LLC v 607 S. Park, LLC* (2008) 159 CA4th 609, 71 CR3d 608. See §§3.2, 5.10.

The agreement in *Ontiveros v DHL Express (USA), Inc.* (2008) 164 CA4th 494, 79 CR3d 471, was so "permeated with unconscionability" that offending terms could not be severed. See §§3.14-3.14B.

An adhesion contract giving the arbitrator authority to decide arbitrability was substantively unconscionable because it went beyond the weaker party's "reasonable expectations." *Bruni v Didion* (2008) 160 CA4th 1272, 1279, 73 CR3d 395. See §3.14B.

In *Metters v Ralphs Grocery Co.* (2008) 161 CA4th 696, 701, 74 CR3d 210, the defendant employer argued that the plaintiff employee could not avoid being bound by the contract, because "one who signs an instrument which on its face is a contract is deemed to assent to all its terms." See §3.18.

An unlicensed corporation may not bring an action for the collection of compensation for the performance of any act or contract for which a contractor's license is required. *Great W. Contractors, Inc. v WSS Indus. Constr., Inc.* (2008) 162 CA4th 581, 76 CR3d 8. See §5.10.

Nonmonetary promotional benefits were held to not constitute "gross receipts" for purposes of computing royalty payments. *Wolf v Walt Disney Pictures & Television* (2008) 162 CA4th 1107, 76 CR3d 585. See §§5.23, 8.6.

In *Gueyffier v Ann Summers, Ltd.* (2008) 43 C4th 1179, 77 CR3d 613, an arbitrator was held to have authority to excuse the performance of a 60-day notice and cure provision in a franchise agreement when the arbitrator determined that the franchisor's breach was not curable. See §6.26.

A finance charge on a tax refund anticipation loan need not be refunded as "unearned interest" under 15 USC §1615 when the loan is repaid early. *Davis v Pacific Capital Bank, NA* (9th Cir 2008) 550 F3d 915. See §8.23.

An indemnitor's duty to defend does not depend on the outcome of the litigation. *Crawford v Weather Shield Mfg.* (2008) 44 C4th 541, 558, 79 CR3d 721. See §11.22.

The language of clauses limiting either the survival of representations and warranties or the time within which the indemnitee can bring claims for indemnification must be specific. *Western Filter Corp. v Argan, Inc.* (9th Cir 2008) 540 F3d 947. See §§11.24, 15.21, 17.21.

Exculpatory provisions and releases of known claims should use simple, clear, and unambiguous language comprehensible to a layperson. *Cohen v Five Brooks Stable* (2008) 159 CA4th 1476, 1487, 72 CR3d 471. See §§11.43, 11.50.

An arbitration clause may be held unenforceable if the court finds that it was not called to the attention of the signatory. *Metters v Ralphs Grocery Co.* (2008) 161 CA4th 696, 74 CR3d 210. See §16.17.

A federal court must have subject matter jurisdiction in order to hear a petition to compel arbitration under the Federal Arbitration Act (FAA). *Vaden v Discover Bank* (2009) ___ US ___, 173 L Ed 2d 206, 129 S Ct 1262. See §16.17.

The California Supreme Court held that parties may contract for judicial review of the arbitrator's decision under the California Arbitration Act. *Cable Connection, Inc. v DIRECTV, Inc.* (2008) 44 C4th 1334, 82 CR3d 229. The same is not true under the FAA. *Hall St. Assocs., LLC v Mattel, Inc.* (2008) ___ US ___, 170 L Ed 2d 254, 128 S Ct 1396; *Christensen v Smith* (2009) 171 CA4th 931, 90 CR CR3d 57. See §16.19.

A clause that appears unilateral by the language "I agree… to arbitrate" can be interpreted as mutual and therefore binding. *Roman v Superior Court* (2009) 172 CA4th 1462, 92 CR3d 153. See §16.20.

High costs can render an arbitration provision unconscionable. *Kam-Ko Bio-Pharm Trading Co.-Australasia v Mayne Pharma (USA) Inc.* (9th Cir 2009) 560 F3d 935. See §16.24.

Chapter 21, on promissory notes, has been substantially rewritten to bring the material in line with modern commercial law practice and to provide additional alternatives for several important note provisions.

In order to tie substantive California contract law to drafting considerations, cross references have been added throughout the book to relevant provisions of California Law of Contracts (Cal CEB 2007).

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Cutoff Dates and CEB Citation

Cutoff Dates

We completed legal editing and analysis of authorities cited in this publication as of March 2, 2009, and monitored developments through June 25, 2009.

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Mechanics of Document Drafting

Thomas E. Tyner

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§1.1 I. CHECKLIST: DRAFTING STEPS

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▶ To download **WordPerfect** version, right click and choose *Save Target As*

- Investigate the facts of the transaction (see §§1.3-1.6)
- Investigate the legal issues (see §1.7)
- Prepare a time and responsibility chart (see §1.8)
- Review related and similar documents (see §§1.9-1.10)
- Prepare checklist or outline of issues (see §1.11)
- Draft the document (see §§1.12-1.15, chap 2)
- Negotiate the final document (see §§1.16-1.25)
- Prepare for closing (see §§1.26-1.28)
- Complete postclosing matters (see §§1.29-1.30)

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§1.2 II. SUMMARY OF ESSENTIAL STEPS

The steps that counsel must take to document a transaction frequently differ, depending on the complexity of the transaction, the time available to complete the transaction, and the parties' desires and expectations. Regardless of the type of transaction, however, the time spent organizing and guiding the drafting and closing process saves actual drafting time and helps to produce more accurate, more understandable, more effective, and more comprehensive documents.

The steps described in this chapter apply to most transactions that provide counsel with a reasonable amount of lead time before the parties want to sign the transaction documents. Counsel may need to work on several steps at the same time and to back up and revise work done at an earlier step during the process. The steps include the following (not necessarily in this order):

- Investigate the factual and legal setting (see §§1.3-1.7);
- Prepare the time and responsibility chart (see §1.8);
- Consider using a (binding or nonbinding) term sheet or a letter of intent (see chap 20);
- Review the client's related documents (see §1.9);
- Review documents used in similar transactions (see §1.10);
- Prepare the document outline or checklist (see §1.11);
- Draft the agreement (see §§1.12-1.15);
- Review and negotiate the agreement (see §§1.16-1.25);
- Prepare for and conduct the closing (see §§1.26-1.28); and
- Follow through on any remaining matters (see §§1.29-1.30).

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§1.3 III. INVESTIGATE FACTUAL AND LEGAL SETTING

The contracting parties typically agree on the key business issues. Some significant issues often remain unresolved, however, when the client first meets with counsel. Rarely will the parties have worked out all aspects of their deal before they call on counsel to draft the agreement. Thus, effective drafting is not a narrow legal craft. Counsel should anticipate assisting the client in structuring and negotiating the deal. Drafting the agreement is only one, albeit an integral, part of those processes.

If possible, counsel should discuss the transaction with the client before the parties begin negotiations. Clients may be unaware of the legal, tax, or other consequences of various terms. If this discussion is not held, a client who agrees to a term may, after counsel gives advice on the legal ramifications, want to change its position. Counsel may then be seen as a "deal breaker."

PRACTICE TIP: Before starting negotiations with the other side, it may be helpful for both client and counsel to create a chart of the major business and legal issues in the transaction and to rank each issue on a scale of relative importance to the client. Ranking the issues—and developing compromise positions on those issues—in advance should help both counsel and client to maintain perspective during negotiations with the other side and to resolve outstanding issues more efficiently.

Most clients tend to think of the big picture when they negotiate deals, leaving the details to the attorneys. Counsel cannot draft a clear, coherent, and complete document that carries out the client's wishes, however, without fully understanding all aspects of the transaction. Counsel's task is twofold:

- To discover and grasp the client's vision, goals, and interests, and identify how they are affected by the details of the transaction; and
- To incorporate these matters into the document in a meaningful and acceptable way.

The drafting attorney must work closely with the client (see §§1.4-1.6) and must perform the necessary substantive legal research (see §1.7). An issue that seems unimportant to counsel may have significance to the client, and vice versa.

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A. Client Communications

§1.4 1. Counsel's Role

Generally, the lawyer drafts the contract and all related documents and identifies the legal issues; the client resolves all business or economic issues. Often, however, the line between legal and business issues is blurred. A legal risk, when quantified, becomes a business issue. Conversely, some business issues may be avoided or resolved by expert contract drafting. Some clients—particularly those with long working relationships with the same attorney—may defer most if not all decision making to counsel on both legal and business issues. To the extent that an attorney is asked to make a business or economic decision for his or her client, it is advisable for the attorney to clearly identify the issue to the client as a business issue and to ensure that the client, rather than the lawyer, has the first chance to decide the issue.

Some clients may want counsel to play an active or a leading role in negotiations. Other clients may want to control all key negotiations directly, with counsel playing only the role of scrivener.

Misunderstandings about counsel's role can be embarrassing and expensive and can result in the client's dissatisfaction with counsel's representation. Counsel should clarify with the client, at the outset of the transaction, the role counsel will play in the contract negotiations, and should keep the client informed of all significant developments in the transaction as it progresses. This ensures that both counsel and client understand and are comfortable with counsel's representation and with all aspects of the transaction as it moves toward a conclusion.

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§1.5 2. Timing of Counsel's Involvement

Counsel obtains most information about the transaction directly from client conversations or correspondence. If counsel is involved in negotiations at the outset, the lawyer will have a full grasp of the details of the deal. Early communications also reduce the risk of essential information being omitted in discussions between the client and attorney.

Often, a client fails to call counsel until the client has negotiated many of the major terms of the agreement, possibly because the client wants to keep its expenses in check by deferring the involvement of counsel. In this situation, counsel should identify the issues that the parties have agreed to and the issues that remain open. See §1.6. The attorney should then verify this information with the client. Otherwise, counsel might consider a certain provision to be essential to the client, only to discover later that the parties have already decided the issue. Such a mistake can be expensive for the client because the attorney may unnecessarily spend time on settled issues. It can also cause the other side wrongly to question the motives of counsel's client. By learning which matters the parties have discussed, counsel can avoid a duplication of effort.

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§1.6 3. Obtaining Information From Client

The first draft of the transaction documents is the client's statement of its position. Counsel will generate a better product if counsel has a sense of the following facts:

- What is the parties' relationship (past, present, and future)?
- How far along are the parties in their negotiations?
- Which party, if any, has the leverage?
- How aggressive does the client want to be?
- How aggressive can the client afford to be?
- How aggressively is the other side behaving?
- Do any of the parties really need the deal?
- Are any of the parties indifferent to the deal?
- Do any of the parties have any alternatives, and, if so, what are they?

Direct conversations between counsel and client can provide answers to these questions and highlight essential terms that the parties might otherwise overlook. Preparing a chart of the major business and legal issues in consultation with the client—as suggested in §1.3—will assist in this process.

Counsel should review carefully the client's file on a transaction, if available, to discover all pertinent details. The file may contain correspondence, internal memos, charts, term sheets, and personal notes from which counsel can draw both the key terms of the deal and a flavor for the parties' relationship. This information affects the tone used in drafting the document and the strategy for subsequent negotiations. The review can also identify important issues that the parties neglected to address among themselves.

In many transactions, the parties have not worked out or agreed to important details before the lawyer begins drafting the document. The client may want to approach the other party with a first draft of the controlling document to use as a basis for continuing negotiations. (It is customary for counsel to the party supplying money in a transaction, *e.g.,* a lender or a buyer of a business, to prepare the first draft.) Although this tactic gives counsel an opportunity to prepare a document that is heavily weighted in the client's favor, perhaps providing a significant advantage in later negotiations, an overbearing draft can also significantly lengthen the negotiation and revision process.

In a complex transaction, it is customary, and normally more productive, to prepare a term sheet or letter of intent (see chap 20) before drafting the controlling documents, to expose open issues. The cost of preparing or revising a letter of intent is less than the cost of preparing or revising the agreement itself, and may reduce the costs of drafting the definitive agreement.

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§1.7 B. Substantive Legal Analysis

Counsel must watch for significant legal issues that may be created by, or have an effect on, the proposed terms and structure of the transaction. These issues must be resolved as early as possible; they are more likely to become deal-breakers if they are raised after the parties think they have reached an agreement. If these issues become an impediment to the transaction, it is easier, less expensive, and less damaging to any continuing relationship between the parties to unwind the deal early, before the parties have poured substantial energy and expense into it.

Counsel may need to research the law to resolve substantive legal issues. The attorney drafting the documents may or may not have all necessary legal expertise relating to the transaction, especially, *e.g.*, in areas such as tax or environmental law. An attorney who is not an expert in an area of law material to the transaction should consult with a colleague or seek outside counsel with expertise in the area.

ETHICAL CONSIDERATION: Competence in the subject matter area not only improves counsel's representation of the client's interests but also is required by the California Rules of Professional Conduct. Cal Rules of Prof Cond 3-110. See §2.16.

Substantive legal review is particularly important in:

- Transactions that depend on anticipated tax consequences;
- Transactions involving complex and highly regulated areas, such as securities, antitrust, or hazardous waste;
- Rapidly changing areas of the law; and
- Areas of the law in which legislation was recently enacted or new legal decisions were recently issued.

For discussion of other preliminary legal considerations, see chap 3.

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§1.8 IV. PREPARE TIME AND RESPONSIBILITY CHART

The preparation and distribution of a chart for completion of the project greatly assists the organization of the transaction and document drafting. A time and responsibility chart helps ensure that all necessary documents are prepared, reviewed, and completed, or received and approved, before the scheduled close of the transaction. The chart may assist the often enthusiastic client in establishing a realistic closing date and may indicate whether the client's timing expectations are reasonable. Usually, the lawyer develops this chart by working backwards from the targeted closing date, but the lawyer may also start in the present and work toward the conclusion.

The chart should identify the persons and entities involved, and their attorneys, by providing the following information:

- Names of all parties to the transaction;
- Mailing addresses;
- Telephone numbers;
- Fax numbers;
- E-mail addresses; and
- For very time-sensitive transactions, the addresses and numbers for the participants' residences (for evening and weekend delivery of materials).

The chart can then also serve as the distribution list for document drafts.

The chart should next identify every document, letter, approval, certification, opinion, and other writing that is necessary for closing the transaction or is otherwise included in the final transaction documentation, together with the following information:

- The person responsible for preparing or obtaining the document;
- The person (or persons) to whom the document should be circulated;
- The person (or persons) who must approve and sign it;
- The date by which the first and subsequent drafts of each document should be circulated for review and comment; and
- The date by which all reviewing parties should submit their comments.

Alternatively, if the parties do not want to provide comments in writing, the schedule can fix dates for document review meetings or conference calls for each of the documents. See §1.17.

For an example of a time and responsibility chart prepared in anticipation of a merger, see Sales and Mergers of California Businesses §1.38 (Cal CEB 2002).

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§1.9 V. REVIEW CLIENT'S RELATED DOCUMENTS

The client may have its own standard contracts for particular types of transactions or may have internal published or unpublished guidelines or checklists to assist corporate officers in negotiating and documenting transactions. If so, these documents should provide a good starting point for any new deal. Counsel's review of the client's standard contracts or guidelines should ensure that the contract conforms to the client's internal requirements; counsel should seek approval from an appropriate person in the client's organization for any material deviations from those standards. Clients may also have a particular corporate culture that they wish to extend in their dealings with third parties. If so, counsel should be aware of the client's culture and conduct negotiations in accordance with that objective.

Counsel should also review the client's existing contracts and other documents that may be related to the new transaction to assure that the new transaction does not violate any covenants of, or otherwise cause a breach under, the existing documents. This due diligence review should identify any consents or approvals that the client should obtain and any representations and warranties that may need to be modified to avoid defaults under new or existing agreements. If review by counsel is impractical, counsel should discuss the potential risks of a failure to obtain consent or other breach of existing agreements with the client, and obtain appropriate assurances from the client that the client has performed or will perform the necessary due diligence review.

A review of any documents from previous deals with the other party can simplify negotiations. If the client made particular concessions in the agreements documenting similar transactions, counsel can discuss with the client whether similar concessions should be part of the current document. The parties thus avoid "starting from scratch" after having established a satisfactory relationship.

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§1.10 VI. REVIEW DOCUMENTS FROM SIMILAR TRANSACTIONS

The drafting attorney should review previously drafted or negotiated documents from similar transactions before starting to draft a new document. Prototype documents are available from a variety of sources, including, *e.g.*:

- The drafting attorney's own form files;
- A colleague's form files;
- The client's form files (see §1.9);
- Published practice or continuing legal education materials containing current examples of similar documents;
- Form books;
- Internet resources for legal forms, such as FindLaw (see http://contracts.corporate.findlaw.com) and U.S. Legal Forms (see http://www.uslegalforms.com); and
- The SEC's EDGAR database, available on the Internet (see http://www.sec.gov/edgar/searchedgar/webusers.htm), which contains actual agreements filed by public companies in securities transactions as exhibits to filings.

WARNING: Form book documents are sometimes archaic and outdated. They may also contain only forms, with no discussion of the importance of stated or hidden issues. These forms must be thoroughly reviewed and edited before being used.

Once the attorney has located appropriate prototype documents, counsel should view them as sources of ideas and a starting point for developing a document. Counsel should never assume that a document from one transaction can be used in another simply by changing the names and dates. The documents may reflect the perspective of one side to a transaction, which may not conform to the client's perspective for the current transaction. They may incorporate substantially negotiated key terms that are unacceptable or unnecessary in the current transaction.

WARNING: One feature of Microsoft Word is its ability to store so-called metadata or hidden text in Word documents, including the original version of a document and subsequent changes made to it. Metadata can be viewed by anyone with access to the file. Therefore, counsel should never start drafting a new document using an electronic copy of a document from a prior deal without first assuring that all metadata and hidden text has been purged from the file. Otherwise, the other parties to the current deal may be able to access confidential business terms and other key information from the client's prior deal with different parties—thus seriously compromising the client's position in the current deal and violating counsel's obligation of client confidentiality.

Even if a new transaction closely resembles a previous transaction between the same parties, the lawyer should carefully review the previous documents. The time elapsed since the previous deal may change the analysis of some legal or business issues, and different dollar amounts or subject matter descriptions may affect the importance of particular terms. Failure to include necessary changes may make the counsel appear careless, uninterested, or out of touch with the transaction—which can harm the attorney's relationship with the client and other counsel and the relationship of the parties to the transaction.

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§1.11 VII. PREPARE CHECKLIST OR OUTLINE

Before beginning to draft a document, counsel should prepare a checklist, an outline, or a term sheet of key issues or provisions that have arisen in the course of discussions with the client, legal research, and review of sample documents. Moreover, the process of identifying the document's major components may raise factual or legal issues that the attorney should examine further. The checklist, outline, or term sheet also serves as an organizing device that enables the drafting attorney to visualize the organization and flow of the document.

Counsel should evaluate carefully what issues to address in the agreement. It does not necessarily serve the client well to include in the first draft all important issues that counsel and client have identified. There may be issues that the other side has not focused on, which, if raised, are likely to be resolved unfavorably to the client because of a lack of leverage. Before taking a silent approach, however, counsel should discuss the issues with the client so they can plan their strategy together. For example, if counsel has identified an issue that should concern the other side, "hiding" the issue may just defer discovery of the problem and result in a "busted" deal after the parties have expended considerable time and expense. Further, omission of an issue in the agreement may result in an ambiguity, which could be construed against the party that prepared the agreement. See §17.23.

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VIII. DRAFTING THE AGREEMENT

§1.12 A. Tactical Advantage of Adopting the Drafting Role

The drafting attorney generally has a tactical advantage. The agreement should accurately state the contracting parties' business agreement, but the drafting attorney is in a position to prepare the first draft to favor its client on major points not previously addressed by the parties. Although drafting the document requires more work initially, it usually takes less time to draft a document advancing the client's interests than to modify another party's document to achieve that result. An attorney should not overplay this tactic, however. It can be obvious and create ill will. In addition, experienced counsel can usually predict how most issues will be resolved.

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§1.13 B. Approaching the Task of Drafting

Few attorneys sit down at a blank computer screen or with a piece of blank paper to draft a document from scratch. Most attorneys refer to form documents from their files and make changes necessary to create a new document that reflects the current agreement of the parties. Other attorneys adopt a "cut and paste" approach, adding language from a variety of samples or sources. See §§1.9-1.10.

The attorney should draft the document to be understandable by its expected audience, *i.e.*, the parties who will sign it and others who may be affected by it. The document may be technically perfect, but if the parties cannot understand or apply its terms, counsel will have failed in his or her task. Indeed, retail installment sale contracts and other consumer contracts are subject to very specific statutory drafting and content requirements so that they will be readily understandable by consumers. See, *e.g.*, CC §§1803.1-1803.11.

If the document is derived from several different sources, counsel must diligently edit it for consistency and completeness, and avoid contradictory language. See §§2.11, 2.13-2.14. Counsel should also verify that defined terms are used consistently and correctly. See §§5.23-5.35 for discussion of defined terms.

It is easier to negotiate a good document when the first draft is comprehensive and well written. If counsel prepares a disorganized, poorly written first draft, the other parties must waste time struggling to understand it instead of working out the terms of the transaction. If the parties spend too much time on ministerial issues, they may overlook major issues. As a result, the final product may be choppy and confusing because of the attorneys' different writing styles and attempts to close gaps in the logical flow of the document.

For discussion of drafting principles, see chap 2.

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§1.14 C. Reediting and Final Review

After drafting and editing the agreement, counsel should review the draft document in conjunction with the previously prepared outline, list of issues, or term sheet to ensure that it covers all points. See §1.11. If possible, another attorney in the firm should also review the agreement to spot any items that were unintentionally included or omitted or any provisions that are unclear. The attorney should then reedit the document so that the version submitted to the client and opposing parties (see §§1.16-1.17) is ready for execution (if all parties agree on the substantive content). It often happens that counsel's review of a document is less attentive to the back of the document, where important "boilerplate" provisions may be located (see chap 17). It may be useful for counsel to review the document once beginning at the back to verify those provisions.

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§1.15 D. Preparing the Drafts for Review by Other Parties

If the draft document is not too long and is to be circulated for review in hard copy, the drafting attorney should consider preparing the draft in double-spaced format with wide margins so that other parties can more easily review the document and note their comments on the hard copy. This courtesy should reward the drafting attorney because any comments obtained should be easier to read, understand, and address.

If the draft document is to be circulated to other parties electronically (as is now the norm), it should be converted to a format that is "write protected" so that the reviewing parties cannot alter the document without having their changes appear as tracked changes in the electronic file. This can be accomplished by protecting the document with a password (*e.g.*, in Microsoft Word, on the Tools menu) or by converting the document to Adobe PDF format before transmission to the other parties. Some law firms establish special password-protected areas on their websites (called "extranets" or "web rooms") to post documents for ready access and review by their clients and the other parties to a transaction.

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IX. REVIEW AND NEGOTIATE THE DOCUMENT

§1.16 A. Review With Client

After counsel has written, proofread, edited, and reedited the document, counsel should review it again with the client before distributing it to any other parties. A careful review by the client should catch mistakes or misunderstandings and enable the lawyer to correct them. Once third parties have seen the document, it becomes difficult to make changes that the client wants without also acceding to the other party's requests for changes.

The lawyer should direct the client's attention to the most crucial, and any questionable, provisions. The client may point out inaccuracies or omissions. The lawyer should review these comments, incorporate them into the document, and again review the document with the client before distributing the draft more widely. This review serves two purposes:

- To verify that counsel made correct assumptions in preparing the document; and
- To verify that the client understands all aspects of the transaction.

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§1.17 B. Soliciting Comments From Other Parties

After the client has approved the document, counsel then circulates it to opposing counsel and other parties for review and comment, with a cover letter or e-mail reminding recipients of the date by which they should provide comments. (The time and responsibility chart (see §1.8) should list everyone involved in this review process.) Counsel should maintain control of the review process and take steps as necessary to ensure that reviewing parties meet the deadline.

Counsel then receives the comments, consolidates them, and incorporates those comments that are acceptable to the client into a second draft, which counsel then recirculates to all parties for final approval. Alternatively, counsel may schedule a document review meeting for all parties and their counsel to negotiate a final draft. Face-to-face meetings or telephone conferences are usually more efficient when multiple parties are reviewing the document. If all parties meet, those with conflicting views can address the issues directly with one another. Otherwise, counsel who receives contradictory comments may find himself or herself in the undesirable position of having to mediate for the other parties.

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§1.18 C. Revising Another Attorney's Agreement

When responding to another attorney's draft agreement, the reviewing attorney should explain his or her client's objections and, in most cases, propose specific new language to replace the objectionable provisions rather than furnishing general "conceptual" comments. By proposing specific language, counsel identifies precisely what changes will be satisfactory and may increase the chance of prevailing on the points at issue. Providing only generalized rather than specific comments may result in a second draft that is still unacceptable, even if the other side agrees in principle to the changes. Proposing specific language also helps overcome inertia. The drafting attorney may resist making changes in response to generalized comments, simply because extra effort is required to decipher the other party's concerns and prepare new language.

NOTE: If the agreement under negotiation is complex, with technical language and many defined terms, opposing counsel may prefer to receive conceptual comments rather than specific language, because any specific language proposed by the reviewing attorney may be worded inconsistently with other provisions of the agreement.

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§1.19 1. Issues to Review

When presented with opposing counsel's draft document, counsel should, at a minimum, consider the following questions:

- Does the agreement accurately identify the parties?
- Does the agreement meet the client's objectives?
- Does the agreement require the other party to undertake all obligations necessary to achieve the client's objectives?
- Does the agreement ask the client to make unnecessary representations and warranties or to undertake unnecessary obligations?
- Are the representations and warranties complete and accurate?
- Do the terms and conditions conform with counsel's and the client's expectations?
- Is the agreement internally consistent and consistent with other documents involved in the transaction?

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§1.20 2. Manner of Suggesting Revisions

If the attorneys do not meet for document review, the usual method for proposing new language is to draft the changes desired in the electronic file of the document (making sure that all revisions show up as tracked changes) or to insert comments in the electronic file by using the "comment" feature of the word processing software. Alternatively, the reviewing attorney can mark changes directly on a hard copy of the draft. Extensive changes that do not fit neatly on the hard copy should be typed on separate pages or riders, and placed directly behind the pages of the agreement on which they are to be inserted. Each rider is usually designated with the number of the page on which it is to be inserted, with letters added to distinguish multiple riders to be inserted on one page (*e.g.,* two riders to page 14 might be designated "Rider 14A" and "Rider 14B").

Counsel can also make comments in a separate letter or e-mail, identifying the exact location of the changes to be made in the draft document by page or section number (*e.g.,* "delete the third sentence of section 2.5" or "insert XYZ after the word 'agreement' in the fourth sentence of section 7.10").

Another approach is for the reviewing attorney to take over production of the document entirely, transferring the document to his or her own word processing system. This tactic is not customary and is not recommended. In the transfer errors may occur, and these may be difficult to find and correct. The drafting attorney will likely react adversely because it will be necessary for him or her to proofread the new version in its entirety to assure that it corresponds with the original and that there are no unmarked revisions. Further, in multiparty transactions, the parties may become confused regarding which draft is the latest and whose comments have been incorporated.

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§1.21 3. Deference to Format and Style

Every attorney has a preferred format and style for drafting contracts. Proposing changes to another attorney's draft often means revising an agreement that does not employ the revising attorney's preferred format or style. However tempted an attorney may be to mold the format or style of the agreement, the reviewing attorney should understand that the drafting attorney may not welcome changes unrelated to substance. Counsel should restrict comments to substantive issues and should acquiesce in matters of format and style unless they substantively affect the content of the agreement or create ambiguities.

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D. Negotiation

§1.22 1. Preparation for Session

Counsel should organize document review sessions to provide maximum efficiency and minimum inconvenience to everyone involved. Counsel should plan a realistic agenda and, if possible, distribute it before the meeting. Each counsel should seek solutions to issues that recognize the legitimate business needs of the parties.

PRACTICE TIP: The attorney who sets the agenda sets the priority of the issues for discussion and therefore has more control over the session.

The meeting should first address simple matters and matters requiring the presence of clients and multiple parties, allowing those with only a few issues of concern to leave early. The host of the session should keep the group focused on the agenda and stay as close to the schedule as possible. Counsel may elect to defer some issues for discussion at a later time with only the necessary parties present. It is sometimes useful to review major business issues first and then to turn to "lawyer's" issues.

Those attending the meeting should be able to reach by telephone others involved in the transaction who are not necessary to, or cannot be present at, the session (*e.g.,* attorneys who researched the legal or factual issues, business people with decision-making power, and individuals who were involved early in the transaction but who are not participating at the document preparation stage).

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§1.23 2. Conduct During Session

Each attorney has a particular negotiating style. An attorney should be prepared, however, to be flexible, creative, and patient in order to see the negotiating process through to a mutually agreeable conclusion. Discussions should emphasize the transaction, not the personalities of parties. An attorney should not use a negotiating session to further a personal agenda. In addition to endangering negotiations, such actions could create ill will between the business people who must work together after they sign the agreement.

Before the negotiating session, counsel and client should agree on their respective roles. The client may ask counsel to control the discussion and look to the client only for input or approval of negotiated points, or vice versa. Alternatively, counsel and client may divide responsibility for the various points on the basis of legal versus business issues, the particular subject matter, or otherwise. Counsel should also verify his or her view of the transaction. An attorney who understands the client's interests, the details of the transaction, and the meaning of the language in the agreement is much better prepared adequately and effectively to represent the client's interests. Ignorance about the deal or a particular document usually manifests itself early, delays the entire process, and frustrates the parties who are well prepared.

Everyone should move briskly through the agenda in a professional, but friendly and cordial, manner. The parties and the transaction do not gain from obnoxious or obstreperous behavior or from grandstanding or overbearing conduct. Counsel should facilitate the consummation of the transaction and protect their respective client's interests, directing all at achieving those results. Counsel should also identify issues and reach agreement on a timetable and methodology for resolving any issues not resolved during the negotiating session.

Generally, all parties must make concessions; counsel's goal is to make sure that the client's major concerns are satisfied, even if minor issues are not all decided in the client's favor. Counsel should also distinguish between concessions, which represent a negotiated change in the rights or obligations of a party, and clarifications, which only make the agreed-upon rights and obligations clearer.

Counsel should keep careful and thorough notes of sessions, indicating who was present, issues addressed, and concessions made. Counsel can use these notes to verify that all modifications agreed to during the negotiations are included in subsequent drafts.

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§1.24 E. Incorporating Changes to One's Own Documents

After receiving comments to the initial circulated draft (either in writing or at a document-review session), the drafting attorney should prepare a clean and consistent second draft of the document. This may require modifying the language supplied by a reviewing party; however, counsel should make every effort to use suggested language (if the substance is acceptable) to minimize subsequent rounds of minor revisions. The negotiation and preparation of an agreement is not a game scored by points "won" and "lost."

Counsel should assure that the redrafted agreement is marked in a way that reveals all changes made since the prior draft. Unless the changes are marked, readers must compare the earlier draft to the new version on a line-by-line basis rather than being able to focus their attention only on the provisions that differ from the previous draft. Besides wasting valuable time, unmarked changes will likely irritate the reader and adversely affect the goodwill of the parties to the transaction. In the worst case, a failure to bring material changes to the attention of the other side could lead to liability for the lawyer for fraud or breach of trust.

Word-processing programs and other software programs have features that track and compare changes to draft documents. These programs can show both added and deleted language, typically by striking through deleted material and underlining or highlighting new material. If the document has many revisions, however, a computer-generated comparison may be lengthy and difficult to follow. In that case, counsel should furnish a "clean" version of the document as well as a marked version as a courtesy to reviewers.

The first page of the marked (or "redlined") document should indicate the date of the redraft and the date of the predecessor draft to which the redraft is being compared, and may indicate a draft number as follows:

Draft no. _ _ of _ _[*date*]**_ _**
showing changes since
draft no. _ _ of _ _[*date*]**_ _**

Counsel should number and retain the electronic file of each version to facilitate redlining. In some instances, counsel may need to prepare different redlines for different parties. For example, counsel should show the redlined version that incorporates the proposed changes (the second draft) to the client before submitting it to the other side. The client may then request further changes before transmittal to the other side. That redraft (the third draft) will need to be redlined two ways—the version sent to the other side must show changes made since the first draft, because that was the previous draft seen by the other side. The version sent to the client, however, may show only changes made since the second draft, because the client last saw the second draft.

ETHICAL CONSIDERATION: One final warning about redlining: *It must be accurate.* Even if only a result of sloppiness, failure to redline accurately may raise concerns about counsel's integrity.

Even though counsel has solicited and incorporated changes, the revision process is not necessarily complete after the first round of changes. Some revisions may not fully address another party's concerns. Changed circumstances may lead to additional revisions. The parties may need to negotiate further some points.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/1 Mechanics of Document Drafting/§1.25 F. Retaining Drafts

§1.25 F. Retaining Drafts

Generally, counsel prepares several drafts before the parties sign the final version. This raises several questions about which drafts to save. Should counsel retain drafts exchanged with other parties or their counsel? Drafts shared solely with the client? Internal drafts that never left the law firm or legal department and that neither the client nor the other party ever saw?

Retained drafts of an agreement can aid in the later interpretation of that agreement, especially if ambiguities in language and gaps in coverage become evident. Understanding how the agreement evolved may explain the parties' intentions. The retained drafts often provide useful evidence in discussions of disputes and admissible parol evidence in litigation.

For the same reasons, retained drafts can be a client's undoing. If the drafts resolve ambiguities or explain history in a way that is disadvantageous to a client, the client may be better served by discarding the drafts. Once litigation begins, however, relevant drafts cannot be discarded. To do so would amount to destruction of evidence and might result in an adverse ruling if the factfinder determines that drafts were destroyed because they contained information harmful to the client's position.

WARNING: The computer backup system for counsel's law firm may store an electronic copy of each draft each night. Thus, merely deleting a draft from counsel's word-processing files may not entirely eliminate all electronic copies of the draft.

Counsel should consider the following factors in deciding whether to retain drafts:

- Some drafts are protected by the attorney-client privilege, some are protected by the work product doctrine, some fall in both categories, and some are not protected at all. See CCP §§2018.010-2018.080; Evid C §§950-962. The status of the drafts affects whether counsel can be required to (or will want to) relinquish a particular draft to another party at a later date. If the drafts are privileged, the disadvantages of retaining them may be minimal.
- If the other party to the agreement, or that party's counsel, has retained drafts, it is best to retain drafts and maintain the same knowledge as the potential adversary.
- If the other side generated the first draft, which is typically the articulation of its opening negotiating position for the core issues, subsequent drafts are probably progressively more favorable to the nondrafting side. For example, an unfavorable provision that appeared in a draft but was later deleted indicates that the parties considered that provision and rejected it.

There is less reason to retain drafts the other side never saw—those shared only with the client or that never left the office—because they are unlikely to affect the interpretation of the agreement. Only drafts shared with the other side should bear on both parties' intentions, as opposed to the intentions of one side.

To retain some but not all drafts within a specific category (*i.e.,* shared with both sides, seen only by the client, or seen only in the office) may raise an inference that the discarded drafts were harmful to the client. Departures from normal document retention practices for a particular transaction may raise the same inference. Ethical questions can also arise based on the motivation for the selective retention. Therefore, counsel should be consistent in its approach to document retention.

Retained drafts also help the attorney whose client later questions provisions in the final document. If a client required that counsel make a change against counsel's advice, the draft may show who requested the change. Conference notes written in margins and requested changes written in different colors, indicating who requested the change, also provide a later explanation for the approach taken. Counsel therefore might decide to retain drafts until the time for bringing a professional liability action has run.

This matrix of issues yields different conclusions in different situations. It is impossible to predict whether retained drafts will help or harm the client.

For discussion of retaining final transaction documents, see §1.29.

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X. CLOSING PREPARATIONS

A. Preclosing

§1.26 1. Preclosing Meeting or Review

Closings often require that all parties meet in person together to sign and exchange the closing documents. The attorneys may hold a preclosing meeting a day or more before the actual closing to ensure that all documents are in final form and ready to be signed, and that the closing progresses smoothly. To prepare for this meeting, counsel should make a final review of the documents, comparing them to the initial notes of the transaction and notes from negotiations to ensure that the documents address all necessary points.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/1 Mechanics of Document Drafting/§1.27 2. Closing Checklist and Closing Memorandum

§1.27 2. Closing Checklist and Closing Memorandum

Counsel should distribute a closing checklist before or at the preclosing meeting. The checklist should indicate for each document to be executed:

- The party responsible for producing it at closing;
- The number of copies of each document to be signed;
- The parties who must sign each document; and
- The parties who are entitled to receive original copies of the signed document.

Parties (including counsel) who do not receive an original copy of a signed document usually receive a photocopy of the signed document.

If there is a formal closing, counsel should prepare a closing memorandum, identifying all parties to the transaction and their counsel and indicating who is responsible for doing each follow-up task. For example, counsel may need to file or record certain documents, deliver notices, or copy and circulate other documents to other parties. Failure to attend to these details may critically undermine the effectiveness of the document.

For an example of a closing memorandum prepared in connection with a corporation's acquisition of a target corporation, see Sales and Mergers of California Businesses, chap 1 (Cal CEB 2002).

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§1.28 B. Closing

At the closing, counsel guides the client through the signing and exchange of documents. The closing itself is usually only a formality and is brief if the parties resolved all issues and counsel solicited all comments to the documents in advance of the closing, made all necessary changes, and prepared for the closing by, *e.g.,* assembling all documents for execution and making sure that the correct number of copies were available. Last-minute changes to documents can cause significant delays and irritation, and should be avoided if possible.

Counsel must feel free to advise a client not to consummate a transaction, however, if there is any significant problem with any aspect of the deal, assuming that the client is not otherwise legally bound to close.

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XI. FOLLOW-UP MATTERS

§1.29 A. Retaining Closing Documents

Counsel should retain one set of originals or copies of all transaction documents for future reference. Whether placed in a binder or filed in a drawer, counsel should keep and index them in a manner that allows counsel to locate them easily at a later date. Either the attorney or the client may retain the original documents; the lawyer's file should indicate who has retained the original documents.

Counsel should prepare complete sets of the final documents with an index, and place the sets in binders for delivery to the parties. In large transactions, the final documents may be sent to a bookbinder to be copied and bound. The final documents may also be copied onto a computer disk or otherwise stored electronically.

Further, counsel should flag or label its file copies of documents that were heavily negotiated or that contain unusual or unique provisions to prevent them from being erroneously used as standard forms in similar future transactions. A cross-reference to the office file for the original transaction should enable counsel to locate notes from negotiations that may clarify why the parties included certain unusual provisions in the document.

Counsel or the client should retain final documents for as long as they are in effect or govern an existing relationship, and thereafter until the statutes of limitation have run for any action on the documents or for professional liability under the documents.

For discussion of retaining drafts of the transaction documents, see §1.25.

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§1.30 B. Calendaring Key Dates

Documents sometimes contain options, *e.g.,* to extend or shorten the duration of an agreement or to change pricing. If the client forgets these options, the dates on which they first become exercisable, or the dates on which they expire, the client could forgo valuable benefits by letting an option expire or by exercising the option at other than the best possible date. The client may also need to anticipate whether and when the other side will exercise an option that runs in its favor.

In other transactions, the parties may have significant performance or reporting obligations after the closing. A client who fails to meet these obligations may breach the agreement, resulting in liability or an adverse change in position.

When the document is signed, the client should calendar the key dates and set up an advance warning system to permit adequate planning. Counsel may also set up a calendar as a courtesy to the client. Often, counsel advises the client of key dates and disclaims any responsibility to advise the client in the future of those dates. As a courtesy, counsel should communicate with the client in anticipation of significant dates to discuss the actions that the client wishes to take. Counsel may want to send the client a postclosing letter advising the client of particular deadlines and placing on the client the obligation to meet those deadlines.

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2

Drafting Principles: Strategy, Standards, and Ethics

Thomas E. Tyner

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/2 Drafting Principles: Strategy, Standards, and Ethics/§2.1 I. CHECKLIST: DRAFTING PRINCIPLES

§2.1 I. CHECKLIST: DRAFTING PRINCIPLES

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- Evaluate whether a writing is necessary (see §2.3)
- Structure the agreement (see §§2.5-2.7)
- Wording
- Plain English (see §§2.8-2.10)
- Not ambiguous (see §2.11)
- Not sexist (see §2.12)
- Consistent (see §2.13)
- Not redundant (see §2.14)
- Consider ethics
- Competent representation (see §2.16)
- Multiple representation (see §§2.17-2.18)
- Overreaching provisions (see §§2.19-2.23)

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II. DRAFTING STRATEGY

§2.2 A. Basic Principles

The lawyer preparing a contract should strive to have the document state the terms and conditions of the parties' agreement clearly and completely, using as few words as will accomplish the job. The merit of a document is not measured by the number of words, pages, or pounds, but by how effectively and efficiently it states the parties' intentions. The drafter advances the agreement's clarity and completeness by following basic drafting principles:

- The parties must understand the document if they are to use it. Thus, the attorney should prepare a complete, readable working document rather than an eloquent example of impressive but difficult-to-understand legal prose.
- Laypersons should be able to understand the wording of the agreement because a jury of laypersons may have the ultimate say on what the agreement means.
- The attorney must understand the details of a transaction to draft the documentation properly for the transaction. The time spent in learning the details of the transaction and structuring the agreement will make the document more accurate, effective, and complete; it will also enable the drafting attorney to be more efficient. See chap 1.
- The document should accomplish the following:
- Transform the parties' imperfectly formed ideas into a fully formed, legally binding agreement; *i.e.,* the agreement should contain all legally essential and material elements.
- Establish policies and procedures for the continuing relationship between the parties.
- Establish and protect the rights of the parties.
- Anticipate risks and problems so that the parties can allocate risks by agreement and thereby reduce the possibility of future litigation.
- Be enforceable in accordance with the meaning explained to counsel.

The document should not create traps for the unwary—that approach can damage the relationship between the parties, raise ethical issues, and generate unnecessary litigation.

NOTE: Counsel should be familiar with the Civil Code and the Code of Civil Procedure rules regarding contract interpretation. These rules are set forth in California Law of Contracts, chap 5 (Cal CEB 2007).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/2 Drafting Principles: Strategy, Standards, and Ethics/§2.3 B. Purposes of Written Agreement

§2.3 B. Purposes of Written Agreement

Not every transaction requires a written agreement. The attorney must evaluate the need for and advisability of a writing. To do so, counsel should consider what a writing would achieve. A written agreement may accomplish some of the following purposes:

- Serve as a symbolic step, indicating that the parties have made a deal.
- Serve as a source of information.
- Organize a complex transaction.
- Identify prospective obligations.
- Memorialize an agreement for later reference, by providing either a general or specific guide to conduct.
- Deter undesirable acts, even if the document is unenforceable.
- Maintain the interest and participation of parties (*e.g.,* a guaranty may keep an essential individual involved in a company's operations).
- Allocate risk.
- Satisfy the statute of frauds or other statutes or case law that may require an agreement be written to be enforceable. For example, the following types of transactions may require a signed writing on an authenticated record:
- Transfers or leases of real estate (CCP §1971; CC §1624(a)(3)-(4), (6));
- Promises that by their terms will not be performed within a year after the date they are made or within the lifetime of the promisor (CC §1624(a)(1), (5));
- Extension of credit of more than $100,000 (CC §1624(a)(7));
- Contract modifications that are required to be written (CC §1698; Com C §2209);
- Certain agreements for the sale of goods in excess of $500 (Com C §2201(1)), and certain agreements for the sale of other personal property in excess of $5000 (Com C §1206(1));
- Creation of a security interest in personal property (Com C §9203); and
- Interest provisions in lending documents (Truth in Lending Act (15 USC §§1601-1693r)).

NOTE: Regardless of the advisability of a written agreement, it is increasingly possible that courts will uphold agreements in nontraditional formats that meet the criteria for enforceable contracts. For example, a Massachusetts Appeals Court enforced an e-mail settlement of a contractual dispute between the parties when their e-mail exchange contained all the necessary, essential terms of their settlement. See *Basis Technol. Corp. v Amazon.com, Inc.* (Mass App 2008) 878 NE2d 952.

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§2.4 C. Costs of Drafting Imprecise Contracts

A contract that fails to reflect adequately or accurately a transaction or to describe and protect the client's rights fails in one of its essential purposes. An imprecise or badly drafted contract may result in either a dispute regarding an ambiguous or incomplete contract or a malpractice claim based on an inadequate contract that worked to the client's disadvantage. Even if a malpractice action is not instituted, a client who is unhappy with a contract prepared by an attorney is less likely to use the same attorney again.

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III. DRAFTING STANDARDS

A. Structuring the Agreement

§2.5 1. Principles of Contract Construction

A contract is a form of communication that a diverse audience will read and use: the client, the other party or parties to the contract, all parties' attorneys, the persons who must perform under the contract, a judge or a jury (if the contract becomes the subject of litigation), successors in interest to the original parties (*e.g.,* trustees in bankruptcy, executors, receivers, new management), and possibly other third parties (*e.g.,* lenders). A contract should fully, clearly, and accurately describe the transaction and identify and protect the rights and responsibilities of the parties to the contract in a manner that all interested persons can understand and agree to.

The contract should be as succinct as possible while still being comprehensive. Each provision should serve a specific purpose in the transaction; if it does not, or if the attorney cannot explain its significance, the attorney should eliminate it. See §2.14. The fact that a provision appeared in a form document or an earlier agreement does not necessarily justify its inclusion in a new agreement. The lawyer should delete anachronistic or irrelevant provisions.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/2 Drafting Principles: Strategy, Standards, and Ethics/§2.6 2. Organization of Provisions

§2.6 2. Organization of Provisions

The presentation and organization of an agreement can significantly improve the effectiveness of the agreement. Following are some general principles of organization:

- General provisions should come before specific provisions.
- Major provisions should come before minor provisions.
- Provisions that will be used more often should come before provisions that will be used less often.
- The rules should come before their exceptions.
- Permanent terms should come before temporary terms.
- Technical and housekeeping provisions should come at the end of the document.

Depending on the transaction, however, it may be preferable to follow the typical organizational structure of other agreements of the same kind, because both counsel and clients will be accustomed to seeing, and will expect to see, certain provisions in a certain order in that type of agreement. For example, Appendix A includes an organizational outline that illustrates the typical order of provisions in an institutional loan agreement. Adhering to the normal organizational structure for such agreements in drafting will assist the parties in review and interpretation of the agreement after it is signed.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/2 Drafting Principles: Strategy, Standards, and Ethics/§2.7 3. Design

§2.7 3. Design

All contracts, not merely those involving consumers, should be as readable as possible. Mechanically, this means that the font should be large enough to be visible and legible, and margins should be wide enough to allow the reader to note any comments. If space or the format of the final contract is a concern, the attorney may print drafts in a larger font than the final contract.

It may be desirable for a contract of more than a few pages to have a table of contents at or near the beginning. See §5.3. The attorney should group related provisions together.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/2 Drafting Principles: Strategy, Standards, and Ethics/ B. Style and Word Usage/§2.8 1. Level of Formality; Use of Plain English

B. Style and Word Usage

§2.8 1. Level of Formality; Use of Plain English

The agreement should not use stilted or legalistic language, even if the agreement documents a complex commercial transaction. Some attorneys use Latin terms or formal legal language, such as "said," "hereinafter," "whereas," and "vehicular collision." The use of these words is neither necessary nor helpful. Effective agreements are written in language the parties can read and understand.

The drafter should keep in mind that, despite a popularly held view to the contrary, under California law the "words of a contract are to be understood in their ordinary and popular sense." CC §1644; *Cedars-Sinai Med. Ctr. v Shewry* (2006) 137 CA4th 964, 41 CR3d 48. Therefore, as much as possible, the drafter should avoid obscure words or "legalese" and should make sure that technical words are used as commonly understood in the profession or business to which they relate. CC §1645.

PRACTICE TIP: If a word or phrase is used in more than one section of the contract, the attorney should double check to make certain it has exactly the same meaning each place it is used.

Documents written in plain English typically have the following characteristics:

- They use familiar words and avoid legalistic and foreign terminology;
- They omit needless words and avoid redundancy;
- They use active rather than passive verbs;
- They may use multiple columns if the document is printed in a small font size, because the human eye has difficulty following small print across a wide page;
- They use short and specific sentences, paragraphs, and sections;
- They use "bullets" or numbered clauses to break up long sentences and lists;
- They use real words rather than jargon (*e.g.,* using "task" as a verb); and
- They use numerous article, section, and paragraph headings.

Because a person reading a document prepared in plain English can more easily understand the agreement, the obligations stated in these documents are more likely to be fulfilled. An attorney does not have to apply these rules dogmatically, but should attempt to use these techniques as frequently as feasible. The drafting attorney who has a choice should avoid legalistic terminology and complicated structures to the greatest extent possible. The Securities and Exchange Commission publishes an excellent handbook on preparing documents in plain English. See *A Plain English Handbook* (U.S. Securities and Exchange Commission, August, 1998), available at http://www.sec.gov/pdf/handbook.pdf. See also Adams, *A Manual of Style for Contract Drafting* (2004), published by the American Bar Association Section of Business Law.

NOTE: In some situations, the law requires the preparation of certain documents in simple, readily understood language. See, *e.g.,* Govt C §11346.2 (documents produced by state government agencies and administrative regulations); CC §1793.1 (express warranties on consumer goods); Fam C §17406 (notice related to representation in support cases).

A complex transaction does not necessarily require complex documents. However, some concepts are difficult to state in plain English. For example, the attorney may have difficulty expressing a mathematical calculation in plain English. Even in this circumstance, attorneys should be aware that modern word-processing software can readily generate formulas, for example:

$$\frac{\textit{Annual Number of Units Sold} \times \textit{Price}}{\textit{Number of Months}} = \textit{Average Monthly Revenue}$$

PRACTICE TIP: See §2.24 for a list of plain English alternatives to legalistic terminology.

The two agreement preambles that follow contain the same information. The first version, relying on legalistic terminology, is legally sufficient (see §2.9), but the second version, also legally sufficient, is easier to understand (see §2.10).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/2 Drafting Principles: Strategy, Standards, and Ethics/§2.9 a. Form: Example of Legalistic Terminology in Noncompetition Agreement Recitals

§2.9 a. Form: Example of Legalistic Terminology in Noncompetition Agreement Recitals

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2.9-1 Example of legalistic terminology

NONCOMPETITION AGREEMENT

NONCOMPETITION AGREEMENT (hereinafter referred to as the "Agreement") made as of this first day of January, 1995, by and between XYZ CORPORATION, a corporation formed and existing under the laws of the State of California and having its principal office at 123 Middle Street, Center City, California (hereinafter referred to as "XYZ"), ABC INCORPORATED, a corporation formed and existing under the laws of the State of California and having its principal office at 789 Lower Avenue, Uptown, California (hereinafter referred to as "ABC"), and Mary Smith, an individual residing at 321 Side Street, Center City, California (hereinafter referred to as "Smith").

RECITALS

WHEREAS, ABC and all of the shareholders of XYZ have entered into a Stock Purchase Agreement dated as of even date herewith (hereinafter referred to as the "Stock Purchase Agreement"); and

WHEREAS, pursuant to said Stock Purchase Agreement, ABC will purchase all of the outstanding shares of the common stock, $1.00 par value per share, of XYZ (hereinafter referred to as "XYZ Common"); and

WHEREAS, Smith is a key employee of XYZ and the owner of One Thousand, One Hundred and Twelve (1,112) shares of XYZ Common; and

WHEREAS, one of the conditions precedent to ABC's obligation to purchase the outstanding shares of XYZ Common set forth in said Stock Purchase Agreement is that Smith first enter into this Agreement; and

WHEREAS, Smith is therefore entering into this Agreement in order to induce ABC to complete the purchase of the outstanding shares of XYZ Common.

NOW, THEREFORE, in consideration of the premises, of the mutual covenants herein contained, and of other good and valuable consideration, the receipt and adequacy of which are hereby acknowledged, the parties hereto hereby agree as follows:

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§2.10 b. Form: Example of Plain English in Noncompetition Agreement Recitals

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2.10-1 Example of plain English

NONCOMPETITION AGREEMENT

THIS NONCOMPETITION AGREEMENT (this "Agreement"), dated as of January 1, 1995, is among XYZ CORPORATION, a California corporation ("XYZ"), ABC INCORPORATED, a California corporation ("ABC"), and Mary Smith ("Smith").

RECITALS

A. ABC and the shareholders of XYZ entered into a stock purchase agreement dated as of January 1, 1995 (the "Stock Purchase Agreement"). The Stock Purchase Agreement requires ABC to purchase all the outstanding shares of XYZ.

B. Smith is a key employee of XYZ and owns 1112 XYZ shares. One of the conditions to ABC's obligation to purchase the XYZ shares is that Smith enter into this Agreement.

C. Smith is willing to do so to induce ABC to complete the purchase the XYZ shares under the Stock Purchase Agreement.

NOW THEREFORE, in consideration of the mutual promises in this Agreement and other good and valuable consideration, the receipt and sufficiency of which is acknowledged by the parties, XYZ, ABC, AND SMITH AGREE AS FOLLOWS:

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/2 Drafting Principles: Strategy, Standards, and Ethics/§2.11 2. Avoid Ambiguity

§2.11 2. Avoid Ambiguity

Ambiguities are construed against the drafting party. CC §1654. See §§17.23-17.24. To avoid ambiguity, the writer should follow basic rules of composition:

- Keep sentences short.
- Start the sentence with the subject, follow closely with the verb, and end with the object.
- Place adjectives close to the words they modify.
- Use words consistently (see §2.13).

Examples:

Ambiguous language:	*Use instead:*
"A claim for damages, which shall not exceed $1000, must be filed with the court." (What is it that may not exceed $1000, the claim or the damages?)	"Claims for damages may not exceed $1000 and must be filed with the court."
"ABC Corp. is the wholly owned subsidiary of XYZ Co., which shall execute the guaranty." (Who signs the guaranty, ABC or XYZ?)	"ABC Corp. is the wholly owned subsidiary of XYZ Co. ABC will execute the guaranty."

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§2.12 3. Avoid Sexist Language

Attorneys should not use sexist language. Instead, attorneys should use gender-neutral terms or restructure sentences as necessary whenever possible. See §2.25 for a list of gender-neutral alternatives. Some writers alternate between male and female pronouns more or less at random, but many readers find this technique confusing and distracting. It is also better not to coin new and equally distracting words such as "repairperson" or "waitperson."

The following rules reduce the need for use of gender-neutral terms:

RULE	AVOID	USE
Use plural instead of singular nouns.	"A lawyer may ask his secretary or law clerk to file and serve papers."	"Lawyers may ask their secretaries or law clerks to file and serve papers."
Do not use possessives.	"A trial lawyer must rely on his quick wits and his thorough understanding of the Evidence Code when making objections."	"A trial lawyer must rely on quick wits and a thorough understanding of the Evidence Code when making objections."
Replace third person singular possessives with articles (a, an, or the).	"The new rules require a lawyer to complete his 36 hours of continuing education every 3 years."	"The new rules require a lawyer to complete the 36 hours of continuing education every 3 years."
Replace pronouns with nouns.	"He sent his tenant a new lease."	"The lessor sent a new lease to the tenant."
Use "who" structures to avoid unnecessary gender identification.	"The judge argued that a new constitutional rule should be applied for the benefit of a defendant if his case is still pending on direct appeal."	"The judge argued that a new constitutional rule should be applied for the benefit of a defendant whose case is still pending on direct appeal."
Replace words that indicate gender with those that do not.	"The problem is that one man's symbolic act is another man's civil liberties violation."	"The problem is that one person's symbolic act is another's civil liberties violation."
Refer to the office or function.	"The trustee may, in his absolute discretion, invade principal."	"The trustee may, in the trustee's absolute discretion, invade principal."

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§2.13 4. Use Consistent Terminology

The drafter should use words consistently throughout a document. If, for example, the agreement defines or uses "days" to mean "business days" at one point in a contract, then it may confuse the reader to use "days" in another part of the same document to mean "calendar days."

A "Defined Terms" section of a contract (see §§5.20-5.35) may alter the commonly understood meaning of a term. Counsel should then use the defined meaning of the term consistently throughout the document. If a defined meaning gives a term an obscure meaning, the definition should occur at the first use of the term.

If a transaction involves multiple contracts, all documents should use terms consistently. If this is not possible, the contract should warn that the terms in one contract do not necessarily have the same meaning as those terms have in related contracts.

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§2.14 5. Avoid Redundancy

The agreement should not address a single issue in the same contract more than once. A repeated provision may contain slight variations, creating internal inconsistencies or confusion. This problem may occur when an attorney uses a standardized contract as a starting point and then expands or modifies it in the course of negotiations.

Multiple provisions on the same issue can lead to inconsistency problems even if the first draft used the terms consistently. If the parties change the contract, either before or after execution, internal conflicts can result if all similar provisions are not similarly modified.

PRACTICE TIP: Counsel using a standardized contract must review and be familiar with the contract provisions to avoid adding redundant provisions during negotiations.

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§2.15 IV. ETHICS OF DRAFTING

The organized bar has given little attention to ethical considerations in drafting agreements. Both the California Rules of Professional Conduct and the American Bar Association's Code of Professional Responsibility address ethics and rules of conduct predominantly from a litigation or adversarial perspective. Nevertheless, many ethical issues may arise in connection with drafting documents:

- The attorney must act competently. See §2.16.
- The attorney must make appropriate disclosure and obtain necessary consents if representing multiple parties in preparing transaction documents. See §§2.17-2.18.
- The attorney must be loyal to the client.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/2 Drafting Principles: Strategy, Standards, and Ethics/§2.16 A. Competent Representation

§2.16 A. Competent Representation

An attorney should not attempt to draft a contract in an area of law in which the attorney is not competent. An attorney must attain sufficient competency before undertaking the effort, or associate with or professionally consult an attorney who is competent to do the work. Cal Rules of Prof Cond 3-110. Every transaction potentially involves an area of law unfamiliar to the attorney drafting the contract; counsel should identify the possible effect of these other areas of law and seek assistance, if necessary.

An attorney retained only to draft a contract and not to analyze the issues addressed in the contract should send the document to the client with a cover letter that clearly states the limited scope of the attorney's representation. Counsel should advise the client that the client must still address and resolve the issues presented by the contract.

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B. Representing More Than One Party

§2.17 1. General Principles

An attorney owes his or her client certain ethical obligations, including the duties of competency and loyalty. Thus, an attorney must know who the client is. Although the identity of the client is usually obvious, difficulties can arise. For example, does the attorney represent a partnership, all partners, or only one partner? Does the attorney represent a corporation or specific shareholders or officers? Is the attorney drafting the document for one party or for the benefit of both parties?

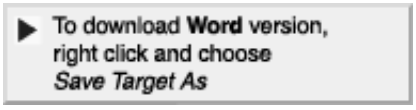
Counsel must provide written disclosure if he or she has an interest in the subject matter of the transaction, has a relationship with another party to the transaction, or has a relationship with anyone who has an interest in the subject matter of the transaction. Cal Rules of Prof Cond 3-310(B). Counsel must also disclose the potential adverse aspects of representing more than one party in a transaction. Cal Rules of Prof Cond 3-310(C). If counsel represents more than one person and those persons have a potential or an actual conflict of interest, counsel must obtain their written consent to dual representation. Cal Rules of Prof Cond 3-310(D). See *Klemm v Superior Court* (1977) 75 CA3d 893, 142 CR 509 (absent conflict, joint representation permitted when fully informed clients consent to it in writing). Clients frequently ask counsel to prepare an agreement reflecting the interests of "all sides." Counsel should then obtain a written waiver of conflict of interest from all parties. See *Pringle v La Chappelle* (1999) 73 CA4th 1000, 87 CR2d 90 (written waiver required when attorney represents corporation and officer); but see *Buehler v Sbardellati* (1995) 34 CA4th 1527, 41 CR2d 104 (no written waiver required when attorney unequivocally informed partners that he represented only partnership). See also *In re Egedi* (2001) 88 CA4th 17, 105 CR2d 518 (attorney's services as clients' scrivener did not constitute dual representation). For form conflict of interest and waiver letter, see §2.18.

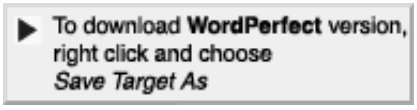
Conflicts of interest can result when, for example, a lawyer assists in the formation of a business entity through representing one of several parties who will constitute the new entity. In addition to written waivers, counsel should be prepared to withdraw from representing the initial client and the new entity if any dispute over the relationship develops. See, *e.g., Woods v Superior Court* (1983) 149 CA3d 931, 197 CR 185 (attorney of family-owned business should not represent one owner against another in dissolution action focusing primarily on that business).

See also *Johnson v Superior Court* (1995) 38 CA4th 463, 45 CR2d 312 (attorney advising general partner assumed duty of care and loyalty to limited partners); *Pringle v La Chappelle* (1999) 73 CA4th 1000, 87 CR2d 90 (corporate officer consenting to dual representation on own behalf and on behalf of corporation later asserted conflict of interest to avoid paying attorney fees). Counsel preparing an agreement should be aware of potential third party liability to persons for whom the document is intended, *e.g.,* investors or shareholders. See *McDermott, Will & Emery v Superior Court* (2000) 83 CA4th 378, 99 CR2d 622 (shareholder derivative suit sought to void affiliation agreement); *Forslund v Rein* (CD Cal, Sept. 8, 2003, No. SACV-01-1085-GLT) 2003 US Dist Lexis 16832 (no privity needed when investors suspecting Ponzi scheme sued attorneys who drafted company documents). In certain circumstances, if an attorney intends to affect a third party, the attorney could have liability to that party. *Bily v Arthur Young & Co.* (1992) 3 C4th 370, 410, 11 CR2d 51.

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§2.18 2. Form: Provisions for Conflict of Interest Disclosure and Waiver Letter to New Client





2.18-1 Provisions for conflict of interest disclosure and waiver letter to new client

Under professional rules of ethics, a lawyer cannot undertake representation adverse to a current client, even in an entirely unrelated matter, without the client's consent. This law firm currently represents _ _[*other client*]_ _. I wish to emphasize to you the full nature of the potential conflict arising from our representation of _ _[*other client*]_ _ and our possible representation of you. The possibility exists that _ _[*identify potential adverse consequences*]_ _.

This law firm requires its attorneys to manage their cases and files in the most zealous manner possible, consistent with the California Rules of Professional Conduct. As long as _ _[*name of attorney or firm*]_ _ represents _ _[*other client*]_ _, it owes _ _[*other client*]_ _ a duty of zealous advocacy, and the lawyers of this law firm representing _ _[*other client*]_ _ will represent _ _[*his/her*]_ _ interests against you, if any, with as much determination and commitment as I would devote to my representation of your interests. If you decide to retain _ _[*name of attorney or firm*]_ _, I can assure that I will exert my undivided loyalty and zeal on your behalf. I urge you to make no decision, however, until you have carefully considered all of the points raised in this letter.

You may wish to consult independent counsel on this conflict issue. If so, and if you have no attorney in mind, I would be happy to refer you to attorneys with special expertise in the field. With or without such consultation, you may decide to engage other counsel. Again, I would be happy to recommend qualified counsel.

If, after careful consideration, you still desire _ _[*name of attorney or firm*]_ _ to represent you, please sign and date the consent below, acknowledging your full appreciation of the circumstances of the conflict.

Sincerely,

__[*Signature*]__
_ _[*Typed name of attorney*]_ _

CONSENT

I have read and understand the foregoing, and I consent to _ _[*name of attorney or firm*]_ _ representing me in _ _[*describe matter*]_ _.

Dated: _ _[*date*]_ _ __[*Signature*]__
_ _[*Typed name of client*]_ _

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§2.19 C. Fraudulent, Unfair, and Unconscionable Provisions

An attorney drafting an agreement has an obligation to represent the client zealously and to generate a contract that maximizes the client's legal and business advantages consistent with the agreement of the parties But does this mean that an attorney can try to include onerous provisions, or must the attorney try to prepare a contract that is fair and balanced? The inclusion of a patently illegal or unconstitutional provision is improper (Cal Rules of Prof Cond 3-210), but most questionable provisions a client may want to include fall in a gray area short of improper activity. For a discussion of analyses employed by California courts to determine whether contract terms are merely unfair or are unconscionable, see *Flores v Transamerica HomeFirst, Inc.* (2001) 93 CA4th 846, 113 CR2d 376 (policy favoring alternative dispute resolution does not sanction "take it or leave it" arbitration agreements); *A&M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114 (disclaimers in one-sided, complex sales contract unenforceable as oppressive and unfair). See also §§2.20-2.23.

In this context, it is important to note that the implied covenant of good faith and fair dealing is not applicable to the parties before a contract is formed. It does not apply to precontractual negotiations. *Racine & Laramie, Ltd. v Department of Parks & Recreation* (1992) 11 CA4th 1026, 1034, 14 CR2d 335 ("the fact that parties commence negotiations looking to a contract, or to the amendment of an existing contract, does not by itself impose any duty on either party not to be unreasonable or not to break off negotiation, for any reason or for no reason"); *Smith v San Francisco* (1990) 225 CA3d 38, 49, 275 CR 17 ("[t]he prerequisite for any action for breach of the implied covenant of good faith and fair dealing is the existence of a contractual relationship between the parties, since the covenant is an implied term in the contract").

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1. Unfair Provisions as Poor Negotiation Strategy

§2.20 a. Doctrine of Unconscionability

Courts may use the doctrine of unconscionability to invalidate particularly unfair or oppressive clauses. See §3.14. A court's finding that some aspects of a contract are unconscionable might cause the court to view the remainder of the document as equally unfair or oppressive and to refuse to enforce it in the manner that the drafting party had envisioned. See CC §§1599, 1670.5. See also *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 99 CR2d 745 (arbitration agreement fatally tainted by unconscionable terms too pervasive to sever). But see *Parker v McCaw* (2005) 125 CA4th 1494, 1507, 24 CR3d 55 (*Armendariz*'s unconscionability rule inapplicable when substantial employment contract was negotiated by counsel rather than generic). An attorney who drafts patently unenforceable clauses thus may have failed to achieve one of the client's central objectives—to establish and protect the client's rights.

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§2.21 b. Negative Effect on Business Relationship

Unfair, unreasonable, or overreaching contract provisions can diminish the goodwill that is often crucial to a business's success. Unreasonable contract terms can strain relationships and fail to promote mutual trust and cooperation between the parties. The attorney should suggest less oppressive alternatives that nevertheless give the client the legal or business advantage it is seeking.

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§2.22 2. Damage to Attorney's Reputation

An unfair contract can damage the drafting attorney's reputation. An attorney who goes too far in attempting to maximize the client's advantage may ultimately suffer a lack of respect and trust from the bar, making future negotiations with the same or other parties difficult or contentious to the point of preventing effective legal representation.

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§2.23 3. Attorney's Course of Action

Responsible counsel can usually persuade a client not to insist on an overreaching contract provision. Counsel should point out that the client does not want an unenforceable contract, nor does the client want to damage its reputation or credibility with its customers and associates. Most clients will see the long-term benefits of drafting documents from a "win-win" perspective. If unable to persuade the client to omit an offending clause, the attorney should send the client a letter detailing the attorney's concerns. If the attorney continues to represent a client who insists on overreaching provisions, the attorney should document in the file the attempts made to persuade the client to temper or omit those provisions.

A good, responsible attorney, zealously representing the client, can take into account the legitimate interests of all parties in preparing and negotiating a document. The resulting product will be more fair, more balanced, and more likely to produce a harmonious and mutually profitable relationship between the parties than would a contract written solely to benefit and protect one party at the other's expense.

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V. CHARTS: LANGUAGE USAGE

§2.24 A. Plain English Alternatives to Legalese and Incorrect Usage

LEGALESE	PLAIN ENGLISH ALTERNATIVES
adequate number of	enough; sufficient
aforesaid	previous
all of the parties	all parties
and/or	… or… or both
anticipate	expect
as to whether (or not)	whether
at the time	when
by means of	by; through
contained in	in
contiguous to	next to; adjacent to
deems	considers
does not operate to	does not
during such time as	while
etc.; et al.	and so forth; and others
for the duration of	during
for the purpose of ____ing; with the object of _____ing	to ____
for the reason that	because
hereby; hereof; hereunder; herein	by this ___; of this ___; under this ___; in this ___
heretofore	previously
hopefully	I hope; we hope
in case; in the event that	if
in lieu of	instead of
in many cases	many of; often
in order to	to
in the last analysis	finally
irregardless	regardless
is (un)able to	can(not)
it is directed; it is the duty	must; shall
it is incumbent on X to	X must; X shall

literal(ly)	actual(ly); exact(ly)
loan (verb)	lend
monies	money
necessitate	require
necessity of	need to
occasion (as a verb)	cause
of a technical nature	technical
on the part of	by
possess	have; own
prior to	before
render (*i.e.*, to give)	give
render (*i.e.*, to cause to be)	make
said	the, that
secondly	second
subsequent to	after
such	the, that
suffer	allow
take into consideration	consider
thereby; thereof; thereunder; therein	by that ____; of that ____; under that ____; in that ____
to the effect that	that
transpire	happen
try and	try to
under the provisions of; pursuant to	under; in accordance with
until such time as	until
utilize	use, make use of
with respect to	about

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§2.25 B. Alternatives to Sexist Terms

AVOID	USE
businessman	business manager; business executive; business person
cameraman	camera operator; photographer
chairman	chair; presiding officer; person chairing (or leading) a meeting; moderator; coordinator
congressman	senator; representative; member of Congress
draftsman	drafter
fireman	fire fighter
foreman	supervisor
husband or wife	spouse
insurance man	insurance agent
mailman	mail carrier; letter carrier
man (verb)	staff (verb)
policeman or policewoman	police officer
salesman	salesperson; sales clerk; sales representative
statesman	leader; public servant
steward or stewardess	flight attendant
workmen's claims	workers' claims

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3

Preliminary Considerations

I. CHECKLIST: PRELIMINARY CONSIDERATIONS §3.1

II. CLIENT'S CAPACITY TO CONTRACT §3.2
- A. Minors §3.3
- B. Unsound Mind §3.4
- C. Prisoners §3.5

III. CONTRACT GOVERNED BY SPECIAL LAWS AND REGULATIONS §3.6

IV. DECIDING ON FORM OF AGREEMENT §3.7

V. CONTRACT DEFENSES §3.8
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- B. Duress §3.10
- C. Illegality §3.11
- D. Mistake §3.12
- E. Contract of Adhesion §3.13
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  1. Not Enforceable §3.14
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- G. Impossibility and Impracticability §3.15
- H. Undue Influence §3.16
- I. Statute of Frauds §3.17

VI. PRINCIPLES OF CONTRACT CONSTRUCTION §3.18

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§3.1 I. CHECKLIST: PRELIMINARY CONSIDERATIONS

To download **Word** version, right click and choose *Save Target As*

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- Capacity to enter into contract
- Client as minor (see §3.3)
- Lack of mental capacity (see §3.4)
- Deprived of civil rights (see §3.5)
- Application of special laws (see §3.6)
- Form of agreement (see §3.7)
- Contract defenses (see §§3.8-3.17)
- Illusory contract (see §3.9)
- Duress (see §3.10)
- Illegality (see §3.11)
- Mistake (see §3.12)
- Contract of adhesion (see §3.13)
- Unconscionability (see §§3.14-3.14C)
- Impossibility and impracticability (see §3.15)
- Undue influence (see §3.16)
- Statute of frauds (see §3.17)

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§3.2 II. CLIENT'S CAPACITY TO CONTRACT

A contract may be void or voidable if entered into by someone who lacks the capacity to enter into the contract. Counsel therefore cannot draft an effective contract unless all parties have the capacity to contract. Common bases of incapacity are that the party:

- Is a minor (see §3.3);
- Is of unsound mind (see §3.4);
- Has been legally deprived of civil rights (see §3.5);
- Lacks the authority or legal capacity to act on behalf of a business entity (see chap 18); or
- Is a suspended corporation (see §3.11).

See generally California Law of Contracts, chap 2 (Cal CEB 2007). A nonexistent business entity may be a party to a contract if, after forming, it expressly or impliedly ratifies or adopts the contract. This rule applies to LLCs as well as corporations. *02 Dev., LLC v 607 S. Park, LLC* (2008) 159 CA4th 609, 71 CR3d 608.

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§3.3 A. Minors

People under the age of 18 are minors under California law. Fam C §6500. A minor cannot enter into the following types of contracts (Fam C §6701):

- A delegation of power;
- A contract relating to, or an interest in, real property; or
- A contract relating to personal property, not in the minor's immediate possession or control.

A contract for attorney fees incurred for litigation services is also void unless the fees are approved by the court on petition of an interested person, but the reasonable value of the services may be recoverable even if the contract is not approved. Fam C §6602; *Leonard v Alexander* (1942) 50 CA2d 385, 122 P2d 984.

Most other contracts with minors are voidable and can be disaffirmed by the minor. Fam C §6710. However, a minor cannot disaffirm an otherwise valid obligation that was made under the express authority or direction of a statute. Fam C §6711. Also, a minor cannot disaffirm a contract for necessities if the necessities were furnished and the minor was not under the care of a parent or guardian able to provide for the minor. Fam C §6712. A minor is also prohibited from disaffirming an arts, entertainment, or professional sports contract that was approved by the court. Fam C §§6750-6751. See California Law of Contracts, chap 2 (Cal CEB 2007).

NOTE: An emancipated minor may enter into a binding contract. Fam C §7050(e)(2). An emancipated minor is a person who is under the age of 18, and either is or has been married, is a member of the armed forces, or has been judicially declared to be an emancipated minor. Fam C §7002. See also Cal Contracts §§2.21-2.22.

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§3.4 B. Unsound Mind

A contract is void if made by a person who, at the time of entering into the contract, either has been judicially determined to be insane (CC §40(a)) or is wholly without understanding (CC §38). In the first situation, there has been a court adjudication that the person is of unsound mind. Such an adjudication includes the establishment of a conservatorship, which is a judicial determination that the conservatee does not have the capacity to enter into a contract. CC §40(b). In the second situation, there has been no judicial determination, but the person is entirely without understanding and thus is unable to understand the nature and consequences of the contract. *Ripperdan v Weldy* (1906) 149 C 667, 673. In both instances, the person will be liable for the reasonable value of goods furnished to the person or person's family that are necessary for support. CC §38.

A contract with a party of unsound mind who has not been judicially determined to be incapacitated and who is *not* wholly without understanding is voidable. CC §39(a). The trier of fact decides whether a person is of unsound mind and whether the person is wholly without understanding. If the person is substantially unable to manage his or her own financial resources or resist fraud or undue influence, a rebuttable presumption exists that the person is of unsound mind and thus not able to fully understand the nature and consequences of the contract. CC §39(b). Because these statutes were enacted for the benefit of the incapacitated person, only that party (or his or her representatives) may raise the defense. *San Francisco Credit Clearinghouse v MacDonald* (1912) 18 CA 212, 122 P 964. However, the contract may be voidable by the opposing party for other reasons, such as failure or inability to perform (see §§14.6, 14.11) or a mistake of the parties as to the terms or obligations of the contract (see §3.12). See California Law of Contracts §§2.24-2.28 (Cal CEB 2007).

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§3.5 C. Prisoners

A state prisoner may be prohibited from entering into a business contract during the term of confinement if the prohibition is necessary for the reasonable protection of the prison or the public. Pen C §§2600-2601. See also CC §2225, which prohibits felons from profiting from materials related to the story of a felony. See California Law of Contracts §2.29 (Cal CEB 2007).

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§3.6 III. CONTRACT GOVERNED BY SPECIAL LAWS AND REGULATIONS

Certain agreements are governed by, or trigger application of, specific sets of laws or regulations. These laws or regulations may impose special requirements on the enforceability of any contract. For example:

- **Commercial transactions.** These include transactions in goods, except leases (Com C §§2101-2801); secured transactions (Com C §§9101-9709); and leases of goods (Com C §§10101-10600).
- **Consumer transactions.** These are governed by, *e.g.,* the Consumer Credit Protection Act (15 USC §§1601-1693r); the Unruh Act (CC §§1801-1812.20); the Credit Card Act (CC §§1747-1748.31); the Consumer Credit Reporting Agencies Act (CC §§1785.1-1785.34); and the Karnette Rental-Purchase Act (CC §§1812.620-1812.649).
- **Intellectual property rights.** Examples include patents (35 USC §§1-376); copyrights (17 USC §§101-1332); federal trademark law (15 USC §§1051-1141n); and the California Model State Trademark Law (Bus & P C §§14200-14272).
- **Employment contracts.** These are governed by, *e.g.,* the Labor Code; the Americans with Disabilities Act (42 USC §§12101-12213); and the Employee Retirement Income Security Act (ERISA) (29 USC §§1001-1461). For further discussion of employment agreements, see Advising California Employers and Employees, chaps 2, 11 (Cal CEB 2005).
- **Insurance contracts.** These are governed by, *e.g.,* the Insurance Code and insurance regulations.

In addition, federal and state securities laws (*e.g.,* the Securities Exchange Act of 1934 (15 USC §§78a-78kk), the Securities Act of 1933 (15 USC §§77a-77aa), and the Corporate Securities Law of 1968 (Corp C §§25000-25706) affect many transactions, as do federal, state, and municipal tax and franchise laws. Counsel should also examine governmental regulations when drafting governmental agreements (*e.g.,* procurement contracts).

In all transactions, if specialized laws apply, counsel must review their effect and consider their consequences before drafting the contract. Failure to comply may result in unexpected duties, remedies, or penalties against the client's interest.

NOTE: When a party to the agreement is a resident of, or a corporate or other business entity headquartered in, another state or foreign jurisdiction, counsel must be aware that the laws of that state or foreign jurisdiction may apply to the terms of the contract or its enforceability even though the contract specifically elects California law and California jurisdiction.

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§3.7 IV. DECIDING ON FORM OF AGREEMENT

In determining the form that the agreement should take, counsel must consider who the parties are, what they want to accomplish, their level of sophistication, and the amount of time and money they are realistically willing to invest in the transaction. An agreement may take one of several forms:

- **Letter agreement that outlines the major points of the parties' transaction.** This type of agreement, usually sent by one party, should be acknowledged and agreed to or accepted by the other party or parties.
- **Printed form agreement.** Many stationery stores sell printed form agreements for a variety of common transactions, such as leases or property transfers. These forms, by design, seldom address unusual or specific provisions that the parties may want. Counsel can supplement these form agreements for clients who do not need a more tailored agreement. However, the cost and inefficiency of supplementing a printed form agreement may make a custom-drafted document a better choice.

NOTE: Generally, written terms control printed terms, and custom-drafted printed terms control printed form terms. CC §1651; CCP §1862. See §§17.9-17.10. However, the best practice is to include in any second or supplemental agreement (or an amendment or attachment to a previous or contemporaneous agreement) a reference to that other related agreement, and the drafter should designate which document is controlling if a conflict should arise.

- **Custom-drafted agreement.** This document, prepared by counsel, is usually the most time-consuming and expensive to prepare. Over the life of the transaction, however, the cost may be justified by the complexities of the transaction, the need to tailor the agreement to the parties' specific needs, and the ability to service the contract without further modifications.
- **Oral agreement.** Although entering into an oral agreement generally is not good practice, an oral agreement is binding absent application of the Statute of Frauds. On the Statute of Frauds and its exceptions, see §3.17.
- **Electronic agreements.** An agreement created and transmitted by electronic means may not be denied legal effect or enforceability because it is in an electronic form; an electronic signature satisfies the legal requirements for a signature, including the Statute of Frauds. On creating valid electronic agreements and electronic signatures, see chap 18A.

NOTE: Specific types of agreements may be required for transactions governed by special laws and regulations. See §3.6.

PRACTICE TIP: The two most important factors to consider when deciding how detailed a written contract should be are the trust between the parties and the value of the agreement. Parties who have little experience with one another or who inherently distrust each other will appreciate a lawyer who has anticipated the possible turns in their agreement. When the value of an agreement goes up, the parties generally expect that some provisions of the written contract will be more detailed, and many optional provisions will be included. The greatest benefit that the lawyer can serve is to accurately write out the important deal points and then identify a way for the parties to cooperate when problems arise.

However, it should be recognized that the individuals negotiating a contract are not necessarily those who will have to perform or enforce the contract over its term. Therefore, to maintain a long-term relationship, the terms of the contract should be set forth in a clear, unambiguous written document that can be readily understood by others over the term of the agreement. On avoiding ambiguity in contract language, see §2.11.

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§3.8 V. CONTRACT DEFENSES

In addition to ascertaining whether the parties have the capacity to form a contract (see §§3.2-3.5), counsel must also examine the contract to see whether, under the circumstances of the transaction, it is subject to other contract defenses. A contract defense can render a contract void or voidable. If an agreement is drafted so that it is susceptible to such a defense, counsel has failed in its primary objective of giving effect to the parties' intent. Some of the more common contract defenses that should be considered by counsel drafting agreements are discussed in §§3.9-3.17.

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§3.9 A. Illusory Contract

Contracts need not state every term and condition of the transaction. A contract that grants one party so much discretion as to render the contract totally lacking in consideration as to the other party, however, is an unenforceable illusory contract. *Perdue v Crocker Nat'l Bank* (1985) 38 C3d 913, 216 CR 345 (contract containing reciprocal promises not illusory even though one party could unilaterally set price); *Goodwest Rubber Corp. v Munoz* (1985) 170 CA3d 919, 216 CR 604 ("fair market value" price term did not render contract illusory). However, when the purchase price terms are uncertain in a contract subject to the Statute of Frauds, even if extrinsic evidence of the contemplated price is provided, the contract does not have the certainty for enforcement. *Sterling v Taylor* (2007) 40 C4th 757, 55 CR3d 116. But see *Powell v Central Cal. Fed. Sav. & Loan Ass'n* (1976) 59 CA3d 540, 549, 130 CR 635 (party's discretionary rights did not render contract illusory when discretion was reasonably exercised).

NOTE: Requirements and output contracts under the Commercial Code are not treated as illusory, and are enforceable, because "the party who will determine quantity is required to operate his plant or conduct his business in good faith"; Official Comment 2 to UCC §2-306.

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§3.10 B. Duress

Duress can take several forms; *e.g.,* physical compulsion, detention of property, economic pressure. Physical compulsion renders a contract void; other acts of duress render a contract voidable. *Rich & Whillock v Ashton Dev.* (1984) 157 CA3d 1154, 204 CR 86. See California Law of Contracts §3.9 (Cal CEB 2007).

A contract formed under economic duress can be set aside. *Rich & Whillock v Ashton Dev., supra.* In *Rich,* a developer and a general contractor knew that unless the subcontractor received payment, the subcontractor would face financial ruin. The developer and the contractor offered to pay the subcontractor less than the amount owed, even though they had no good faith objection to the balance claimed by the subcontractor, stating that if the subcontractor did not accept the amount offered it would have to sue for payment. The court set aside the contract based primarily on the developer's and contractor's bad faith manipulation of the subcontractor's economic duress. Whether a contract was entered into because of economic duress is a question of fact. *Philippine Export & Foreign Loan Guar. Corp. v Chuidian* (1990) 218 CA3d 1058, 1077, 267 CR 457.

NOTE: Settlement of a mistaken but good faith dispute does not constitute economic duress. See *Rich,* 157 CA3d at 1159.

To constitute economic duress sufficient to render an agreement voidable, the party subjected to the duress must have no reasonable alternative but to comply. The court does not set aside agreements that the complaining party entered into merely for expediency; to do so would undermine all negotiations and transactions. *London Homes, Inc. v Korn* (1965) 234 CA2d 233, 44 CR 262.

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§3.11 C. Illegality

The four elements required to make a contract are (1) competent parties, (2) consent, (3) sufficient consideration, and (4) a lawful objective. CC §1550. If the purpose of an agreement is unlawful, the agreement is not enforceable. *Homami v Iranzadi* (1989) 211 CA3d 1104, 260 CR 6.

Civil Code §1667 defines "unlawful" as:

- Contrary to an express provision of law;
- Contrary to the policy of an express provision of law; or
- Contrary to good morals.

See California Law of Contracts §§3.36-3.41 (Cal CEB 2007).

In *Murphy v Check 'N Go of Cal., Inc.* (2007) 156 CA4th 138, 67 CR3d 120, two unconscionable provisions—a provision for arbitrator determinations of unconscionability issues and a class action waiver—supported the trial court's conclusion that the agreement was permeated by an unlawful purpose and was therefore unenforceable.

A contract supported by illegal consideration is also void. CC §1607; *Bovard v American Horse Enters.* (1988) 201 CA3d 832, 247 CR 340 (manufacture of products to be used in illegal activity was illegal consideration); *Kallen v Delug* (1984) 157 CA3d 940, 203 CR 879 (attorney's promise to refrain from violating Rules of Professional Conduct was illegal consideration). See *Whorton v Dillingham* (1988) 202 CA3d 447, 248 CR 405 (providing sexual services was illegal consideration). The legal portion of a contract can be severed from the illegal portion, however, and enforced. CC §1599. See *Marathon Entertainment, Inc. v Blasi* (2008) 42 C4th 974, 70 CR3d 727; *Whorton v Dillingham, supra*.

A contract entered into to circumvent the law of the jurisdiction where the cause of action arose is not enforceable under California law, under principles of comity, even if the contract is legal under California law. *Wong v Tenneco, Inc.* (1985) 39 C3d 126, 216 CR 412. A *judgment* from a jurisdiction in which a contract is legal is enforceable in California, however, even if the underlying contract is illegal under California law. *Harrah's Club v Van Blitter* (9th Cir 1990) 902 F2d 774; *Kelly v First Astri Corp.* (1999) 72 CA4th 462, 485, 84 CR2d 810.

A suspended corporation is not allowed to exercise the powers and privileges of a corporation in good standing, including the right to sue or defend a lawsuit while its taxes remain unpaid. While a suspended corporation may not be a competent party, a contract entered into by a suspended corporation is not void but is voidable by the other party. Rev & T C §23304.1(a). *Performance Plastering v Richmond Am. Homes of Cal., Inc.* (2007) 153 CA4th 659, 63 CR3d 537.

PRACTICE TIP: If enforcement of the contract might trigger application of foreign law, counsel should consider obtaining an opinion of counsel from the foreign jurisdiction before drafting the agreement.

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§3.12 D. Mistake

Mistake can form the basis for rescinding a contract. *Rescission* is the appropriate remedy if:

- A material mistake of fact or law is mutual, even if the mistake results from an innocent misrepresentation; or
- A material mistake of fact or law is unilateral, but it is known to the other contracting party, who encourages or fosters the mistake.

CC §1689; *Merced County Mut. Fire Ins. Co. v State* (1991) 233 CA3d 765, 284 CR 680; *Crocker-Anglo Nat'l Bank v Kuchman* (1964) 224 CA2d 490, 36 CR 806. The mistake must relate to a past or present law or fact. *Mosher v Mayacamas Corp.* (1989) 215 CA3d 1, 263 CR 373. See CC §§1577-1578 for definitions of mistake of fact and mistake of law. See California Law of Contracts §§3.33-3.34 (Cal CEB 2007).

Reformation is the remedy for a mistake in writing, *i.e.,* if the writing does not express the parties' intent. However, reformation is available only if it does not prejudice any rights acquired by third parties for value and in good faith. CC §3399. The mistake must be either mutual or, if unilateral, the other party to the contract must have known of or suspected the mistake. After reformation, the court can order specific performance of the revised agreement. CC §3402. See Cal Contracts §§11.62-11.64.

NOTE: Because reformation and rescission are equitable remedies, they may be denied if the mistake was the result of a lack of reasonable care and diligence (*e.g.,* an error in judgment or negligence of a legal duty). *Appalachian Ins. Co. v McDonnell Douglas Corp.* (1989) 214 CA3d 1, 19, 262 CR 716; *Schultz v County of Contra Costa* (1984) 157 CA3d 242, 203 CR 760; *White v Berrenda Mesa Water Dist.* (1970) 7 CA3d 894, 87 CR 338. But see *Balistreri v Nevada Livestock Prod. Credit Ass'n* (1989) 214 CA3d 635, 262 CR 862 (failure to read deed of trust reasonably caused by trustee; contract canceled).

Parol evidence may be admitted to show mistake under CCP §1856(e) or fraud under CCP §1856(f). *Pacific State Bank v Greene* (2003) 110 CA4th 375, 1 CR3d 739. See Cal Contracts §5.41.

PRACTICE TIP: Before drafting the contract, counsel should consider asking the client to produce a "term sheet" that lists the major deal points. The other party should approve the term sheet before counsel begins drafting the contract. See chap 20 for a discussion of letters of intent. Counsel should draft the agreement, and discuss its meaning with the client, in sufficient detail to avoid allegations that the agreement was entered into through mistake.

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§3.13 E. Contract of Adhesion

A contract of adhesion is a standardized form contract entered into by parties of unequal bargaining power, with the weaker party given no opportunity to negotiate terms; *i.e.,* the weaker party has only the choice of accepting or rejecting the contract. *Graham v Scissor-Tail, Inc.* (1981) 28 C3d 807, 171 CR 604. Generally, the weaker party has no realistic alternative for the product or service. *Madden v Kaiser Found. Hosps.* (1976) 17 C3d 699, 711, 131 CR 882; *Tunkl v Regents of Univ. of Cal.* (1963) 60 C2d 92, 102, 32 CR 33. An adhesion contract is fully enforceable, subject to the following limitations (see *Gutierrez v Autowest, Inc.* (2003) 114 CA4th 77, 7 CR3d 267; *Marin Storage & Trucking, Inc. v Benco Contracting & Eng'g, Inc.* (2001) 89 CA4th 1042, 107 CR2d 645; *California Grocers Ass'n v Bank of America* (1994) 22 CA4th 205, 27 CR2d 396):

- Terms that frustrate the reasonable expectations of the injured party are unenforceable; and
- Terms that are unfair, unconscionable, or contrary to public policy are unenforceable.

See California Law of Contracts §§5.72-5.74 (Cal CEB 2007).

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F. Unconscionable Contracts

§3.14 1. Not Enforceable

The courts need not enforce an unconscionable provision or a contract containing an unconscionable provision. CC §1670.5(a). This restriction applies to all contracts generally, not just adhesion contracts. *California Grocers Ass'n v Bank of America* (1994) 22 CA4th 205, 27 CR2d 396.

NOTE: Because consumers can usually prove unconscionability more easily than businesspeople, the defense is more common in consumer cases. See *A&M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 489, 186 CR 114. See also *Morris v Redwood Empire Bancorp* (2005) 128 CA4th 1305, 1317, 27 CR3d 797. What may be unconscionable in a contract with a consumer (see, *e.g.*, *Perdue v Crocker Nat'l Bank* (1985) 38 C3d 913, 216 CR 345) may, in some instances, be acceptable when the contract is between merchants (see, *e.g.*, *Morris v Redwood Empire Bancorp* (2005) 128 CA4th 1305, 1322, 27 CR3d 797, in which the court found it reasonable "to expect even an unsophisticated businessman to carefully read, understand, and consider all the terms of an agreement affecting such a vital aspect of his business.").

It is possible for an entire agreement to be held unenforceable based on unconscionability. A court will first try to sever unconscionable provisions, but an agreement may contain so many unconscionable provisions that it cannot be made enforceable by severing them. In that situation, the entire agreement is unenforceable. *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 99 CR2d 745 (one-sided arbitration agreement was completely unenforceable). See also *Ontiveros v DHL Express (USA), Inc.* (2008) 164 CA4th 494, 79 CR3d 471 (agreement that was so "permeated with unconscionability" that offending terms could not be severed held unenforceable).

NOTE: The unconscionability rule discussed in *Armendariz* has been held inapplicable when counsel negotiated a substantial employment contract rather than using a generic or standard agreement. *Parker v McCaw* (2005) 125 CA4th 1494, 1507, 24 CR3d 55.

Civil Code §1670.5 provides only a defense to the enforceability of an unconscionable contract; it cannot form the basis of an affirmative course of action. *California Grocers Ass'n v Bank of America* (1994) 22 CA4th 205, 27 CR2d 396.

PRACTICE TIP: If a provision is *potentially* unconscionable, the contract may nevertheless be held valid if the provision is clearly and fully disclosed to the party adversely affected. Counsel should include a provision stating that each party was given the opportunity to obtain the advice of counsel and, if applicable, chose not to do so.

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2. Tests for Unconscionability

§3.14A a. Procedural/Substantive Test

The standard for ascertaining whether a contract is unconscionable, formulated in *A&M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114, states that a contract is unenforceable if it satisfies both of the following two requirements:

- **Procedural unconscionability.** The contract (1) is oppressive (*i.e.,* there is an inequality of bargaining power resulting in a lack of meaningful choice) and (2) contains an element of surprise (*i.e.,* the terms are effectively hidden). Note that a contract of adhesion might satisfy the "oppression" component of procedural unconscionability. *West v Henderson* (1991) 227 CA3d 1578, 1586, 278 CR 570.
- **Substantive unconscionability.** The terms of the contract are, without justification, too harsh or one-sided, or reallocate the risks of the bargain in an objectively unreasonable or unexpected manner. See *Morris v Redwood Empire Bancorp* (2005) 128 CA4th 1305, 1317, 27 CR3d 797; *Jones v Wells Fargo Bank* (2003) 112 CA4th 1527, 1539, 5 CR3d 835. Note that even a "market" price term may be unconscionable, depending on the facts of the transaction. See *Perdue v Crocker Nat'l Bank* (1985) 38 C3d 913, 216 CR 345. See also *Nagrampa v MailCoups, Inc.* (9th Cir 2006) 469 F3d 1257; *Gatton v T-Mobile USA, Inc.* (2007) 152 CA4th 571, 61 CR3d 344; *Marin Storage & Trucking, Inc. v Benco Contracting & Eng'g, Inc.* (2001) 89 CA4th 1042, 107 CR2d 645; *Dean Witter Reynolds, Inc. v Superior Court* (1989) 211 CA3d 758, 259 CR 789.

The two types of unconscionability "need not both be present to the same degree"; California courts apply a "sliding scale," so that "the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa." *Nagrampa v MailCoups, Inc.* (9th Cir 2006) 469 F3d 1257, 1280 (internal citations omitted). See also *Gatton v T-Mobile USA, Inc.* (2007) 152 CA4th 571, 579, 61 CR3d 344.

The parties in *Shroyer v New Cingular Wireless Servs., Inc.* (9th Cir 2007) 498 F3d 976 agreed that California contract law applied to determine whether the class arbitration waiver was unconscionable. In assessing unconscionability, the court followed *Discover Bank v Superior Court* (2005) 36 C4th 148, 30 CR3d 76, in which the supreme court stated that a procedurally unconscionable contract generally takes the form of a contract of adhesion, requiring the subscribing party to adhere to the contract or reject it, while the substantive element, which takes many forms, may generally be described as a contract that is unfairly one-sided. 36 C4th at 160. The *Shroyer* court concluded that under *Discover Bank*, the waiver was both procedurally and substantively unconscionable. *Shroyer*, 498 F3d at 984. In *Ontiveros v DHL Express (USA), Inc.* (2008) 164 CA4th 494, 79 CR3d 471, the court found procedural unconscionability as well as several indicators of substantive unconscionability, including provisions severely limiting discovery and requiring the employee to pay a portion of costs.

If one party alleges or the court finds that a contract is unconscionable, the parties have a reasonable opportunity to present evidence to the contrary. CC §1670.5(b).

The Federal Arbitration Act (FAA) (9 USC §§1-16) provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 USC §2. Unconscionability is a contract defense that may render an arbitration clause unenforceable. *Nagrampa v MailCoups, Inc.* (9th Cir 2006) 469 F3d 1257, 1280, citing *Doctor's Assocs., Inc. v Casarotto* (1996) 517 US 681, 686, 134 L Ed 2d 902, 908, 116 S Ct 1652. The FAA does not preempt the California contract law defense of unconscionability. *Shroyer v New Cingular Wireless Servs., Inc.* (9th Cir 2007) 498 F3d 976, 987.

See generally California Law of Contracts §§5.76-5.77 (Cal CEB 2007).

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§3.14B b. Contract-of-Adhesion Test

In *California Grocers Ass'n v Bank of America* (1994) 22 CA4th 205, 27 CR2d 396, the court rejected the procedural/substantive approach and relied on a different standard. See *Graham v Scissor-Tail, Inc.* (1981) 28 C3d 807, 819, 171 CR 604. It equated procedural unconscionability with a finding of a contract of adhesion. After this issue was resolved, the pivotal issue was whether the contract was "unconscionable." Holding that the standard of "reasonableness" in *A&M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114, was too subjective, the court in *California Grocers* required that the contract "shock the conscience" if it was to be found enforceable on the basis of unconscionability. This determination is a question of law. *American Software, Inc. v Ali* (1996) 46 CA4th 1386, 1391, 54 CR2d 477. See *Gutierrez v Autowest, Inc.* (2003) 114 CA4th 77, 7 CR3d 267 (arbitration clause in lease agreement requiring plaintiff to pay unaffordable arbitration fee was contrary to public policy and unconscionable; however, clause was severable unless provision was drafted in bad faith, which would render entire contact illegal). See also *Independent Ass'n of Mailbox Ctr. Owners, Inc. v Superior Court* (2005) 133 CA4th 396, 415, 34 CR3d 659 (further explaining basis for *Gutierrez* decision).

Under California law, a contract of adhesion is "a standardized contract, imposed upon the subscribing party without an opportunity to negotiate the terms." *Nagrampa v MailCoups, Inc.* (9th Cir 2006) 469 F3d 1257, 1281 (quoting *Flores v Transamerica HomeFirst, Inc.* (2001) 93 CA4th 846, 853, 113 CR2d 376). See also *Shroyer v New Cingular Wireless Servs., Inc.* (9th Cir 2007) 498 F3d 976, 982; *Discover Bank v Superior Court* (2005) 36 C4th 148, 160, 30 CR3d 76. A finding of adhesion is not necessary for a finding of unconscionability when procedural unconscionability is obvious. *Harper v Ultimo* (2003) 113 CA4th 1402, 7 CR3d 418 (when contract provided for arbitration according to rules of Better Business Bureau, and rules precluded tort damages but were not attached to contract, arbitration clause was unconscionable; rules had effect of substantially limiting defendant's exposure and rendered clause one-sided). Similarly, a finding that a merchant agreement constitutes an adhesion contract does not end the inquiry into enforceability. A court must also find the agreement to be oppressive, which refers to the absence of negotiating power and the absence of reasonable market alternatives. See *Morris v Redwood Empire Bancorp* (2005) 128 CA4th 1305, 1322, 27 CR3d 797.

A plaintiff's consent to a provision granting an arbitrator exclusive authority to arbitrate unconscionability issues was found to be "vitiated by the fact that it was set forth in a contract of adhesion" in *Murphy v Check 'N Go of Cal., Inc.* (2007) 156 CA4th 138, 144, 67 CR3d 120. Citing *Graham v Scissor-Tail, Inc.* (1981) 28 C3d 807, 820, 171 CR 604, the *Murphy* court identified two judicially imposed limitations on the enforcement of adhesion contracts: (1) A contract or clause that does not fall within the reasonable expectations of the weaker (or adhering) party will not be enforced against that party, and (2) a contract or clause, even if consistent with the parties' reasonable expectations, will not be enforced if it is procedurally and substantively unconscionable. 156 CA4th at 145. Providing that an arbitrator, rather than a court, determine unconscionability was not consistent with the party's reasonable expectations; thus the provision was substantively unconscionable. 156 CA4th at 145. See also *Bruni v Didion* (2008) 160 CA4th 1272, 1279, 73 CR3d 395 (adhesion contract giving arbitrator authority to decide arbitrability found substantively unconscionable because it went beyond the weaker party's "reasonable expectations").

Following *Murphy*, the court in *Ontiveros v DHL Express (USA), Inc.* (2008) 164 CA4th 494, 79 CR3d 471, held that notwithstanding any contrary language in the arbitration agreement, the court retains the power to determine whether an arbitration agreement is enforceable. Despite the appearance of mutuality, the agreement assigning enforceability issues to an arbitrator was in fact one-sided because the drafter of an arbitration agreement was not likely to seek a ruling on whether its agreement provisions were unconscionable. On the issue of whether a claim of fraud in the inducement of an entire contract should be decided by an arbitrator, the court cited *Prima Paint Corp. v Flood & Conklin Mfg. Co.* (1967) 388 US 395, 18 L Ed 2d 1270, 87 S Ct 1801 (dissenting opinion of Black, J). In *Prima Paint*, Justice Black pointed out that asking an arbitrator to decide whether an entire contract is void raises due process issues by tying the arbitrator's decision to his or her compensation, *i.e.,* an arbitrator who finds a contract void will have nothing left to arbitrate. 388 US at 416, 18 L Ed 2d at 1284. The *Ontiveros* court applied Justice Black's reasoning, holding that an arbitrator should not be permitted to decide whether an arbitration agreement is unconscionable when a finding of unconscionability not only would reduce the arbitrator's work in the case at hand but also could diminish prospects for future business from the defendant employer, thus placing the arbitrator in an inappropriate conflict situation.

The court in *Murphy* also found that the class action waiver in the contract was unconscionable under CC §1668 and *Discover Bank, supra.* 156 CA4th at 147. The class action waiver acted as an exculpatory clause, exempting the

defendant from responsibility for its transgressions, because given the individually small sums involved, individual class members would have difficulty securing legal representation. The court held that the arbitration agreement, permeated by unconscionability, was unenforceable. 156 CA4th at 149.

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§3.14C c. Which Test to Use

The California Supreme Court has stated that both analytical approaches to the unconscionability issue discussed in §§3.14A-3.14B should reach the same result. *Perdue v Crocker Nat'l Bank* (1985) 38 C3d 913, 925 n9, 216 CR 345. The court has approved both approaches without expressing a preference for either. *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 113, 99 CR2d 745. However, in at least one case, the court relied exclusively on the procedural/substantive approach. See *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 130 CR2d 892.

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§3.15 G. Impossibility and Impracticability

The contract defenses of impossibility and impracticability are available if a contract imposes a substantially greater burden than originally anticipated and if the injured party was unable to avoid the impossibility or impracticability. See CC §1511; *G.W. Andersen Constr. Co. v Mars Sales* (1985) 164 CA3d 326, 210 CR 409. In *Andersen,* a building moratorium caused a delay in the plaintiff's performance, and the defendants alleged that the delay triggered this defense. The court refused to recognize the defense, however, because the defendants wanted the delay, time was not of the essence, and the contract anticipated delays greater than 6 months. The court also held that the delay worked only to postpone the parties' performance.

NOTE: This defense is distinguished from a force majeure provision (see §§14.10-14.12), which provides an excuse for nonperformance.

PRACTICE TIP: Counsel should include a "time is of the essence" clause if the client would want this defense to be available if a delay occurs. See §§17.17-17.18. Alternatively, counsel should include a due diligence clause that sets dates for milestones and deadlines and gives the injured party the right to terminate or renegotiate terms of the agreement, or receive penalty payments, if there is failure to perform according to the stated terms.

For further discussion of impossibility and impracticability, see §§14.11-14.13.

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§3.16 H. Undue Influence

A contract entered into as a result of undue influence is subject to rescission. See CC §§1567, 1575. Undue influence occurs when one party takes unfair advantage of another through confidence or authority, or takes unfair advantage of the other's needs, distress, or weakness of mind. CC §1575. Undue influence corresponds to a lack of true consent. Undue influence can result from a confidential or authoritative relationship or from a combination of undue susceptibility and excessive pressure. *Odorizzi v Bloomfield Sch. Dist.* (1966) 246 CA2d 123, 54 CR 533. See California Law of Contracts §§3.21-3.31 (Cal CEB 2007).

PRACTICE TIP: For transactions between parties who have a confidential relationship (*e.g.,* attorney and client, trustee and beneficiary, or financial adviser and client), consent to the agreement should be clearly established and the conflicts of interest that could arise from the confidential relationship clearly explained.

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§3.17 I. Statute of Frauds

The Statute of Frauds requires that certain agreements be supported by a writing if they are to be enforceable. The statute provides a defense only; it cannot be used to enforce an agreement. Some of the agreements generally governed by the Statute of Frauds are:

- Agreements incapable of performance within 1 year. CC §1624(a)(1).
- A promise to a creditor to meet the obligations of another (*e.g.,* a suretyship). CC §§1624(a)(2), 2793-2794.
- Certain agreements relating to the purchase, sale, or lease of real property. CC §§1091, 1624(a)(3)-(4); CCP §1971.
- Agreements incapable of performance during the lifetime of the promisor. CC §1624(a)(5).
- Certain agreements for the assumption of indebtedness secured by a deed of trust on property purchased. CC §1624(a)(6).
- Certain agreements to make a consumer loan in excess of $100,000. CC §1624(a)(7).
- Certain modification agreements. CC §1698; Com C §2209(2).
- Authorization for another to enter into an agreement that must be in writing (the "equal dignities rule"). CC §2309.
- Certain agreements for the sale of goods in excess of $500 (Com C §2201(1)).
- Letters of credit. Com C §5104(1).
- Certain equipment leases. Com C §10201(a)(2).
- Agreements to pay the debts or liabilities of a decedent from one's own estate. Prob C §9604.
- A trust in relation to real property. Prob C §15206.
- Premarital agreements. Fam C §1611.

See California Law of Contracts §§4.44-4.50 (Cal CEB 2007).

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§3.18 VI. PRINCIPLES OF CONTRACT CONSTRUCTION

The intent of the parties controls the interpretation of contracts. CC §1636; CCP §1859. This intent, however, may be difficult to establish. In *Metters v Ralphs Grocery Co.* (2008) 161 CA4th 696, 701, 74 CR3d 210, the defendant employer argued that the plaintiff employee could not avoid being bound by the contract because "one who signs an instrument which on its face is a contract is deemed to assent to all its terms." The court disagreed, however, citing *Marin Storage & Trucking, Inc. v Benco Contracting & Eng'g, Inc.* (2001) 89 CA4th 1042, 1049, 107 CR2d 645, for the exception to the general rule that exists "when the writing does not appear to be a contract and the terms are not called to the attention of the recipient." *Metters,* 161 CA4th at 702.

When interpretation of a contract is disputed and the court is asked to construe it, the court applies certain statutory principles. See CC §§1635-1662, 2778; CCP §§1857-1866. Counsel must be aware of these principles when drafting an agreement in order to ensure that they will not counteract the parties' intent. See California Law of Contracts, chap 5 (Cal CEB 2007). The following are some of the more common principles that the courts call on in interpreting contracts:

- If possible, a contract is interpreted to give meaning to all its provisions (CC §1641; CCP §1858) and to be lawful, operative, definite, reasonable, and capable of being given effect (CC §1643).
- Technical words are interpreted according to their technical meanings, and nontechnical words are interpreted according to their ordinary meanings. CC §§1644-1645.
- A contract is construed according to the law of the place where it is to be performed or, if the place of performance is not indicated, where it was made, except that the parties can choose to have California law apply for many contracts involving more than $250,000. CC §§1646-1646.5. See §§16.56-16.57 for choice of law provisions.
- Ambiguous or uncertain promises are interpreted according to what the promisor believed that the promisee understood the promise to be. CC §1649.
- Written terms control printed terms, and printed terms added to a contract control terms on a preprinted form. CC §1651; CCP §1862.
- Uncertainties are construed against the party that caused the uncertainty (usually, the drafting party). CC §1654. See §§17.23-17.24 for language negating this rule.
- Promises of multiple parties who benefit from the agreement are presumed to be joint and several. CC §1659. See §§17.25-17.26 for discussion of joint and several obligations.
- Particular provisions control general provisions. CCP §1859.
- If two constructions of a provision are equally proper, the provision is construed in favor of the party for whose benefit the provision was made. CCP §1864.
- The courts consider trade usage to interpret agreements governed by the Commercial Code. Express terms of an agreement and the course of dealing or trade usage are construed to be consistent when possible but, if not, express terms control. Com C §1303.
- A contract subject to the Statute of Frauds is not valid if an essential term is missing, and parol evidence may not be used to provide that essential element. On the other hand, parol evidence may be used to clarify an ambiguity regarding the essential term. In *First Nat'l. Mortgage Co v Federal Realty Inv. Trust* (Aug. 3, 2006, No.C-03-02013RMW) 2006 US Dist Lexis 57113, the court found that although the term of the lease was missing, it was implied, rendering the agreement ambiguous and allowing introduction of parol evidence to explain the ambiguity. See also *Fremont Indem. Co. v Fremont Gen. Corp.* (2007) 148 CA4th 97, 55 CR3d 621 (demurrer inappropriate when dispute over meaning of judicially noticed document requires introduction of evidence).

PRACTICE TIP: Even at the time of contracting, counsel should consider whether the parties have differing positions with respect to litigation. For example, one party may have a reputation for litigiousness. Counsel should consider whether one party might not have the financial or practical capability or wherewithal to litigate disputes. On alternative dispute resolution, see chap 16.

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4

Client Interview

Steven L. Morgan

I. CHECKLIST: CLIENT INTERVIEW §4.1

II. PURPOSE OF INITIAL CLIENT INTERVIEW §4.2

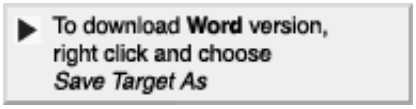
III. ETHICAL CONSIDERATIONS §4.3

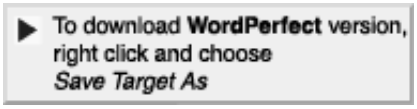
IV. ISSUES TO DISCUSS
- A. Parties to Transaction §4.4
- B. Negotiation of Terms §4.5
- C. Duties of Each Party §4.6
- D. Significant Dates §4.7
- E. Existing Contracts §4.8
- F. Role of Other Advisers §4.9

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/4 Client Interview/§4.1 I. CHECKLIST: CLIENT INTERVIEW

§4.1 I. CHECKLIST: CLIENT INTERVIEW





- Obtain information about transaction (see §§1.3-1.6, 4.2-4.7)
- Determine client's goals (see §4.2)
- Determine whether transaction is affected by other obligations of client (see §§4.7, 1.9)
- Define scope of representation and fees for work performed (see §4.2)
- Obtain client's written agreement to representation (see §4.2)
- Introduce client to others who will be working on the transaction (see §4.2)
- Consider any ethical issues raised by representation (see §§4.2, 2.16-2.18)
- Ascertain whether client has any other advisers for the transaction (see §4.8)

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§4.2 II. PURPOSE OF INITIAL CLIENT INTERVIEW

The term "initial client interview" is sometimes used to describe a meeting in which the attorney and client are gathering information to make a decision about representation. For purposes of this chapter, however, we will assume that the client has already retained the attorney to represent him or her in the negotiation and preparation of a particular agreement and that the initial client interview refers to the initial meeting between counsel and client to discuss a specific transaction.

The attorney's objectives in meeting with the client for that purpose are threefold:

(1) To determine how far the transaction has already progressed;

(2) To gather the information necessary to prepare the agreement; and

(3) To make recommendations to the client to assist in the consummation of the transaction.

The initial client interview is one of the most important meetings the attorney will have with the client. It is the best opportunity for gathering information, determining the client's goals, and deciding what issues must be addressed. See §1.6. Some preliminary concerns are:

- Has an agreement been reached, or are the parties still negotiating?

NOTE: If the client believes an oral agreement has been reached, counsel should generate a written record of the client's understanding. If there is a written document or correspondence, obtain copies so that a determination can be made whether there is a binding contract or an agreement to agree.

- Does the client have any prior experience with this type of transaction, or is the client expecting the attorney to structure the deal?
- Is this a new or existing client?

If the client is a new one, the initial interview is the time to define the nature and scope of the engagement, discuss attorney fees, and obtain the client's written agreement to the representation. Under Bus & P C §6148, a written contract for services must be executed when it is reasonably foreseeable that the total bill to the client will exceed $1000. (This provision does not apply when the client is a corporation. Bus & P C §6148(d)(4).) Counsel should discuss with the client any aspect of the attorney's work that will require an extensive amount of time (*e.g.,* research of the tax law). If other attorneys in the office will work on the project, the initial interview is a good opportunity to introduce them to the client, in order to avoid confusion or resentment later over unexpected entries on the client's bill.

The type of client will affect the degree of factual investigation necessary to complete the transaction. The existing client whose business is familiar to the attorney usually does not trigger the same degree of information gathering as will a new client. A client having no prior experience with the transaction in question will require a more in-depth discussion of goals and relevant legal issues.

If the subject matter of the agreement is a product, an item of personal property, or a parcel of real property, it may be useful for the attorney to view the property. Visual inspection may bring to mind legal concerns that the attorney might have otherwise missed. For example, if the proposed agreement concerns the sale of a piece of machinery, seeing it in operation may trigger thoughts about warranty limitations or disclaimers, limitations of liability, patent indemnities, or other provisions that might benefit the client. Also, if the contract relates to a tangible item (such as a product or a machine), real property, or an intangible asset (patents, trademarks, copyrights, or trade secrets), it is important to determine whether the holder of the property has full and unencumbered rights to the property, or whether there are, or could be, claims to title from a third party.

It is impossible to draft an effective agreement unless the attorney fully understands the underlying transaction and the client's objectives. See §1.6. In addition to learning what the client wants to achieve, the attorney must be able to determine whether those objectives are reasonable and what the client should reasonably expect to sacrifice to achieve them.

The attorney drafting the agreement must remember that the contract is a record of the parties' respective rights and

obligations. It is the attorney's responsibility to gather all the information necessary to create that record. This job begins in the client interview.

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§4.3 III. ETHICAL CONSIDERATIONS

The attorney may learn in the course of the initial interview that the client's interests potentially or actually conflict with the interests of another of the attorney's past or present clients. If so, Cal Rules of Prof Cond 3-310 prohibits the attorney from accepting or continuing representation of the new client unless both the new and the preexisting clients are informed in writing of the conflict and both give their written consent to the joint representation. Consent is also required when the attorney has or had a legal, business, financial, or professional interest in the subject matter of the representation. This rule does not require either the disclosure of the new engagement to a former client or the consent of the former client to the new engagement, unless by reason of the representation of the client or former client, the attorney obtained confidential information material to that representation. See Discussion (1993) to Cal Rules of Prof Cond 3-310.

An attorney drafting an agreement in an area of the law in which the attorney has limited experience should also be mindful of Cal Rules of Prof Cond 3-110, which requires the attorney to perform legal services with competence. "Competence" for purposes of Rule 3-110 means "to apply the 1) diligence, 2) learning and skill, and 3) mental, emotional, and physical ability reasonably necessary for the performance of such service." If the attorney does not have sufficient learning and skill when the legal service is undertaken, Rule 3-110 provides that he or she may nonetheless perform such service competently by "1) associating with or, where appropriate, professionally consulting another lawyer reasonably believed to be competent, or 2) by acquiring sufficient learning and skill before performance is required." The attorney's first duty is to become familiar with the factual and legal contexts of the transaction, including any common trade usages in the client's industry. If the transaction raises legal issues outside the scope of the attorney's practice experience (*e.g.,* environmental or tax issues), the attorney is ethically obligated to obtain the assistance of more experienced counsel, to suggest that the client also retain the services of an additional attorney or a nonattorney (such as an accountant) with special expertise in the area of concern (such as tax, intellectual property, or conflicts of law), or otherwise to become sufficiently knowledgeable to competently advise and serve the client. A nonspecialist who fails to consult or associate a specialist when a reasonable practitioner would do so in the circumstances will be subject to the same standards that apply to a specialist in that area. See *Horne v Peckham* (1979) 97 CA3d 404, 158 CR 714.

For further discussion of ethical considerations, see §§2.15-2.23.

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IV. ISSUES TO DISCUSS

§4.4 A. Parties to Transaction

The starting point for preparing an agreement is learning who the necessary parties are. The first question should be: Who is the client? Is it an individual, the sole proprietor of a business, a partnership (general or limited), or a corporation? If it is an entity, is the person representing it the owner, an officer, or a partner? What authority does this person have? Can he or she make binding decisions on crucial points in the transaction? If not, should others be involved in planning or negotiating? See §§5.10-5.14 for further discussion of parties to an agreement.

When the client is an entity, the attorney must conform his or her representation to the fact that the client is the organization itself, not the individual with whom the attorney is dealing. Cal Rules of Prof Cond 3-600.

The attorney should also make clear to the individual that representation is of the business entity and not the individual, explore whether the individual has conflicting fiduciary and personal interests, and suggest that the individual may want to retain separate counsel to protect his or her personal interests if they conflict with those of the business entity. If such conflicting interests exist, it may be necessary to identify another individual in the business entity as its representative for discussions regarding the entity's legal representation. Counsel who represents the interests of both the business entity and the individual should make it clear to the individual and the other officers of the entity that the final resolution may not fully serve the best interests of both the business entity and the individual.

The client should provide the names, addresses, and telephone numbers of each of the other parties to the transaction, including counsel's, when a party is represented. Counsel should ascertain whether the parties are of equal bargaining strength, or whether one party has significantly more leverage. Further, counsel should determine whether another party has the advantage of extensive experience in similar transactions. When the client has no such prior experience, counsel should additionally review the transaction to make sure the client is not subjected to an unfair advantage.

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§4.5 B. Negotiation of Terms

Where in the process of negotiation is the transaction? Has the client signed a letter of intent (see chap 20) or any other document reflecting one or more of the substantive terms of the deal? Does the client have any oral understandings with the other party about any aspect of the deal? Does the client have an ongoing business relationship with the other party that could result in certain contractual terms being implied?

If further negotiation is required, what are the client's expectations and objectives? What does the client expect of *you* as its attorney? Are you qualified to negotiate the deal? This question is very important to consider at the outset, because counsel has an ethical obligation to obtain competent assistance if he or she is not competent. Cal Rules of Prof Cond 3-110. See §4.2.

At the initial interview, it is important to have the client express—in the client's own words—his or her understanding of the transaction. Counsel should take copious notes and write down new questions as they occur while listening to the client. Sometimes a client will digress into lengthy explanations of the history of the client's relationship with the other party, especially if the parties have an emotional attachment to the transaction. Although the attorney can glean relevant and insightful information from allowing the client to expound unchecked, it may become necessary to control the direction of the conversation and keep the client focused. However, the client's assumptions and expectations are an important part of the process of evaluating the transaction, so the attorney should resist the temptation to seek only the information the attorney believes is critical.

After the client has explained the transaction and counsel has filled in any gaps in his or her understanding, counsel is in a position to diagram the transaction. It is very important to do this (especially a complex transaction) to illustrate who the parties are and what the deal is. When multiple parties are involved, it is helpful to diagram the rights and obligations each has to the others. This tool will assist counsel greatly in understanding the transaction, assessing the legal issues it raises, and structuring the agreement.

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§4.6 C. Duties of Each Party

Counsel should ascertain each party's obligations to the other parties. What does the client understand his or her obligations to be in exchange for the rights received from the other party? Are there any contingencies to either party's obligations? If so, are they concurrent, or must one party perform before the other? See chap 10.

What consideration is being given by each party in exchange for the other party's performance? See chap 8. How will the risks of the transaction be allocated between them? Is either party required to indemnify the other in certain circumstances? See chap 11.

If one or more parties breach their obligations, what rights do the nonbreaching parties have? Do different parties have different rights depending on the type of breach? See chap 15.

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§4.7 D. Significant Dates

What is the time for performance by the parties? Is the time for performance "of the essence"? See §§17.17-17.18. It is important that the dates for performance be specified and the consequences of untimely performance be understood by all. For example, will the nonbreaching party have the right to terminate the agreement, be entitled to an adjustment in its own performance, or be entitled to receive additional consideration? If the agreement is silent as to relevant dates, the parties will be given what a trier of fact considers a "reasonable" time for performance. See, *e.g.,* CC §1657; Com C §2309(1). See also chap 6, §§17.17-17.18.

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§4.8 E. Existing Contracts

It is important to learn whether any other agreements exist that may affect the transaction at hand, either between the parties themselves or between the client and third parties. If so, the attorney must review those documents thoroughly to be sure that the new agreement does not create a conflict for the client or breach any existing obligations. Alternatively, the client may wish the new agreement to provide that a party who breaches an existing obligation also breaches the new agreement. See §14.21 for an example of a cross-default provision.

Is this a one-time transaction or will the client be using the agreement for further transactions (*e.g.,* a form lease)? If it is the former, the attorney should carefully consider all possible scenarios that may arise and deal with them in the agreement. If the agreement is a form agreement, the client should be educated about the provisions that should be reviewed before entering into each agreement.

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§4.9 F. Role of Other Advisers

It is important to learn whether the client has any other advisers in the transaction, such as an accountant, financial adviser, or another attorney. If so, the transaction should be discussed with each to be sure that their objectives will be met. Counsel should be particularly alert to agreements that include parties from states other than California or from foreign countries. The laws of the other jurisdictions may be different from California law and may affect the interpretation or enforceability of the contract or its terms. Of particular concern in the present commercial environment is the retention by a non-California client of a California attorney to prepare contracts that may not even involve business in California. In such an instance, the California attorney should seriously consider associating with an attorney in the relevant jurisdictions for, at a minimum, a review of the terms of the agreement, to assure that the client is properly protected in the regions where the contract will be performed and enforced.

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5

Format of the Agreement: Appearance and Introductory Information

David C. Burgess

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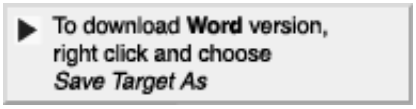
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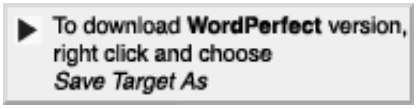
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§5.1 I. CHECKLIST: FORMATTING THE AGREEMENT





- Cover page (see §5.2)
- Table of contents (see §5.3)
- Section headings (see §§5.4-5.8)
- Identification of parties (see §§5.10-5.14, 5.16)
- Dates (see §§5.15-5.16)
- Recitals (see §§5.17-5.22)
- Defined terms (see §§5.23-5.35)
- Proximity organization (see §§5.24-5.25)
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- Stand-alone organization (see §§5.29-5.31)
- Operative contractual provisions (see chaps 6-17)
- Execution blocks (see chap 18)

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II. APPEARANCE OF THE AGREEMENT

§5.2 A. Cover Page

The cover page, if used, states the title of the agreement, the names of the parties, and sometimes the date of the contract. The cover page preserves confidentiality by preventing a casual observer from seeing the operative terms of the agreement; it protects the agreement from soiling; and it provides a more professional look.

Cover pages are often omitted if the agreement is short. A cover page should generally be used if the agreement includes a table of contents, although the cover page information could be printed at the beginning of the table of contents.

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§5.3 B. Table of Contents

The table of contents allows the reader to preview the agreement and to quickly locate specific sections. The table of contents should identify the various sections of the agreement and provide the page numbers on which they begin. If the table is to be useful, sections must be carefully titled to accurately reflect their contents. If subsections are titled, their headings should also be included in the table of contents. See §§5.4-5.8, 17.29-17.30 for discussion of section headings.

The table of contents should also list exhibits, riders, addenda, and other attachments to the agreement so that all parties can see what information is included and can easily locate the appropriate information. For discussion of exhibits, see §§17.15-17.16.

The need for a table of contents depends on the length and complexity of the agreement. While a reader can easily scan a five-page document without referring to a table of contents, it is much more difficult to locate a specific provision in a 30-page agreement.

The table of contents should not be prepared until the agreement is substantially completed, because the section headings and the location of sections may change several times during the course of negotiating and finalizing the agreement. Counsel should update the table of contents each time the agreement is revised.

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C. Section Headings

§5.4 1. Use of Sections

All formal agreements and longer letter agreements should be broken into distinct parts, whether denominated "sections," "paragraphs," or "articles." The parts of the agreement should be designated by means of a hierarchy of letters and numbers as in the parts of an outline, to allow the reader to put the various provisions in their proper context. The hierarchy of designations should be basic and consistent. Following these rules does not necessarily affect the substance of the agreement, but it does generate a less confusing and a more understandable and professional-looking product.

The starting point for deciding where to make breaks between sections is subject matter. The length of each section is another consideration. A four-page section or subsection fails to achieve the goal of including sections—*i.e.,* to quickly locate provisions of interest—while too many short sections (*e.g.,* one-sentence sections) create an unduly long instrument and may be distracting.

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§5.5 2. Cross-Referencing Sections

The consistent use of hierarchical section numbers and informative section headings facilitates cross-references to specific language in the agreement. Cross-references to parts of an agreement should be precise. A covenant that states: "Subject to section 7 of this Agreement, Buyer shall…." can mean something very different from a covenant that states: "Subject to subsection 7(b), Buyer shall…." Moreover, casual references to "this provision" are an invitation to disputes.

Cross-references can also be used in related documents, such as multiple agreements for a single transaction, an amendment to an agreement, or a letter referring to an agreement. However, such cross-referencing, especially if the related agreement is not attached as an exhibit or a rider, may trigger additional problems:

- The drafting attorney must consider the impact of cross-referencing other agreements with the merger clauses in those agreements. It may be necessary to state in the merger clause whether the agreement in which it is included supersedes a cross-referenced agreement. See §§17.11-17.12.
- Cross-referencing related agreements could raise the issue of cross-defaults.
- If the agreement is litigated, the court may be hesitant to look outside the four corners of the particular agreement at issue.
- The attorney should consider whether subsequent modifications in a cross-referenced agreement would render the cross-reference to that agreement inaccurate or obsolete.

Each part of the agreement should have its own designation. For example, counsel should assign a separate letter to each paragraph of section 7, *e.g.,* paragraphs "7(a)" and "7(b)," because a cross-reference to "subsection 7(b)" is more precise and therefore helpful than a cross-reference to "the second paragraph of section 7."

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§5.6 3. Legal Effect of Section Headings

Section headings are generally intended only for ease of reference. They enable the reader to skim an agreement when searching for a particular provision or group of provisions. Section headings are not necessary, but if they are used, they should accurately describe the contents of the section.

Parties seldom want headings to legally affect the substance of the agreement. However, some practitioners disagree on whether headings should have no legal effect at all or whether they should merely have no legal effect if read in isolation. The choice could be important in determining, for example, whether a particular provision is a covenant, a condition, or a covenant *and* a condition. In a carefully structured agreement, headings can help to put various provisions of the agreement in context.

See §§17.29-17.30 for additional discussion of headings.

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§5.7 a. Form: Headings With Limited Legal Effect

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5.7-1 Headings with limited legal effect

Headings. **The section headings used in this Agreement are intended principally for convenience and are not to be used by themselves in interpreting this Agreement or in determining any of the rights or obligations of the parties to this Agreement.**

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§5.8 b. Form: Headings With No Legal Effect

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5.8-1 Headings with no legal effect

Headings. **The section headings used in this Agreement are intended for convenience only and are not to be used in interpreting this Agreement or in determining any of the rights or obligations of the parties to this Agreement.**

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III. INTRODUCTORY INFORMATION

§5.9 A. Introductory Clause

An agreement's introductory clause identifies the parties to and the date of the agreement. It can also list other basic information, such as the parties' addresses (though addresses are usually included in the "Notices" section of the agreement; see §§17.3-17.4), the place of execution, and identifying items such as social security or employer identification numbers.

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1. Parties

§5.10 a. Who Are the Parties?

Counsel must ascertain who will be named as parties to the agreement. The named parties are not necessarily limited to the major participants in the transaction. The agreement may include as parties individuals or entities who own or control the major participants in the transaction or who will be expected to stand behind the obligations of the major participants.

If there is any doubt about a corporation's ability to fulfill its obligations under an agreement, the controlling shareholders as well as the corporation may be included as parties to the agreement. Alternatively, such "secondary" parties could be asked to guarantee performance of all or part of the "primary" party's obligations under the agreement. By adding secondary parties, either as formal parties to the agreement or as guarantors, a complainant may have additional defendants to pursue after a default under the agreement.

Under the doctrine of privity of contract, a plaintiff generally will not have a breach of contract claim unless both the plaintiff and the defendant were parties to the contract in question. (But see §5.13 regarding third party beneficiaries.) For example, a general contractor was held not liable in contract to a sub-subcontractor when the latter had a contract only with the subcontractor and did not have a contract directly with the general contractor. Although the sub-subcontractor was able to recover from the general contractor on a negligence theory, the sub-subcontractor was unable to obtain interest and attorney fees, which would have been recoverable on a contract claim. *Superior Gunite v Ralph Mitzel Inc.* (2004) 117 CA4th 301, 316, 12 CR3d 423.

Even though it is axiomatic that a nonexistent entity cannot be a party to a contract, a corporation can enforce preincorporation contracts made in its behalf as long as the corporation adopts or ratifies the contract. This long-established principle was recently extended to limited liability companies. *02 Dev., LLC v 607 S. Park, LLC* (2008) 159 CA4th 609, 71 CR3d 608.

It may be appropriate or even necessary to include the principals' spouses as parties to the agreement in a community property state such as California. See Fam C §§1100, 1102. If the principals prefer not to include their spouses as formal parties, however, community property concerns can sometimes be addressed by using spousal consents attached to the end of the agreement. See §§18.19-18.22.

The capacity of certain persons, such as minors, persons of unsound mind, and persons deprived of civil rights, to enter into a contract is restricted under California law. See CC §§38, 1556; Fam C §§6500-7143. Therefore, such persons should ordinarily not be included as parties to an agreement. See §§3.2-3.5.

Counsel should also be alert to other limitations on the kinds of persons that may be parties. One or more of the parties may need to meet certain licensing standards to lawfully perform the duties required by the contract or to enforce the contract. For example, an unlicensed contractor generally may not bring an action for the collection of compensation for the performance of any act or contract for which a contractor's license is required, and one who uses the services of an unlicensed contractor may bring an action to recover all compensation paid to the unlicensed contractor. Bus & P C §7031(a)-(b); *Great W. Contractors, Inc. v WSS Indus. Constr., Inc.* (2008) 162 CA4th 581, 76 CR3d 8 (motion for nonsuit granted where corporation attempting to collect payment was not licensed at time work was performed). In addition, only a natural person (*i.e.,* a human being, as opposed to a corporation or other entity) who has the capacity to contract may grant a power of attorney for powers subject to the Uniform Statutory Form Power of Attorney Act (Prob C §§4000-4465). Prob C §§4022, 4026, 4120.

Whether a party to a contract for services is determined to be an employee or an independent contractor can have important consequences in a number of areas, such as withholding requirements and tax treatment, entitlement to benefits, and termination rights. The designation by the parties in the contract will not necessarily be respected; rather, the status of a party as employee or independent contractor will be determined under a complicated series of tests that require careful analysis by counsel. See Advising California Employers and Employees, chap 3 (Cal CEB 2005).

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§5.11 b. Identifying the Parties

Counsel should identify with precision the appropriate parties to the agreement in the introductory clause. If a natural person is legally known by more than one name, all such names should be listed.

The introductory clause should identify any party who is not a natural person by the type of entity and the state in which it was formed. An entity's legal name, as opposed to a trade name, should be used. Counsel should consult the Secretary of State's website (see http://www.ss.ca.gov/business/business.htm), or obtain the articles of incorporation, a certificate of good standing, an LP-1 statement, or other appropriate document from the Secretary of State, to confirm the existence and status of the entity and its precise name.

PRACTICE TIP: Typically, a corporation, a partnership, or a limited liability company will also be required to deliver, at closing, certified copies of articles of incorporation, bylaws, and an authorizing resolution; a copy of the partnership agreement; or articles of organization and a copy of the operating agreement. See §§18.8, 18.11.

Anyone entering into an agreement in a representative capacity, such as a trustee, a conservator, or a guardian, should be identified accordingly. After identifying the parties in the agreement, the drafter should assign an appropriate short name to each party, in quotes and in parentheses, following the party's full name, for future reference. See §§5.23-5.35 for discussion of defined terms.

The signature blocks should correspond with the introductory clause in naming the parties, to clarify whether the individuals executing the agreement are signing on their own behalf or in a representative capacity. See *G.W. Andersen Constr. Co. v Mars Sales* (1985) 164 CA3d 326, 210 CR 409. For discussion of execution and signatures, see chap 18.

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§5.12 c. Parties Not Bound by Entire Agreement

In some transactions, there may be parties who will be bound by some but not all provisions of the main agreement. The rights and obligations of these parties can be provided for in several ways:

- They can be named as parties in the main agreement;
- They can be named in a provision at the end of the main agreement, after the signatures of the parties; or
- They can be named in an ancillary agreement.

In any transaction, the affected party or parties must execute the applicable agreement or part of the agreement by which they are bound.

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§5.13 d. Third Party Beneficiaries and Other Nonparties

A contract made expressly for the benefit of a third person may be enforced by that person at any time before the parties to the agreement rescind it. CC §1559. The third party beneficiary need not be specifically referred to in the agreement to enforce this right if it can be shown that the beneficiary is within a class of persons for whose benefit the contract was made. See *Bily v Arthur Young & Co.* (1992) 3 C4th 370, 11 CR2d 51; *Marina Tenants Ass'n v Deauville Marina Dev. Co.* (1986) 181 CA3d 122, 226 CR 321. However, the agreement can include an intended third party beneficiary as a party to the agreement to remove any ambiguity about that party's rights to enforce the agreement. In contrast, if the parties wish to preclude third persons from having rights or remedies under the contract, they should include a disclaimer of third party beneficiaries in the contract. See form in §13.44.

WARNING: A general disclaimer of third party beneficiaries may be overridden by specific provisions giving rights under the contract to third parties. When a corporate acquisition agreement provided that the acquiring company would grant certain continued employment and severance rights to employees of the acquired company, the court held that employees were intended third party beneficiaries, despite the contract's inclusion of a general disclaimer of third party beneficiaries. *Prouty v Gores Technol. Group* (2004) 121 CA4th 1225, 1232, 18 CR3d 178.

When a homeowner sued a subcontractor under a contract between a general contractor and the subcontractor for work on the homeowner's house, the homeowner was found to be an intended third party beneficiary (see CC §1559) and entitled to recover attorney fees under the contract (see CC §1717). *Loduca v Polyzos* (2007) 153 CA4th 334, 341, 62 CR3d 780. Note that the result in *Loduca* very well could have been different if the contract had expressly precluded the recovery of attorney fees by third party beneficiaries.

Counsel should review the potential rights and obligations of not only third party beneficiaries but other nonparties to an agreement, and consider drafting strategies to achieve desired results:

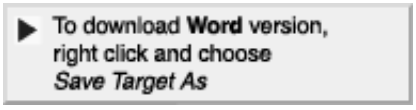
- Under the doctrine of privity of contract, a plaintiff will ordinarily not have a breach of contract claim unless both the plaintiff and the defendant were parties to the contract in question, or the plaintiff is a third party beneficiary of an agreement between another party and the defendant. For example, a general contractor was held not liable in contract to a sub-subcontractor when the latter had a contract only with the subcontractor and did not have a contract directly with the general contractor. Although the sub-subcontractor was able to recover from the general contractor on a negligence theory, the sub-subcontractor was unable to obtain interest and attorney fees, which would have been recoverable on a contract claim. *Superior Gunite v Ralph Mitzel Inc.* (2004) 117 CA4th 301, 316, 12 CR3d 423.
- A nonsignatory is ordinarily not bound by an arbitration agreement, except in some cases when an agency or similar relationship exists between the nonsignatory and one of the parties to the agreement, or when the nonsignatory is a third party beneficiary of the agreement. Thus, the court held that the son of deceased actor Walter Matthau could not be compelled to arbitrate a claim that he owed commissions to a talent agency on payments received pursuant to his father's employment contracts. The son was not a party to any agreement providing for arbitration with the agency, and the exceptions under which a nonsignatory can be bound by an arbitration agreement did not apply. *Matthau v Superior Court (William Morris Agency, LLC)* (2007) 151 CA4th 593, 60 CR3d 93. The result in *Matthau* might have been different if the agreement between the actor and the agency had provided that the arbitration provisions would bind the actor's successors and assigns under the employment agreements.
- A nonsignatory may not ordinarily enforce an arbitration agreement. However, as an exception to this rule, it has been held that a nonsignatory sued as an agent of a signatory or as the alter ego of a signatory may enforce an arbitration agreement. *Rowe v Exline* (2007) 153 CA4th 1276, 63 CR3d 787.

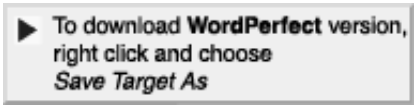
For further discussion of the rights of third party beneficiaries and other nonparties, see chap 13.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/5 Format of the Agreement: Appearance and Introductory Information/§5.14 e. Form: Sample Provisions for Identification of Parties

§5.14 e. Form: Sample Provisions for Identification of Parties





5.14-1 Sample provisions for identification of parties

[*Add one of the following sample identification clauses*]

[*Alternative 1: Natural person with more than one name*]

John S. Doe, also known as Jack Doe ("Seller"), …

[*Alternative 2: Natural person in a representative capacity*]

John Doe, as trustee of the John Smith and Jane Smith Trust ("Trustee"), …

[*Alternative 3: Corporation*]

ABC Corporation, a California corporation ("Corporation"), …

[*Alternative 4: Limited liability company*]

ABC Limited Liability Company, a California limited liability company ("Company"), …

[*Alternative 5: General partnership*]

ABC Partnership, a California general partnership ("Partnership"), …

[*Alternative 6: Limited partnership*]

ABC Limited Partnership, a California limited partnership ("Partnership"), …

[*Alternative 7: Limited liability partnership*]

ABC Limited Liability Partnership, a California limited liability partnership ("Partnership"), …

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§5.15 2. Date

The introductory clause should indicate the date of the agreement, which is typically the date the agreement is signed. In general, a written contract is effective on execution and delivery. See CC §1626. If the effective date is to be different from the date of execution and delivery, the agreement should reflect this fact. If different parts of the agreement are to have different effective dates, the agreement should specifically state this fact in order to avoid any ambiguity. See CC §§1626, 1657; *Hoover Community Hotel Dev. Corp. v Thomson* (1985) 167 CA3d 1130, 213 CR 750. See also §6.2.

An agreement is presumed to have been correctly dated. Evid C §640. For rules relating to the dates of negotiable instruments, see Com C §3113.

ETHICAL CONSIDERATION: In general, retroactive dates should be avoided. If certain results hinge on the date an agreement is entered into (*e.g.,* tax consequences), incorporating a date earlier than the date of signing could be unethical, fraudulent, or even illegal. Use of a retroactive date is less objectionable when the transaction actually occurred on the stated prior date but is being documented at some later time, such as when a loan is made under agreed terms but the promissory note is not executed and delivered until a later date. Ethical problems can generally be avoided by specifying that a stated prior date is merely an "effective" date and including the actual date of signing.

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§5.16 3. Form: Basic Introductory Clause

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

5.16-1 Basic introductory clause

This Agreement ("Agreement") is made _ _[*on/as of*]_ _ _ _[*date*]_ _ **between** _ _[*name of first party*]_ _ **(**_ _[*e.g., "Buyer"*]_ _**), and** _ _[*name of second party*]_ _ **(**_ _[*e.g., "Seller"*]_ _**).**

Comment: Counsel should use "on" if the agreement becomes effective on the day all parties sign. Counsel should use "as of" if different parties sign on different days or if the parties intend that the rights and obligations under the agreement become effective on a date other than the signing date. "Among" should be used instead of "between" if there are more than two parties to the agreement.

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§5.17 B. Recitals

The recitals, or background section, set the stage for the substantive contractual provisions that follow. Recitals have several notable uses:

- They can provide historical background (see §5.18);
- They can state the purposes of the agreement (see §5.19); and
- They can serve as a tool of advocacy (see §5.20).

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§5.18 1. Providing Historical Background

The recitals provide historical background for the transaction by describing previous agreements between the parties, the status of those agreements, and whether the current agreement is intended to supersede, supplement, or otherwise modify the earlier agreements. The recitals can introduce the major players and provide the dates of formation of corporate or partnership parties and the dates of other germane events. This background helps to place a transaction in proper perspective, and it is useful to third parties who must later interpret the agreement without being specifically acquainted with the history of the parties.

For recitals to effectively establish the historical background, they must be thorough and accurate. Thus, counsel compiling the recitals must become educated about the parties and pertinent events. This knowledge is essential in drafting the remainder of the agreement.

See §7.3 for further discussion of the use of recitals to identify the factual basis for the agreement.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/5 Format of the Agreement: Appearance and Introductory Information/§5.19 2. Stating Purposes of Agreement

§5.19 2. Stating Purposes of Agreement

Including a statement of purposes of an agreement is useful for two reasons:

(1) It forces the drafter, and presumably the parties, to focus on why the parties are entering into the agreement and what they hope to achieve. Once the parties' motivations and goals have been identified, it is easier to prepare an agreement that meets their needs and desires.

(2) A statement of purposes serves as a summary of the agreement for the reader. This feature is of particular benefit to outsiders who approach the contract without detailed knowledge of the transaction.

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§5.20 3. Serving as Tool of Advocacy

An artful drafter can prepare recitals with a particular slant or bias, framing facts and issues to advance the client's interests. In choosing which facts to include and which to omit, and in how to word and organize the recitals, counsel subtly affects how the agreement will be interpreted. However, excessive efforts to slant recitals may conflict with the recitals' purposes of providing a thorough and accurate historical background and a statement of purposes for the agreement.

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§5.21 4. Legal Effect of Recitals

There is some question among practitioners on the binding legal effect of recitals. Facts recited in a written agreement other than recitals of consideration are conclusively presumed to be true. Evid C §622. If the operative words of a grant are doubtful, recitals may be used to assist in its construction. CC §1068. Recitals, therefore, are of greater legal effect than may be commonly thought; counsel should review them carefully to ensure that they are not worded—whether through lack of precision or inadvertence of the drafter or through unchecked chicanery of the opposing party—in a way that could be interpreted adversely to the client's interests. To avoid ambiguity, language that is intended to be binding should generally be expressly stated in the body of the agreement.

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§5.21A 5. Recital of Consideration

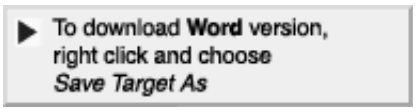
The lead-in at the end of the recitals may be stated simply as "The parties therefore agree as follows." See sample recitals in §5.22. Many contracts use significantly different and more elaborate language, such as

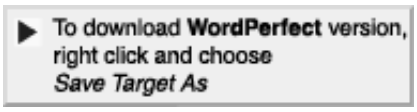
NOW, THEREFORE, in consideration of the terms and conditions set forth herein, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereby agree as follows.

This type of language is unnecessary, however, and renders the contract less readable and less comprehensible. First, language such as "NOW, THEREFORE" is archaic. In addition, a boilerplate recital of consideration nominally purports to make a contract enforceable that would otherwise be unenforceable due to lack of consideration, but a mere recital cannot transform into consideration something that does not already constitute consideration. Moreover, a false recital of consideration does not create consideration when none exists. See Adams, *A Manual of Style for Contract Drafting* §§2.63-2.71 (2004), published by the American Bar Association Section of Business Law. Thus, because a traditional recital of consideration is ineffectual and archaic, it may be omitted, making the read-in of the agreement much more understandable.

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§5.22 6. Form: Sample Recitals





5.22-1 Sample recitals

[*Add one of the sample recitals*]

[*Alternative 1: Sale of stock agreement*]

A. Shareholder represents that she owns all the outstanding stock of Corporation (the "Shares").

B. Buyer desires to purchase from Shareholder, and Shareholder desires to sell to Buyer, the Shares.

C. Corporation and Subsidiary wish to consummate this transaction.

The parties therefore agree as follows:

[*Alternative 2: Sale of assets agreement*]

A. Buyer wishes to purchase from Corporation, and Corporation wishes to sell to Buyer, on the terms and subject to the conditions of this Agreement, all the business and properties of Corporation in exchange for the cash and property of Buyer described in paragraph 3.

B. Shareholder and Subsidiary wish to consummate this transaction.

The parties therefore agree as follows:

[*Alternative 3: Shareholder's agreement*]

A. Shareholders each own 50 percent of the issued and outstanding shares of the Common Stock of Corporation (the "Stock").

B. Shareholders desire to promote their mutual interests and the interests of Corporation by imposing certain restrictions and obligations on themselves, on Corporation, and on the Stock.

The parties therefore agree as follows:

[*Alternative 4: License agreement*]

A. Company is the inventor of two-inch flexible widgets (the "Widgets"), which are being sold under the name Wonder Widgets (the "Tradename").

B. Manufacturer has special manufacturing and marketing expertise in the area of widgets.

C. Company and Manufacturer desire to enter into a license agreement under the provisions set forth below, granting Manufacturer the right to manufacture Widgets and market Widgets under the Tradename throughout the United States (the "Territory").

The parties therefore agree as follows:

Comment: These sample provisions are intended to give the drafting attorney a sense of how recitals can be written. Because the background and facts are different in every transaction, recitals must be carefully tailored by the attorney.

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IV. USE OF DEFINED TERMS

§5.23 A. Function of Defined Terms

Defined terms allow the use of short-form references for names, terms, and concepts that are frequently repeated in an agreement, thus saving space, improving readability of the agreement, and assuring consistency. Using defined terms also encourages the drafter to be precise in stating important concepts and procedures.

The definitions section should define every word that is critical to understanding and enforcing the agreement. This section helps avoid arguments over whether a word is to be interpreted in its normal, technical, legal, or local sense or whether a meaning peculiar to the trade is to be given to the word. Definitions are particularly important when parties have different levels of sophistication (*e.g.,* an established commercial entity and a lay person) or when one party is a foreign entity, because words often have different meanings when translated from or interpreted in light of different cultural backgrounds, economic or legal systems, or trade experiences.

If a definition in an agreement is clear and unambiguous, it will be applied by the court and used to interpret the agreement. Otherwise, the general meaning will prevail (*Cohn v Cohn* (1942) 20 C2d 65, 123 P2d 833; *Morrison v Wilson* (1866) 30 C 344), which may not have been the parties' intention. If technical terms are used but not defined, expert testimony may be needed to determine their meaning.

Despite the value of defined terms, the drafter should be judicious in creating them. If defined terms are overused, readers will need to continually look up the definitions, consequently losing their train of thought. Excessive use of defined terms can also result in stuffy prose. There is usually no need to define short terms or terms that have commonly understood meanings, such as the United States of America as the "U.S." A defined term generally should not be created unless the term is used at least several times in the agreement.

Examples of critical terms that generally should be defined include:

- The property that is the subject of the agreement. The description should include the metes and bounds of real property and recording information, all details necessary to identify personal property, and a detailed explanation of services to be rendered if services are the subject of the agreement. It is common practice to also refer to an attachment to the agreement that includes detailed drawings, maps, photographs, or other material that would be suitable evidence in a court of law to describe the property clearly and unambiguously.

WARNING: A seller of real property who misstates the number of acres or the dimensions of the property can be held liable for negligent misrepresentation. See 1 Miller & Starr, California Real Estate 3d, §1:126 at 448 (3d ed 2000). The effect of a misstatement can be particularly significant when the selling price or the rental rate for real property is based on the stated square footage. Thus, counsel should be careful to verify the accuracy of any quantitative information included in a description of real property.

- The territory involved in a distribution agreement.
- The markets covered by a sales representative agreement.
- Financial terms and requirements. Such terms might include, *e.g.,* "gross profit," "adjusted gross sales," "net sales," "purchase price." If necessary, further explanation of terms such as "purchase price" may be set forth in an attachment to the agreement and referred to in the definitions section (particularly if the price may vary depending on volume of goods purchased or the year of the agreement). Nonmonetary promotional benefits received in exchange for the licensing of cartoon characters were held to not constitute "gross receipts" for purposes of computing royalty payments. *Wolf v Walt Disney Pictures & Television* (2008) 162 CA4th 1107, 76 CR3d 585. The dispute in *Wolf* could have been avoided if the royalty contract had explicitly stated whether nonmonetary consideration was intended to fall under the definition of "gross receipts."
- A clarification of the parties bound by the agreement. This may become necessary if any party has subsidiaries, divisions affiliates, franchises, or other related organizations that have not been previously identified in the heading or recitals.

- Related agreements referred to but not identified in the heading or recitals.

Counsel should be careful when labeling defined terms, selecting words that communicate their meaning by themselves and are related to the meaning. For example, the defined term "Minimum Royalty" means more to a reader than "Section 4 Payment." The defined terms should also be relatively short, because conciseness is one of the chief benefits of using defined terms.

Counsel should avoid using terms whose accepted meanings are different from the desired meaning. For example, counsel should not use the term "Shareholder's Equity" unless it is defined to mean a corporation's assets less its liabilities. Similarly, any defined term should have the same meaning regardless of where it is used in the agreement.

EXAMPLE: In an acquisition agreement, certain representations relate to the acquired company and its "Subsidiaries" (defined in the agreement as entities in which the acquired company owns 100 percent of the voting stock). Counsel should not later provide, in the same agreement, that the acquirer covenants that neither it nor its "subsidiaries" (entities in which the acquired company owns more than 50 percent of the voting stock) will disclose or misuse confidential information that the acquirer obtains in the course of its preclosing due diligence, because "subsidiary" has a different meaning in this clause.

Generally, acronyms should not be used as defined terms. Often their meaning is not self-evident, or they may have a common meaning different from that intended in the agreement, causing confusion for the reader. For example, the term "customer deposit" should not be defined as "CD," because that acronym customarily refers to either a "certificate of deposit" or a "compact disc."

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/5 Format of the Agreement: Appearance and Introductory Information/§5.24 B. Placement in Agreement

§5.24 B. Placement in Agreement

There are three standard approaches for placement of definitions: proximity, collection, and stand-alone. Choosing an approach often depends on the length and complexity of the agreement. As a rule, counsel should select one approach and use it consistently throughout the agreement.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/5 Format of the Agreement: Appearance and Introductory Information/ 1. Proximity Method/§5.25 a. General Principles

1. Proximity Method

§5.25 a. General Principles

The most common approach is to define the term in the context in which it is used. This proximity approach has three variations:

- Explain the concept and follow it with the defined term;
- Use the defined term one or more times and then define it; or
- Identify the location of the definition immediately following the first use of the defined term.

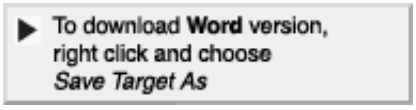
The proximity approach is most effective if the agreement contains relatively few defined terms and if the particular terms are confined to one section or a few adjacent sections.

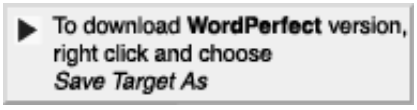
If terms are defined in context, it may be helpful to prepare a glossary listing the defined terms in alphabetical order and the sections (or pages) in which they are defined.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/5 Format of the Agreement: Appearance and Introductory Information/§5.26 b. Form: Sample Provisions for Proximity Method of Defining Terms

§5.26 b. Form: Sample Provisions for Proximity Method of Defining Terms





5.26-1 Sample provisions for proximity method of defining terms

[*Add one of the following sample methods of defining terms*]

[*Alternative 1: Follow explanation with defined term*]

Distributor has the exclusive right to sell the Product in the contiguous states of the United States west of the Mississippi (the "Territory").

[*Alternative 2: Define term after one or more uses*]

Buyer shall pay this amount no later than the Payment Date, and deliver to Seller copies of all invoices within 3 business days after the Payment Date. For purposes of this Section, "Payment Date" means the last day of the month following each calendar quarter during the term of this Agreement.

[*Alternative 3: Locate definition*]

Employee shall provide to Employer during the term of this Agreement all Services, as defined in Exhibit B to this Agreement. The Services may be periodically revised by mutual agreement of the parties, and the agreements must be signed, dated, and attached as an amendment to this Agreement.

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2. Collection Method

§5.27 a. General Principles

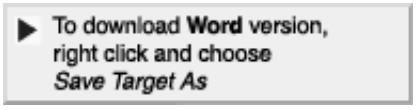
If many defined terms are used or if a particular term is used in several sections of the agreement, counsel should consider collecting all definitions in a single section consisting exclusively of definitions. This section should be placed at the beginning of the agreement; it is easy to find in this location and it gives the reader a helpful preview of the agreement. It is helpful to list the terms in alphabetical order with parallel sentence construction for each definition. See §5.28.

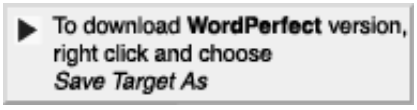
Although the collection approach makes sense generally, defined terms are sometimes more easily understood if they are defined in context in the body of the document. The drafter can use a hybrid of the proximity and collection approaches by collecting all defined terms in one place, with cross-references for the terms defined in the text. This "hybrid" approach is most often used when the defined terms involve complex quantitative subjects, are very technical, or comprise multiple provisions.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/5 Format of the Agreement: Appearance and Introductory Information/§5.28 b. Form: Sample Provision for Collection Method of Defining Terms

§5.28 b. Form: Sample Provision for Collection Method of Defining Terms





5.28-1 Sample provisions for collection method of defining terms

1. *Definitions.* As used in this Agreement, the following terms have the following meanings:

(a) "Agreement of Merger" means the agreement of merger between Buyer and the Company, together with the related officers' certificates required by California Corporations Code §1103, in substantially the form attached to this Agreement as Exhibit A.

(b) "Audited Financial Statements" means a consolidated balance sheet of the Company as of the end of a fiscal year and the related consolidated statements of income, retained earnings, and changes in the Company's financial position for the year then ended, in each case accompanied by an unqualified report of Debit & Credit Incorporated, the Company's independent certified public accountants.

(c) "Company" means:

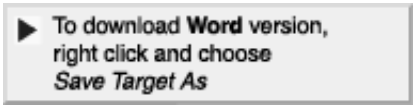
(1) International Products, Inc., all its divisions, and all organizations of any form or nature, wherever located, (a) in which International Products, Inc., owns or has a controlling interest in 50 percent or more of the stock or other equity interests, as the case may be, of such organization, or (b) in which International Products, Inc., has Management Control; and

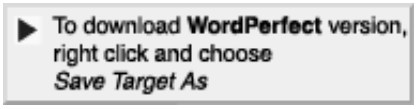
(2) Any organization or person that owns or has a controlling interest in 50 percent or more of the Stock of International Products, Inc., or that has Management Control of International Products, Inc.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/5 Format of the Agreement: Appearance and Introductory Information/§5.29 c. Form: Sample Provision for Proximity-Collection Hybrid Method of Defining Terms

§5.29 c. Form: Sample Provision for Proximity-Collection Hybrid Method of Defining Terms





5.29-1 Sample provision for proximity-collection hybrid method of defining terms

1. *Definitions.* As used in this Agreement, the following words and phrases have the following meanings:

(a) "First Option" has the meaning set forth in subsection 7(a).

(b) "Net Sales" means Seller's gross billings on Product sold by Seller to an unaffiliated organization less (i) sales tax directly imposed on those sales, (ii) outbound transportation charges, (iii) prompt payment discounts actually allowed, (iv) returns actually allowed, (v) allowances actually credited for damaged goods, (vi) allowances for purchases of other goods when indicated on the same invoice, and (vii) other royalties required of Seller to sell Product. When Product is sold in combination with other products, the formula set forth in subsection 4(b) should be used to calculate Net Sales.

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3. Stand-Alone Document

§5.30 a. General Principles

The third approach is to pull the definitions out of the agreement and put them in a separate glossary. This approach is most effective in a complex transaction, such as a project financing having many agreements and parties. The agreements may use numerous defined terms, many of which appear in more than one agreement. The risk of errors and confusion (for example, using different definitions for the same concept or defined term) is increased, as may be the legal bill, if the definitions are repeated in each agreement, especially if the terms or their definitions change frequently during the negotiations.

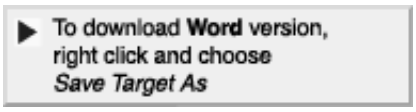
In these circumstances, the definitions may all be listed in a separate Glossary or Definitional Supplement document. All terms should be defined there or, when preferable, the Glossary or Definitional Supplement should identify the location of the definitions. If there is a concern for the evidentiary record, the parties should initial the Glossary.

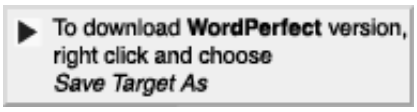
The format of the glossary or Definitional Supplement is like a definitional section created under the collection approach. See §§5.27-5.28. An explanatory provision should be inserted at the start of each agreement used in the transaction that incorporates the Glossary or Definitional Supplement. See §5.32.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/5 Format of the Agreement: Appearance and Introductory Information/§5.31 b. Form: Introduction to Glossary

§5.31 b. Form: Introduction to Glossary





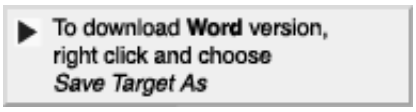
5.31-1 Introduction to glossary

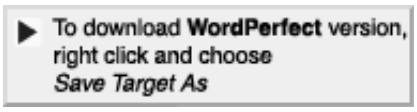
Capitalized terms used in _ _[*identify agreements*]_ _ have the meanings assigned to them in this Glossary.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/5 Format of the Agreement: Appearance and Introductory Information/§5.32 c. Form: Reference to Glossary in Agreement

§5.32 c. Form: Reference to Glossary in Agreement





5.32-1 Reference to glossary in agreement

All capitalized terms used _ _[*but not otherwise defined*]**_ _ in this Agreement are defined in the Glossary.**

Comment: If a glossary is used, it is preferable that all terms be defined *only* in the glossary, in which event the optional language in this form would not apply. Otherwise, the meaning of a defined term may be ambiguous. See §5.35.

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§5.33 C. Formulas

Formulas can often clarify complex quantitative concepts in the agreement. Symbols, such as parentheses, should be used in formulas to eliminate the ambiguity inherent in verbal descriptions of quantitative concepts. For example, does the clause "six times salary plus benefits" mean 6 ´ (salary + benefits) or (6 ´ salary) + benefits? Formulas and definitions usually go hand in hand, because a formula is likely to use other defined terms, particularly if stated algebraically rather than textually. For further clarification, the formula can be supplemented with examples in the body of the agreement or in an attached example.

EXAMPLE: If a principal payment is based on a company's net income and the value of its tangible assets, which are defined as "Net Income" and "Tangible Assets Value," respectively, in the agreement, the formula might read as follows:

$$\text{Principal Payment} = (\text{Net Income}) + \frac{\text{Tangible Assets Value}}{100}$$

Counsel should be very precise in articulating formulas, because they often reflect the core of the deal, *i.e.,* its economics. Even minor ambiguities or errors in formulas in an agreement can have far greater consequences than errors in more general provisions.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/5 Format of the Agreement: Appearance and Introductory Information/§5.34 D. Importance of Defined Terms

§5.34 D. Importance of Defined Terms

The parties and their counsel often pay less attention to definitions than to the "operative" provisions of a contract. A great deal of substance can reside in definitions, however, and strategic points made in the definitional sections of the agreement may be overlooked. Further, as the negotiations modify the agreement, the definitions may become anachronistic. To avoid later problems, counsel should always review the definitions before the parties sign the agreement, particularly if the agreement was heavily negotiated.

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§5.35 E. Mechanics

Defined terms are effective only if they can be recognized. Thus, a defined term should be capitalized to distinguish it from uses of the same word not intended to have a special meaning. The drafter should also avoid capitalizing words *unless* they are defined terms or are normally capitalized; using the term "Company" without definition may be ambiguous as to the specific company to which the agreement refers.

Counsel should not define terms that are not used, and should not use defined terms that are not defined. Although this admonition sounds elementary, it is often violated, especially when significant changes are made to the agreement in the course of negotiation.

Definitions should be easy to spot in the agreement. It may be helpful to underline the defined term or to print it in bold or italic format so that the reader can scan the agreement to find the required information.

Attorneys sometimes use preambles to definitional sections, which may unnecessarily confuse the reader, *e.g.*: "Unless otherwise defined in this Agreement, the following terms have the following meanings…." This introductory language should not be used unless one or more of the defined terms are "otherwise defined" elsewhere in the agreement. If the terms are otherwise defined elsewhere, counsel should state where the reader can find the alternative definition. For example:

Except as specified in subsections 6(a)-(c), "Cost" means….

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6

Duration of the Agreement

David C. Burgess

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§6.1 I. CHECKLIST: DURATION OF AGREEMENT

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- Execution date (see §6.2)
- Effective date (see §§6.2-6.4)
- Termination date (see §§6.2-6.4)
- Extension procedures (see §§6.5-6.8)
- Early termination (see §§6.9-6.30)
- Dissolution, merger, and other corporate changes (see §§6.20-6.22)
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- Death (see §§6.24-6.25)
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- Loss of license (see §6.28)
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- Single transaction agreements (see §§6.31-6.35)
- Service and employment agreements (see §§6.36-6.42)
- Agreements for use of money or property (see §§6.43-6.45)
- Partnership agreements (see §6.46)
- Agreements creating rights (see §6.47)
- Fiduciary agreements (see §6.48)
- Letters of credit (see §6.49)

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II. EFFECTIVE AND ENDING DATES OF CONTRACT

§6.2 A. General Principles

The term of a contract begins on the contract's effective date. Unless stated otherwise in the contract, the effective date is ordinarily the execution date—the date the contract is signed. If different parties sign on different dates, the contract becomes effective on the date signed by the last party to sign. An agreement is presumed to have been correctly dated. Evid C §640.

An effective date specified in the contract is usually a fixed date, but it may also be a variable date based on the satisfaction of a condition precedent. For example, the effective date may be the date on which one party files a relevant document with the Secretary of State, the date a specific agency issues a license or permit, or the date one party receives a necessary approval. When a brokerage agreement provided that it was effective only after approval of the account application, and the application was denied, the court held that an arbitration provision in the agreement was unenforceable, because no contract had been formed. *Lopez v Charles Schwab & Co.* (2004) 118 CA4th 1224, 1229, 13 CR3d 544. *Lopez* highlights the risk of making the commencement of an agreement subject to the "approval" of one of the parties.

Sloppy drafting as to the effective date of contract provisions can lead to undesirable results. For example, an arbitration clause in an employment application was held not applicable to pre-employment gender discrimination claims. The court interpreted the arbitration clause to extend only to disputes arising out of employment, indicating that the clause could have been enforceable if it had been worded more broadly to also cover disputes arising out of the application itself. *Balandran v Labor Ready, Inc.* (2004) 124 CA4th 1522, 22 CR3d 441.

If different aspects of the agreement are to have different effective dates, counsel should identify those dates to avoid ambiguity.

EXAMPLE: An option agreement includes a 5-year covenant not to compete. The effective date for commencement of the 5-year period is the same as the effective date for the option agreement, not the later date the option was exercised, unless the agreement specifically provides for the latter construction. See CC §§1626, 1657; *Hoover Community Hotel Dev. Corp. v Thomson* (1985) 167 CA3d 1130, 213 CR 750.

The ending date of the contract can be fixed, contingent, or fixed with provision for earlier termination on the occurrence of specified conditions. The length of the term, or whether a term should be stated at all, depends on the nature of the contract and the goals of the parties. If a contract does not specify a term, a court will generally imply a term, based on the nature of the contract and the surrounding circumstances or on what is reasonable. In any event, generally it is better practice to provide when the contract will terminate so as to avoid uncertainty and differing interpretations of what is "reasonable."

For discussion of the term of some specific types of agreements, see §§6.31-6.48. For discussion of events generally triggering early termination, see §§6.19-6.30. For rules relating to the dates of negotiable instruments, see Com C §3113.

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B. Provisions Establishing Term of Contract

§6.3 1. Form: Standard Duration Clause

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6.3-1 Standard duration clause

___. _ _[*Effective Date of Agreement/Duration of Agreement*]**_ _. This Agreement will become effective on _ _**[*date*]**_ _,**

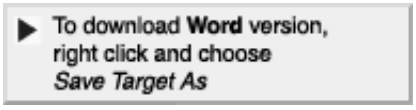
[*If appropriate, add*]

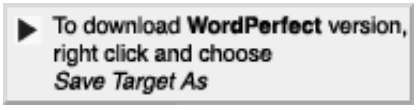
and will continue in full force and effect _ _[*e.g., until January 1, 2010/for 12 months*]**_ _ _ _**[*, unless terminated sooner in accordance with Section _ _ of this Agreement*]**_ _.**

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§6.4 2. Form: Conditional Effective Date





6.4-1 Conditional effective date

___. _ _[*Effective Date of Agreement/Duration of Agreement*]_ _**. This Agreement will become effective** _ _[*specify event triggering effectiveness, e.g., on the merger of Buyer and ABC Corporation*]_ _

[*If appropriate, add*]

and will continue in full force and effect _ _[*e.g., until January 1, 2010/for 12 months*]_ _ _ _[*, unless terminated sooner in accordance with Section _ _ of this Agreement*]_ _**.**

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III. EXTENSION OF TERM

§6.5 A. General Principles

Agreements having a fixed term often provide for extending or renewing the term of the agreement. Counsel should consider the following basic issues before drafting an extension clause:

- Is the extension conditional; *i.e.,* available only after the occurrence or nonoccurrence of some event? If extension is at the discretion of one or both parties, the agreement should state that there is no obligation to extend.
- Can the agreement be extended by the actions of fewer than all parties or must all parties agree?
- Is the right to extend available to both parties?
- Will the agreement be extended *unless* some action is taken (*i.e.,* automatic extension absent advance notice of an intent not to extend), or *only if* some action is taken?
- Will any provisions of the agreement change on its extension (*e.g.,* a rental payment under a lease)?

In drafting extension provisions, counsel should specify any notice periods, the type of notice required, and any other steps necessary for effective extension, so that one party is not taken by surprise at the expected end of the term. Counsel can draft and attach notice forms to the agreement to aid in compliance with extension requirements. Setting a deadline for execution of the extension agreement encourages the parties to focus on the extension issue before the agreement expires. The parties to the agreement and their counsel should calendar any significant dates to avoid an inadvertent failure to extend or not extend. See §1.30.

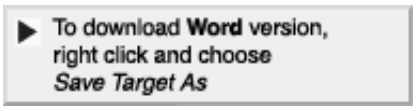
NOTE: Unless different notice requirements apply for the extension, the general notice provision in the agreement can specify whether notice must be written and how it must be delivered. See form in §17.4 for a general notice provision.

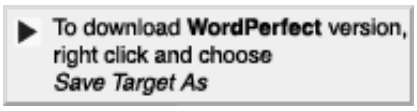
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B. Provisions Extending Term

§6.6 1. Form: Automatic Extension





6.6-1 Automatic extension

___. *Renewal of Agreement.* This Agreement will be automatically renewed for succeeding terms of _ _[*e.g., 12 months*]**_ _ each unless, at least _ _**[*e.g., 30 calendar days*]**_ _ before expiration of any term, either party gives notice to the other of its intention not to renew this Agreement.**

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§6.7 2. Form: Mutually Agreeable Extension

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6.7-1 Mutually agreeable extension

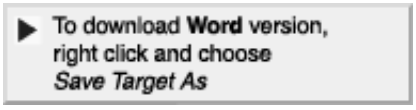
___. *Renewal of Agreement.* This Agreement may be renewed for succeeding terms of _ _[*e.g., 12 months*]_ _ each, by the written agreement of the parties executed at least _ _[*e.g., 30 calendar days*]_ _ before expiration of any term. Nothing in this Agreement requires either party to renew or extend this Agreement or to enter into negotiations regarding the renewal or extension of this Agreement.

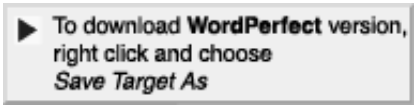
Comment: Parties may make other changes to the agreement (*e.g.,* a change in rent payable because of market changes) in the written "extension" agreement signed by both parties.

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§6.8 3. Form: Either Party May Extend





6.8-1 Either party may extend

___. *Renewal of Agreement.* This Agreement may be renewed for succeeding terms of _ _[*e.g., 12 months*]_ _ each, at the option of either party, by notice to the other party at least _ _[*e.g., 30 calendar days*]_ _ before expiration of any term, of its intention to renew this Agreement. Nothing in this Agreement requires either party to renew or extend this Agreement.

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IV. EARLY TERMINATION

§6.9 A. Termination, Cancellation, and Rescission

Termination of an agreement occurs when a party ends the contract, for reasons other than its breach, under a power created by agreement or law. Contracts often allow for termination before expiration of their term on the occurrence of specified events. The terminating event can cause automatic termination of the agreement, or it can simply give one or more of the parties the right to terminate the agreement. For example, in an employment agreement, the employee's death is an *automatic terminating event* (see §6.24), while the employee's failure to meet certain expected performance standards could give the employer the *option to terminate* the contract (see §§6.37-6.38). After termination, all obligations that are executory on both sides are discharged, but rights based on earlier breach or performance survive. See Com C §§2106(3) (applicable to contracts relating to the present or future sale of goods), 2106(1).

In contrast, cancellation occurs when a party ends the contract because of the other party's breach. After cancellation, the canceling party retains any remedies for breach of the whole contract or any unperformed balance. See Com C §§2106(4) (applicable to contracts relating to the present or future sale of goods), 2106(1).

Termination and cancellation are different from rescission of a contract. Termination and cancellation remove any obligations for further performance under the contract, but all accrued rights survive and remain in effect. A rescission, however, completely extinguishes the contract, restoring the parties to their former positions. CC §1688. A party rescinding a contract is generally required to restore or offer to restore any consideration received under the contract (CC §1691), and is entitled to restitution, *i.e.,* recovery of the consideration given and any other compensation necessary to be made whole. *Modoc Mineral & Oil Co. v Cal-Vada Drilling & Exploration Co.* (1965) 236 CA2d 868, 46 CR 508; CC §1692.

The parties' intent usually controls, but, to avoid ambiguity, the drafter should use the proper term of art in any notice or agreement intended to end the contract. That is, counsel should be precise in designating the action as a "termination," "cancellation," or "rescission."

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§6.10 B. Procedure for Early Termination

A contract that gives a party the right to terminate should detail the termination procedure. The procedure usually includes written notice of an intent to terminate within a certain time. Counsel can protect against the disruption caused by sudden termination by requiring advance notice of termination, *e.g.,* receipt of written notice 30 calendar days before the intended termination. The form of notice can be appended to the agreement for further clarification.

NOTE: Unless different notice requirements apply for early termination, the general notice provision in the agreement can specify whether notice must be written and how it must be delivered. See form in §17.4 for a general notice provision.

If the triggering event is a breach of the agreement, the breaching party may also be given a certain time period, following either the breach or notice of the breach, to cure the default. See §14.4.

The agreement should require that the notice specify when the agreement terminates and that any damages will be calculated through the time of termination. This type of provision prevents a defaulting party from claiming that the period for measuring damages ended when the notice was given.

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C. Consequences of Early Termination

§6.11 1. Extinguished and Surviving Rights and Obligations

Counsel should specify the consequences of early termination. The agreement should address the following questions:

- Do any rights or obligations survive?
- How should the parties treat previously exchanged consideration?
- How should the parties treat previously exchanged information?

An event causing early termination frequently results in complete termination of the contractual relationship, with neither party retaining any rights or obligations from the contract. Sometimes, however, portions of the agreement remain in effect, particularly if the contract provides for different transactions or relationships that are not all interdependent. Certain types of rights and duties also typically survive termination, such as confidentiality and noncompetition restrictions. Counsel should note the limitations on enforceability of noncompetition covenants. See §9.10.

In agreements such as vendor contracts, it can be useful to include transition provisions in conjunction with termination clauses. The transition provisions should ease the change to a new vendor by giving the purchaser the right to continued support and cooperation from the existing vendor for a period of time. Transition assistance could encompass such matters as (1) access to the vendor's technology; (2) support in converting to different technology; (3) access to data and content owned or needed by the purchaser that is in the vendor's possession; and (4) access to the vendor's employees or contractors. Where the vendor's financial condition is tenuous, the purchaser would want to be able to exercise termination rights at a time when the vendor is still able to render the needed transition assistance.

Claims by a terminated employee, made after he was discharged, for torts allegedly committed by his former employer, including defamation and interference with prospective business advantage, were held subject to the arbitration clause in the employment agreement, because the claims were rooted in the contractual relationship of the parties. *Buckhorn v St. Jude Heritage Med. Group* (2004) 121 CA4th 1401, 18 CR3d 215.

PRACTICE TIP: To reduce uncertainty, the contract could specify whether dispute resolution provisions apply to conduct related to the contract but occurring before or after the term of the contract.

An agreement may provide that the parties have no liability to each other after termination, particularly if termination is attributable to factors over which the parties have limited or no control, such as casualties or governmental or other third party actions. In contrast, an agreement may provide that some liability will continue if termination is attributable to factors over which the parties do have control, such as a breach of the contract. See §6.16.

When a stock option plan provided that options would vest on a termination of employment "without cause," the termination of an employee based on the sale of the division in which the employee worked (rather than his performance) constituted a termination without cause. Thus, the options vested. *Scribner v World Com, Inc.* (9th Cir 2001) 249 F3d 902. In *Scribner*, the option plan did not define "cause." The court determined that under Washington contract law a termination for "cause" meant a termination based on some fault or shortcoming on the part of the employee. See §6.36.

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§6.12 2. Parties' Relationship After Termination

The contract can allow the parties to adjust their relationship in a specific manner after the occurrence of an event significant enough to warrant termination of the contract.

EXAMPLE: A joint development and marketing agreement may specify the parties' respective rights in the product and their associated obligations to one another on termination of the agreement, through various licensing and royalty arrangements, especially if termination is likely to occur.

The agreement may provide that, after termination for certain specified reasons, the parties will negotiate with each other in good faith to enter into a new agreement. Counsel should consider providing standards and guidelines on what constitutes good faith negotiation. A negotiation provision is often used if the contract terminates as a result of:

- The merger or other change in status or management of one of the parties; or
- Occurrence of an event beyond the parties' control that renders the contractual relationship problematic (such as changes in economic or legal conditions), but both parties still stand to gain from a modified contractual arrangement.

An agreement may provide that on termination the parties' rights and obligations will be determined by or with the assistance of an impartial expert, such as an arbitrator or mediator. Although parties often resist putting their fates in the hands of a third party, this approach is particularly useful if the contract terminates as a result of disputes between the parties unrelated to their economic interests. For discussion of mediation and arbitration, see chap 16.

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§6.13 3. Financial Consequences of Early Termination

The contract may identify financial consequences resulting from early termination. One party may be required to pay the other a prepayment fee, a termination fee, a penalty, interest, or liquidated damages. Counsel must take care that provisions for these payments are structured in a way to be enforceable. A $150 fee payable by a merchant on the cancellation of a credit card merchant account was held to be reasonable liquidated damages and not unconscionable. Indeed, the court held that the fee was not a liquidated damage at all, but simply a deferred charge, as it was assessed independently of whether there had been any breach of the agreement. *Morris v Redwood Empire Bancorp* (2005) 128 CA4th 1305, 1314, 27 CR3d 797. For further discussion of financial penalties and remedies on breach of an agreement, see chap 15.

The agreement should also address the resolution of uncompleted financial transactions, including reconciliation of accounts by the parties and any requirements for the return of deposits or other funds or property received under the agreement. (See §6.18 for sample provisions used by parties to a typical distributorship agreement.) There may also be existing or contingent liabilities to third parties that must be considered, such as claims for damages, lawsuits, or leases.

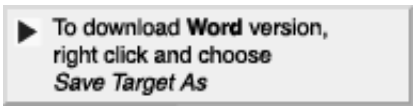
In *DP Aviation v Smiths Indus. Aerospace & Defense Sys.* (9th Cir 2001) 268 F3d 829, a manufacturer was required to pay incentive fees to a sales representative for long-term contracts and commitments to supply made before termination of the representation agreement. The representation agreement in that case provided that the sales representative was entitled to incentive fees for "orders" received and accepted before termination of the agreement. In light of the ambiguity of this term, the court upheld the use of extrinsic evidence to determine that the parties intended "orders" to mean long-term contracts and commitments to supply, as opposed to purchase orders. *DP Aviation* highlights the need to be precise in drafting contract terms dealing with financial rights and obligations of the parties following termination of the agreement.

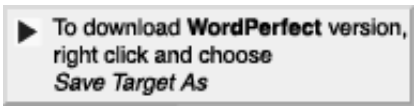
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D. Provisions Defining Obligations and Liabilities After Early Termination

§6.14 1. Form: Return of Confidential Information



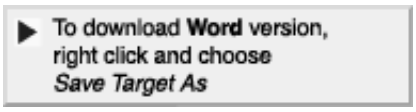


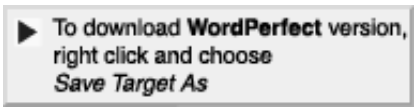
6.14-1 Return of confidential information

___. *Return of Confidential Information.* On termination of this Agreement, each party shall immediately deliver to the other party all documents, data, records, customer lists, notebooks, and similar writings relating in any way to any proprietary information of the other party, including copies then in that party's possession, whether prepared by that party or others. Neither party may retain any documents, data, or other items originated by the other party.

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§6.15 2. Form: Rights and Obligations Cease



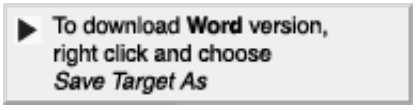


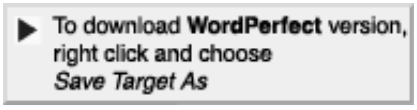
6.15-1 Rights and obligations cease

___. *Rights and Obligations to Cease on Termination.* All rights and obligations of the parties cease on termination of this Agreement. Neither party will be liable to the other for damages of any kind, including without limitation incidental or consequential damages, resulting from the termination of this Agreement _ _[*under Sections* _ _]_ _**.**

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§6.16 3. Form: Survival of Certain Rights and Obligations



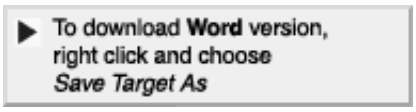


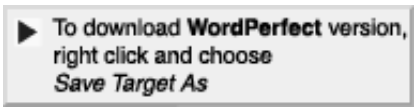
6.16-1 Survival of certain rights and obligations

___. *Certain Rights and Obligations to Survive Termination.* The rights and obligations of the parties under Section _ _ of this Agreement survive any termination of this Agreement _ _[*because of* _ _[*reason for termination*]_ _]_ _ **for a period of _ _**[*e.g., 2 years*]_ _**. All other rights and obligations of the parties cease on termination of this Agreement.**

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§6.17 4. Form: Obligation to Negotiate





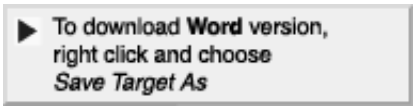
6.17-1 Obligation to negotiate

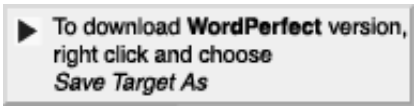
___. *Obligation to Negotiate on Termination.* On termination of this Agreement _ _[*because of _ _*[*reason for termination*]_ _]_ _**, the parties will negotiate in good faith as to their respective rights and obligations with respect to _ _**[*e.g., the Product*]_ _**.**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/6 Duration of the Agreement/ §6.18 5. Form: Sample Provision for Consequences of Early Termination of Distributor Agreement Providing Exclusive Territory

§6.18 5. Form: Sample Provision for Consequences of Early Termination of Distributor Agreement Providing Exclusive Territory





6.18-1 Sample provision for consequences of early termination of distributor agreement providing exclusive territory

___. *Consequences of Early Termination.* On termination of this Agreement:

(a) Company, at its option, may recover any or all Company products then in Distributor's possession that are in unopened factory-sealed boxes at the per unit fees paid by Distributor for those products. On receipt of any Company products so recovered from Distributor, Company shall issue an appropriate credit to Distributor's account.

(b) All outstanding invoices to Distributor for Company products are immediately due and payable by wire transfer on the effective date of termination, even if longer terms were provided previously. All orders or portions of orders remaining unshipped as of the effective date of termination are automatically canceled.

(c) For a period of 6 months after the effective date of termination, Distributor shall make available to Company for inspection and copying all books and records of Distributor that pertain to Distributor's performance of and compliance with its obligations and representations under this Agreement.

(d) On the effective date of termination, Distributor will cease all use of all Company trademarks and may not thereafter use any mark that is confusingly similar to any trademark associated with Company products.

(e) Distributor is entitled to compensation for all orders of Company products from Distributor's territory that were quoted before the date of termination and are placed no later than 3 months after the date of termination. This compensation equals to 5 percent of the gross sales price, and shall be paid to Distributor within 30 days after the Company receives payment.

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§6.19 E. Events Triggering Early Termination

The contract should specify the events triggering termination. The following are some common triggering events:

- **Dissolution or change in the form of one of the parties (*e.g.,* a merger or consolidation).** See §§6.20-6.22. Note that in a merger the surviving corporation automatically succeeds to all rights, property, debts, and liabilities of the disappearing corporation. Corp C §1107(a); *Petrini v Mohasco Corp.* (1998) 61 CA4th 1091, 71 CR2d 910. On a sale of assets, however, the purchaser generally is *not* subject to the seller's contractual liabilities unless the purchaser expressly assumes them. The surviving corporation or the purchaser, as the case may be, often will not want to assume certain liabilities. It may be appropriate to grant either party the right to terminate on a merger or sale of assets because the nonmerging or nonselling party might be prejudiced by the transaction. When a corporation acquired all the assets and liabilities of the business of another corporation, the successor was not entitled to claim insurance policy benefits for claims arising from bodily injuries occurring before the acquisition of the business, because the policies contained a "no assignment" clause, the policies had not been formally assigned to the successor, and the insurers had not consented to any assignment of the policies. *Henkel Corp. v Hartford Accident & Indem. Co.* (2003) 29 C4th 934, 129 CR2d 828.
- **Insolvency or bankruptcy.** See §6.23. For discussion of the effectiveness of these provisions after bankruptcy, see §§14.15-14.19. As further protection, a party should consider including provisions that allow termination of the contract on events short of insolvency or bankruptcy that indicate the other party is unlikely to be able to continue to perform under the contract, such as breach of financial covenants or operational stability requirements.
- **Death of an individual.** See §§6.24-6.25. This triggering event may be the death of one of the contract parties or the death of a nonparty whose performance is considered essential to the contractual relations (*e.g.,* a key employee or the majority owner of a closely held corporation).
- **Breach of the agreement.** See §6.26. The parties should decide which breaches are serious enough to justify termination of the agreement and whether the breaching party will be given an opportunity to cure. The agreement should provide for penalties or remedies for breaches that will not give rise to termination rights in order to deter parties from committing such breaches. Note that a party may be unable to successfully declare a default based on a nonmaterial breach. *Freeman v Lind* (1986) 181 CA3d 791, 226 CR 515. For further discussion of defaults, see chap 14.
- **Breach of law.** See §6.27. Termination could be triggered by a breach of any law by any party, by illegal conduct of only one party (*e.g.,* the employee or the contractor), or by breach of only laws of particular concern.
- **Loss of license.** See §6.28. Listing this triggering event is unnecessary if the agreement provides for termination on default and a loss of license constitutes an event of default (see §6.26) or if the agreement provides for termination on breach of law and the loss of the license violates the law (see §6.27).
- **Mutual agreement of the parties, or one party's exercise of an option to terminate the agreement.** See §§6.29-6.30. Unless provided otherwise, the parties to an agreement can always terminate by written agreement. By specifically providing for termination on the parties' agreement, however, the parties can clarify that fact and can impose procedures for termination (*e.g.,* a writing requirement).

For discussion of common terminating events for specific types of agreements, see §§6.31-6.48.

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F. Provisions Specifying Events Causing Early Termination

1. Corporate Dissolution, Merger, and Similar Events

§6.20 a. Form: Automatic Termination

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

6.20-1 Automatic termination

___. *Automatic Termination of Agreement.*

[*Add one of the following alternatives*]

[*Alternative 1: Agreement terminates on dissolution, merger, sale, or ceasing to do business*]

This Agreement terminates _ _[*, and the obligations of the parties under this Agreement cease,*]_ _ on the occurrence of any of the following events:

(1) The dissolution of _ _[*name of party*]_ _;

(2) The termination of the corporate existence of _ _[*name of party*]_ _ by merger, consolidation, or otherwise (except by a merger or consolidation with the parent corporation, or with a subsidiary or affiliate, of _ _[*name of party*]_ _);

(3) The sale of all or substantially all assets of _ _[*name of party*]_ _; or

(4) _ _[*Name of party*]_ _'s ceasing to continue to do business.

[*Alternative 2: Agreement terminates on dissolution, merger, sale, ceasing to do business, or change in management*]

This Agreement immediately terminates _ _[*, and the obligations of the parties under this Agreement cease,*]_ _ on the occurrence of any of the following events:

(1) The dissolution of _ _[*name of party*]_ _;

(2) The termination of the corporate existence of _ _[*name of party*]_ _ by merger, consolidation, or otherwise (except by a merger or consolidation with the parent corporation, or with a subsidiary or affiliate, of _ _[*name of party*]_ _);

(3) The sale of all or substantially all assets of _ _[*name of party*]_ _;

(4) _ _[*Name of party*]_ _'s ceasing to continue to do business; or

(5) Any substantial change in _ _[*name of party*]_ _'s management or control.

Comment: It is somewhat unusual to provide that a substantial change in management triggers termination, but it may be appropriate if one party is relying heavily on a relationship with the current management of the other party. To avoid ambiguity, the clause could define a "substantial change" as the departure of one or more specified persons from the management of the company.

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§6.21 b. Form: Optional Termination

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

6.21-1 Optional termination

___. *Optional Termination of Agreement.*

On a merger that involves _ _[*name of party*]_ _ in which _ _[*name of party*]_ _ is not the surviving entity, or a sale of all or substantially all assets of _ _[*name of party*]_ _, _ _[*name of party*]_ _ may:

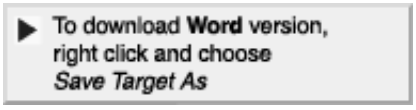
(1) Assign this Agreement and all rights and obligations under it to any business entity that succeeds to all or substantially all business of _ _[*name of party*]_ __ through the merger or sale of assets, or

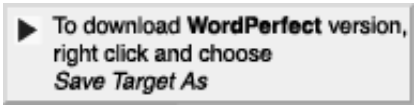
(2) Terminate this Agreement effective on the date of the merger or sale of assets by giving notice at least _ _[*e.g., 30 calendar days*]_ _ before the effective date of the merger or sale.

Comment: This provision allows the seller or disappearing corporation to terminate unwanted liabilities. The other party, however, may resist inclusion of such a provision in the agreement.

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§6.22 c. Form: Binding on Successor Corporation





6.22-1 Binding on successor

___. *Events That Do Not Terminate Agreement.* This Agreement is not terminated by:

(1) The voluntary or involuntary dissolution of _ _[*name of party*]_ _;

(2) Any merger involving _ _[*name of party*]_ _, whether or not it is the surviving or resulting corporation; or

(3) Any transfer of all or substantially all assets of _ _[*name of party*]_ _.

If any merger or transfer of assets occurs, this Agreement binds and inures to the benefit of the surviving business entity or the business entity to which those assets are transferred.

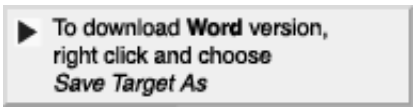
[*If applicable, add the following option*]

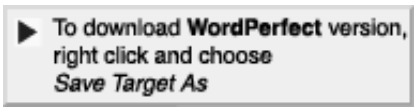
[*Option: Obligation to bind surviving corporation or purchaser*]

_ _[*Name of party*]_ _ will take all actions necessary to ensure that the surviving business entity or the transferee, as the case may be, is bound by this Agreement.

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§6.23 2. Form: Termination on Bankruptcy





6.23-1 Termination on bankruptcy

___. *Termination on Bankruptcy.* Either party may terminate this Agreement by giving notice to the other party at least _ _[*e.g., 5 business days*]**_ _ before the termination is to be effective, if:**

(a) The other party is adjudicated or becomes a bankrupt or an insolvent _ _[*(as that term is defined in 11 USC §101(32))*]**_ _;**

(b) The other party files a voluntary petition under any bankruptcy, reorganization, or insolvency law;

(c) The other party applies for or consents to appointment of a trustee or receiver to take possession of all or substantially all its assets;

(d) The other party consents to or files an answer admitting the jurisdiction of the court and the material allegations of, an involuntary petition filed under any bankruptcy, reorganization, or insolvency law;

(e) Any proceedings of bankruptcy, reorganization, or insolvency are commenced against the other party and not be dismissed within _ _[*e.g., 30 calendar days*]**_ _ after commencement;**

(f) The other party makes any assignment for the benefit of creditors, or other arrangement under any laws for the benefit of insolvents;

(g) Any order is entered under any bankruptcy, reorganization, or insolvency law of any jurisdiction, and is not dismissed or stayed within _ _[*e.g., 30 calendar days*]**_ _ after its entry (a) approving an involuntary petition seeking an arrangement with the creditors of the other party, (b) approving an involuntary petition seeking reorganization, or (c) appointing any receiver or trustee of all or a substantial part of the property of the other party;**

(h) A trustee or receiver is appointed to take possession of all or substantially all assets of the other party and is not dismissed within _ _[*e.g., 30 calendar days*]**_ _ after appointment; or**

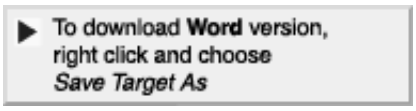
(i) Any writ of attachment, garnishment, or execution is levied against all or substantially all assets of the other party, or all or substantially all assets of the other party are subject to any attachment, garnishment, execution, or other judicial seizure, and are not removed, released, or bonded within _ _[*e.g., 30 calendar days*]**_ _ after the date of the attachment, garnishment, execution, or other judicial seizure.**

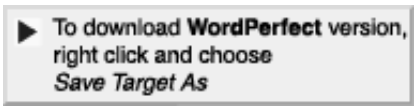
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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/6 Duration of the Agreement/ 3. Death of Individual/§6.24 a. Form: Termination on Death

3. Death of Individual

§6.24 a. Form: Termination on Death



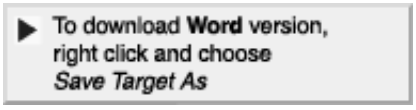


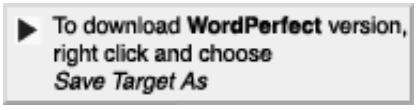
6.24-1 Termination on death

___. *Termination on Death.* This Agreement terminates on the death of _ _[*name*]_ _.

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§6.25 b. Form: No Termination on Death





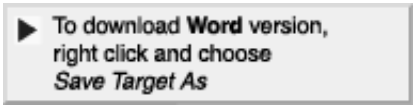
6.25-1 No termination on death

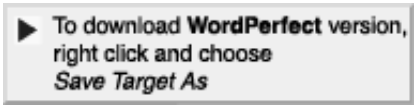
___. *No Termination on Death.* The death of _ _[*name*]_ _ does not terminate or otherwise affect the obligations of _ _[*the parties/*_ _[*name of party*]_ _]_ _ under _ _[*Section* _ _ *of*]_ _ this Agreement.

Comment: The parties should indicate whether the entire agreement, or only certain of its provisions, will remain in effect after the death of a party, and whether the death of the party will trigger any other changes to the agreement. Counsel should consider whether to provide that the contract is binding on and inures to the benefit of the legal representatives and successors in interest of the deceased party. A California appellate court held that the son of a deceased actor could not be compelled to arbitrate a claim that he owed commissions to a talent agency on payments received pursuant to his father's employment contracts, when the arbitration agreement between the agency and the actor did not provide that it was binding on successors and assigns of the actor. *Matthau v Superior Court (William Morris Agency, LLC)* (2007) 151 CA4th 593, 60 CR3d 93.

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§6.26 4. Form: Termination on Breach of Agreement





6.26-1 Termination on breach of agreement

___. *Termination on Breach.* If a default occurs under _ _[*Section _ _ of*]**_ _ this Agreement, and if within _ _**[*e.g., 30 calendar days*]**_ _ after the nondefaulting party has given the defaulting party notice of the event of default the defaulting party has not cured the default,**

[*If applicable, add*]

or, if the default cannot be reasonably cured within that time period, if the defaulting party has not commenced the cure within that time period, diligently continued to pursue that cure, and completed it within _ _[*e.g., 180 calendar days*]**_ _ after that notice,**

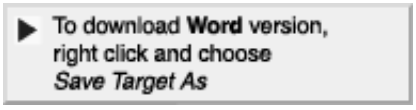
[*Continue*]

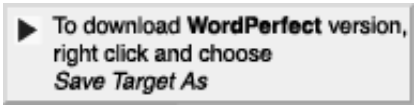
the nondefaulting party may terminate this Agreement at any time thereafter _ _[*e.g., without further notice/by giving notice to the defaulting party at least 5 business days before the termination is to be effective*]**_ _.**

Comment: This provision assumes that events of default are defined elsewhere in the agreement, but if they are not, they should be identified in this provision. It is common to provide that termination is allowed only in the event of a "material" breach. When this term is used, the agreement should clearly state the standards used to determine materiality. It may be appropriate to shorten or even eliminate the cure period for breaches that will cause immediate and significant harm to the nonbreaching party or that are not curable. See *Gueyffier v Ann Summers, Ltd.* (2008) 43 C4th 1179, 77 CR3d 613, in which an arbitrator was held to have authority to excuse the performance of a 60-day notice and cure provision in a franchise agreement when the arbitrator determined that the franchisor's breach was not curable. See discussion and forms for events of default in chap 14.

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§6.27 5. Form: Termination on Breach of Law



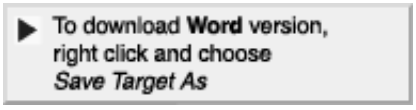


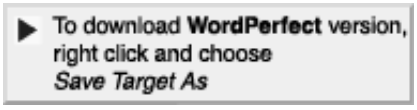
6.27-1 Termination on breach of law

___. *Termination on Breach of Law.* If either party is in material default under any rule, order, determination, ordinance, or law of any federal, state, county, or municipal authority, _ _[*and that party is not in good faith contesting the default,*]**_ _ the nondefaulting party may terminate this Agreement _ _**[*e.g., without further notice/by giving notice to the defaulting party at least 5 business days before the termination is to be effective*]**_ _.**

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§6.28 6. Form: Termination on Loss of License



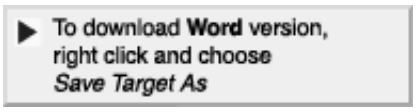


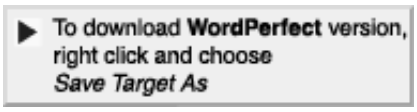
6.28-1 Termination on loss of license

___. *Termination on Loss of License.* On termination or suspension of _ _[*e.g., _ _[name of party*]_ _*'s real estate brokerage license*]_ _**,** _ _[*if such license is required as a condition to _ _[name of party*]_ _*'s legally performing its obligations under this Agreement*]_ _**,** _ _[*name of other party*]_ _ **may terminate this Agreement** _ _[*e.g., without further notice/by giving notice to _ _[name of party*]_ _ *at least 5 business days before the termination is to be effective*]_ _**.**

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§6.29 7. Form: Termination by Mutual Agreement





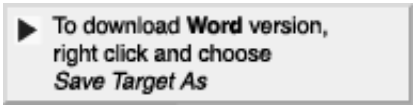
6.29-1 Termination by mutual agreement

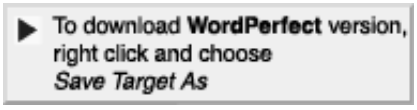
___. *Termination by Mutual Agreement.* This Agreement terminates when all parties agree in writing to terminate.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/6 Duration of the Agreement/ §6.30 8. Form: Absolute Termination Right by Either Party

§6.30 8. Form: Absolute Termination Right by Either Party





6.30-1 Absolute termination right by either party

___. *Right to Terminate.* This Agreement may be terminated by either party at any time, at will, with or without cause, with or without the giving of any reasons, and _ _[*e.g., without notice/by giving notice to the other party at least 30 calendar days before the termination is to be effective*]_ _**.**

Comment: In some situations, it might be argued that an absolute termination produces an illusory contract. This argument generally can be overcome by requiring advance notice of the termination. When an unanticipated termination is likely to cause financial hardship to the other party, it may be appropriate to provide for a termination fee.

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V. TERM OF SPECIFIC TYPES OF AGREEMENTS

§6.31 A. Single Transaction Agreements

There is no need to specify a term in an agreement providing for a single discrete transaction, such as a typical purchase and sale agreement, if the transaction occurs concurrently with execution of the agreement. If any obligations (*e.g.,* indemnities) continue beyond the date of execution, however, the agreement should specify how long those obligations are to remain in effect. See §6.33.

For transactions intended to occur at some future time, the agreement should specify a proposed closing date and the outside date by which the transaction must close. The creation of an outside date prevents one party from keeping the other bound to the agreement for longer than it wishes. If a contract does not specify a time for performance, a court will allow what it considers a reasonable time, which may not be in accord with the parties' expectations. Careful drafting avoids this uncertainty.

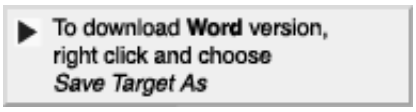
The parties may specify circumstances that would allow postponement of the closing (*e.g.,* reasonable delays in receiving necessary third party consents). The agreement should also specify what consequences will follow if the closing does not occur by the outside date (*e.g.,* forfeiture of deposits, imposition of penalties, or liability for liquidated damages). These consequences may be affected by the reason for the termination.

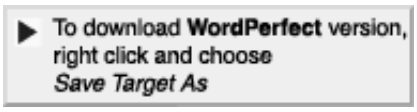
The basic term of an option agreement is the option period. The practitioner should be precise in providing when the option expires.

WARNING: To be enforceable, an option agreement must contain all the essential terms of purchase and sale, including the parties, the term of the option, the identity of the property, and the price and method of payment. *Hennefor v Butcher* (1986) 182 CA3d 492, 501, 227 CR 318. Therefore, counsel should ensure that an option agreement includes detailed provisions regarding the transaction that is to occur if the option is exercised. This concern frequently is addressed by attaching a purchase and sale agreement as an exhibit to the option agreement.

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§6.32 1. Form: Time of Closing





6.32-1 Time of closing

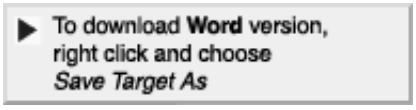
___. *Time of Closing.* The closing of the transactions described in this Agreement (the "Closing") must take place at _ _[*location, including address*]_ _, California, at _ _[*time*]_ _ local time, on _ _[*date*]_ _, or at another time and place as may be approved in writing by the parties. The Closing is subject to reasonable and customary adjournments, provided, however, that the Closing must take place no later than _ _[*date*]_ _ (the "Outside Date").

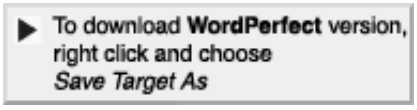
This Agreement is terminable after the Outside Date by either party if (a) the terminating party has performed all obligations required to be performed by it before the Closing and is prepared to perform all obligations to be performed by it at the Closing, and (b) the other party has not performed all obligations to be performed by it before the Closing or is unable to perform all obligations to be performed by it at the Closing.

Despite the foregoing, this Agreement is not to be terminable by either party, and the Closing must be adjourned for a reasonable time, not to exceed _ _ days, if a condition precedent to the obligation of one party to close has not occurred and the failure of that condition to have occurred has not resulted from the default by one of the parties in performing its obligations under this Agreement.

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§6.33 2. Form: Survival of Representations, Warranties, and Obligations





6.33-1 Survival of representations

[*Add one of the following alternatives*]

[*Alternative 1: Representations, warranties, and obligations survive closing*]

___. *Representations Survive Closing.* The representations in _ _[*Section _ _ of*]_ _ this Agreement survive the Closing for a period of _ _[*specify*]_ _, and any action or lawsuit for indemnity with respect to those representations or for breach of those representations must be filed within that time.

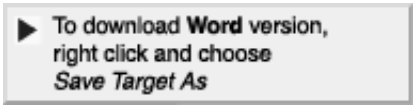
Comment: A stock purchase agreement provided that its representations and warranties survived the closing for 1 year, except for certain specified representations and warranties that survived indefinitely. The court concluded that the 1-year survival clause did not reduce the applicable statute of limitations but merely set forth the time period for which a breach may be discovered. *Western Filter Corp. v Argan, Inc.* (9th Cir 2008) 540 F3d 947. Thus, if the parties desire to reduce the statute of limitations, it is important to include language as in the clause above that specifically limits the time within which to bring a lawsuit.

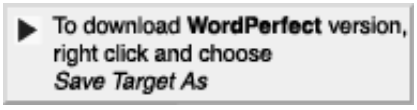
[*Alternative 2: Representations, warranties, and obligations do not survive closing*]

___. *Representations Do Not Survive Closing.* The representations and obligations in _ _[*Section _ _ of*]_ _ this Agreement do not survive the Closing, and no action or lawsuit for indemnity with respect to those representations or for breach of those representations may be filed after the Closing.

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§6.34 3. Form: Termination of Purchase and Sale Agreement Before Closing





6.34-1 Termination of purchase and sale agreement before closing

___. *Termination Before Closing.* This Agreement may be terminated at any time before Closing:

(a) By Seller, if there has been a material misrepresentation or breach of warranty or agreement under this Agreement on the part of Buyer;

(b) By Buyer, if there has been a material misrepresentation or breach of warranty or agreement under this Agreement on the part of Seller;

(c) By Seller, if on the Closing Date any condition precedent to an obligation of Seller at the Closing, as set forth in Section _ _ of this Agreement, has not occurred;

(d) By Buyer, if on the Closing Date any condition precedent to an obligation of Buyer at the Closing, as set forth in Section _ _ of this Agreement, has not occurred;

(e) By Buyer or Seller, if on the Closing Date any litigation, proceeding, or investigation is pending or threatened by federal, state, or local governmental authorities that has resulted or may result in an injunction or other action directed against or alleging material liability of Buyer or Seller, respectively, by virtue of the consummation of the transactions contemplated by this Agreement; or

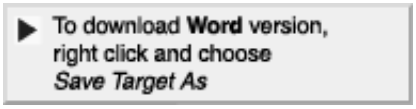
(f) By written agreement between Buyer and Seller.

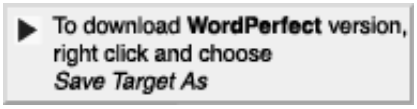
If this Agreement is terminated under this Section, Seller shall promptly refund to Buyer all consideration paid to Seller under _ _[*Section _ _ of*]_ _ this Agreement. After this refund, all further obligations of Seller and Buyer under this Agreement are terminated without liability of Buyer to Seller, or of Seller to Buyer, including without limitation any liability by reason of any misrepresentation or breach of warranty.

Comment: Counsel can modify the last paragraph of this form to include provisions for forfeiture of deposits, penalties, and liquidated damages after any termination or termination resulting from specified causes only.

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§6.35 4. Form: Term for Option





6.35-1 Term for option

___. *Term for Option.* Unless exercised in accordance with the provisions of this Agreement on or before _ _[*time*]_ _ local time on _ _[*date*]_ _, this Option automatically lapses and expires, without notice.

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§6.36 B. Service and Employment Agreements

In an agreement providing for the performance of services, such as an employment, consulting, management, distributor, or construction contract, a short term gives both parties flexibility. A longer term has advantages, too: for the employer, it binds a valuable employee to the job, and for the employee, it increases economic security. The parties may be able to achieve some of the advantages of both a short and long term by using a long-term contract that gives the parties the option of early termination in specified circumstances.

Various laws affect the duration of employment, and often prevail over contrary provisions in an employment agreement. For example, a contract to render personal services is generally not enforceable against an employee for more than 7 years after the services began under the contract. Lab C §2855. Thus, the term of an employment contract usually should not exceed 7 years. The federal and California Worker Adjustment and Retraining Notification (WARN) Acts require certain employers to give 60 days' notice before a plant closing or mass layoff. 29 USC §§2101-2109; Lab C §§1400-1408. The federal and California WARN Acts have some significant differences; the California law is generally broader in scope. The Ninth Circuit has held that the federal WARN Act does not apply to a layoff of privately employed airport security screeners necessitated by the federalization of airport screening, as the layoff was deemed to have been "ordered" by the government rather than by the employer. *Deveraturda v Globe Aviation Sec. Servs.* (9th Cir 2006) 454 F3d 1043. The Ninth Circuit also has held that layoffs at a company's field offices in different states could not be aggregated to constitute a mass layoff at a "single site of employment," as required under the federal WARN Act. *Bader v Northern Line Layers, Inc.* (9th Cir 2007) 503 F3d 813.

Counsel should review these and other special rules and restrictions that govern the term and termination of employment relationships. See, *e.g.,* Lab C §§2920-2929.

Following are some common kinds of termination provisions in service and employment agreements:

- **Cause.** The agreement should specify whether cause is needed to terminate it. If cause is necessary, then cause should be carefully defined. In particular, counsel should consider whether the definition of "cause" is sufficiently broad. For example, when an author agreement provides that a publisher may terminate the agreement only if it finds the manuscript unacceptable in "form and content," the publisher (who conceded the manuscript was of high quality) may not terminate the agreement solely because of concern about the book's commercial prospects. *Chodos v West Publishing Co.* (9th Cir 2002) 292 F3d 992. If an employment agreement is silent on grounds for termination, the court may allow the employee to introduce parol evidence to establish that the parties orally agreed that employment could be terminated only for good cause. *Esbensen v Userware Int'l* (1992) 11 CA4th 631, 638, 14 CR2d 93. The *Esbensen* agreement did not include an integration clause (see §§17.11-17.12); if such a clause had been included, the court might have reached a different result. In *Ben-Zvi v Edmar Co.* (1995) 40 CA4th 468, 473, 47 CR2d 12, the court held that an exclusive distributor's relocation from the distribution territory did not give the other party to the distribution agreement sufficient cause to terminate the agreement. The *Ben-Zvi* court noted that there was no term in the contract requiring the distributor to live in Israel (the distribution territory) or allowing the company to terminate the contract if the distributor left Israel. The court also concluded that residence in Israel was not indispensable to the contract. See §§6.37-6.38.

PRACTICE TIP: If residency is an important factor to a company in a distribution or similar arrangement, the contract should include an express residency requirement and provide that breach of that requirement gives the company the right to terminate the contract.

- **Disability or illness.** Termination of employment for disability or illness can be based on a subjective test (*e.g.,* the opinion of a physician), or on an objective test (*e.g.,* days of work missed during a designated period because of disability). The objective test allows for termination of employment if the employee, although not permanently disabled, frequently misses work because of various illnesses or disabilities. See §§6.39-6.40.

WARNING: Various laws such as the federal Family and Medical Leave Act of 1993 (FMLA) (29 USC §§2601-2654),

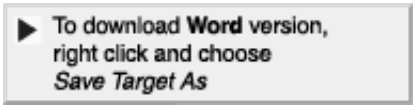
the federal Americans with Disabilities Act (ADA) (42 USC §§12101-12213), the California Family Rights Act of 1993 (CFRA) (Govt C §12945.2), and the California Fair Employment and Housing Act (FEHA) (Govt C §§12900-12996) give employees the right to disability leave under various circumstances and require employers to make reasonable accommodations for disabled employees. These laws may limit the right of an employer to terminate an employee on the basis of disability. But see *Ross v RagingWire Telecommunications, Inc.* (2008) 42 C4th 920, 70 CR3d 382, in which a company terminated an employee for failing a drug test and the employee sued for wrongful termination. The court held that the employee's medical use of marijuana, although pursuant to a physician's certificate and permitted under the Compassionate Use Act of 1996 (Health & S C §11362.5), was not protected under the FEHA. Counsel should carefully review the scope and applicability of such laws before drafting a disability termination provision. See Advising California Employers and Employees, chaps 6, 15 (Cal CEB 2005).

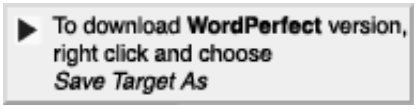
- **At-will.** In California, there is a presumption that employment is "at-will," absent an express oral or written agreement specifying the length of employment or the grounds for termination. Lab C §2922; *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 677, 254 CR 211. However, this presumption may be overcome in various ways. In addition, although an at-will provision may prevent a cause of action for termination of employment, it does not allow an employer to avoid tort liability for fraudulent inducement of contract. *Agosta v Astor* (2004) 120 CA4th 596, 15 CR3d 565. An at-will provision protects the employer against an employee's relying on any verbal or written statements of the employer to negate the absolute right of termination. See Advising Employers & Employees §§17.1-17.28. A provision in an employment contract specifying that an employee would be given a performance review after 12 months of employment was held to not constitute a minimum 1-year contract term. *Lenk v Total-Western Inc.* (2001) 89 CA4th 959, 969, 108 CR2d 34. In *Lenk,* the employment contract set forth no term of employment, and both the employment application signed by the employee and the employee manual provided for at-will employment. Contract provisions requiring written notice of termination and allowing the terminated employee to request an internal review of the termination did not transform an at-will agreement to one requiring good cause for termination. *Bernard v State Farm Mut. Auto. Ins. Co.* (2007) 158 CA4th 304, 69 CR3d 700. See §6.41.

NOTE: An at-will provision does not insulate an employer from liability for terminating an employee in violation of various antidiscrimination laws, in retaliation for exercising certain protected rights, or in violation of public policy. See generally Wrongful Employment Termination Practice (2d ed Cal CEB 1997). The Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA) (38 USC §§4301-4335) prohibits termination of employment based on military service. Where a returning veteran whose job had been eliminated signed a release of claims in exchange for 6 weeks' salary, the release was unenforceable to the extent that it extended to claims authorized by USERRA. *Perez v Uline, Inc.* (2007) 157 CA4th 953, 68 CR3d 872.

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§6.37 1. Form: Termination for Cause—Specifying All Causes for Termination





6.37-1 Termination for cause specifying all causes

___. *Termination for Cause.* Employer may terminate this Agreement at any time, _ _[*without notice/after giving Employee notice at least 30 calendar days before the termination is to be effective*]**_ _, if:**

(a) Employee fails, refuses, or is unable to satisfactorily perform the services required of Employee by this Agreement;

(b) Employee fails, refuses, or is unable to carry out any proper direction by the board of directors of Employer with respect to either the services to be rendered by Employee under this Agreement or the manner of rendering such services;

(c) Employee willfully or habitually neglects the duties that Employee is required to perform under this Agreement or Employer's corporate policies;

(d) Employee is convicted of committing a felony;

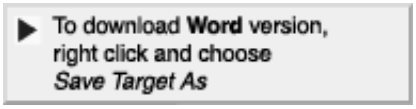
(e) Employee commits any material act of dishonesty, discloses confidential information, is guilty of gross carelessness or misconduct, or acts in any way that has a direct, substantial, and adverse effect on Employer's reputation; or

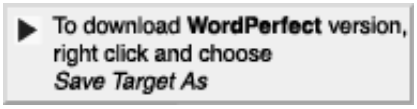
(f) _ _[*List additional causes for termination*]**_ _.**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/6 Duration of the Agreement/ §6.38 2. Form: Termination for Cause--Nonexhaustive Definition of Cause

§6.38 2. Form: Termination for Cause—Nonexhaustive Definition of Cause



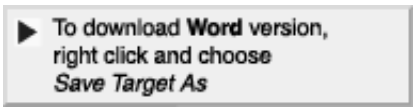


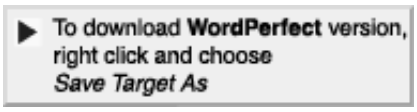
6.38-1 Termination for cause—nonexhaustive definition of cause

___. *Termination for Cause.* Employer may terminate this Agreement for cause at any time, _ _[*e.g., without notice/after giving Employee notice at least 30 calendar days before the termination is to be effective*]_ _**. For purposes of this Agreement, "cause" includes, but is not limited to, willful breach or habitual neglect of the duties that Employee is required to perform under this Agreement or Employer's corporate policies.**

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§6.39 3. Form: Termination on Disability





6.39-1 Termination on disability

___. *Termination on Disability.* This Agreement will terminate if Employee becomes disabled and the disability continues for a period of _ _[*e.g., 3 _ _[consecutive*]_ _ *months*]_ _. For purposes of this Agreement, "disability" means Employee's inability, because of physical or mental illness or other cause, to perform Employee's usual duties under the Agreement, even with reasonable accommodation, as determined by _ _[*name of physician/a physician agreeable to Employer and Employee/Employee's personal physician*]_ _.

[*If applicable, add the following option*]

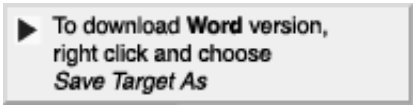
[*Option: Failure to agree on physician*]

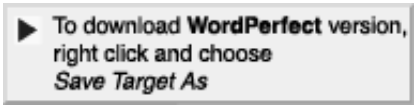
If the parties cannot agree on a physician, each will select a physician and these two physicians will select a third physician. The opinion of a majority of the three physicians selected binds the parties.

Comment: Counsel should take note of various laws that may restrict the ability of an employer to terminate an employee in the case of disability and require "reasonable accommodation" for a disabled employee. See §6.36.

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§6.40 4. Form: Termination for Specified Period of Absences





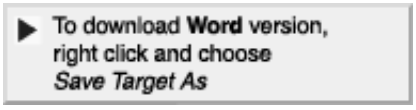
6.40-1 Termination for specified period of absences

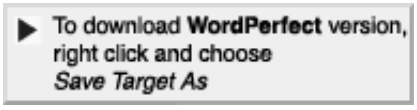
___. *Termination for Specified Absences.* If Employee is prevented by illness, accident, or other disability (mental or physical) from discharging Employee's duties under this Agreement, even with reasonable accommodation, for one or more periods totaling _ _[*e.g., 30 calendar days*]**_ _ during any period of _ _**[*e.g., 12 months*]**_ _ or less, then Employer may terminate this Agreement by giving notice to Employee at least _ _**[*e.g., 30 calendar days*]**_ _ before the termination is to be effective.**

Comment: See Comment to form in §6.39.

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§6.41 5. Form: Termination at Will





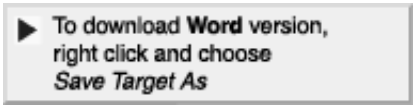
6.41-1 Termination at will

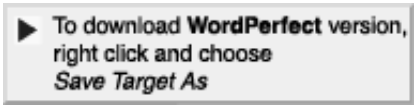
___. *Termination at Will.* This Agreement is terminable by either party at any time, at will, with or without cause, with or without explanation, _ _[*e.g., without notice/after giving notice to the other party at least 30 calendar days before the termination is to be effective.*]_ _**. Employee confirms and acknowledges that any expressions by Employer to the effect that Employer hopes for a long or continuing relationship between Employer and Employee are merely expressions of an intent that the relationship be a beneficial one, and such expressions are not a representation or assurance of continued employment. Employee confirms and acknowledges that any positive comments or evaluations by Employer as to Employee's performance, whether oral or written, in no way contradict the parties' intent that this Agreement is terminable at will. Employee confirms and acknowledges that this Agreement will always be terminable at will, regardless of the term of this Agreement and regardless of any contrary representations of Employer, whether oral or written, express or implied.**

Comment: An agreement providing for "at will" employment, defined to mean simply that employment could be terminated "at any time," was held not per se ambiguous merely because it did not specify whether the employer needed cause to terminate. Rather, the court deemed the provision to cover terminations with or without cause. *Dore v Arnold Worldwide, Inc.* (2006) 39 C4th 384, 46 CR3d 668. Notwithstanding the upholding of the simple at-will clause in *Dore,* it is good practice for an employer to use more comprehensive at-will language and to specify that the employment may be terminated with or without cause, as in the above form.

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§6.42 6. Form: Payment Obligations After Termination





6.42-1 Payment obligations after termination

___. *Payment Obligations After Termination.* After termination _ _[*resulting from _ _*[*specify reasons*]_ _]_ _**, Employer's obligation to pay further compensation under this Agreement ceases immediately**

[*Add one of the following alternatives*]

[*Alternative 1: No severance pay*]

and Employee will not be entitled to any severance pay whatsoever.

[*Alternative 2: Severance pay*]

except that Employee will be entitled to _ _[*e.g., 2 weeks'*]_ _ **severance pay.**

[*Alternative 3: Exception for compensation and commissions for fixed period*]

except that Employee or Employee's legal representative will be entitled to receive Employee's fixed compensation for the period _ _[*e.g., up to the last day of the month in which termination occurs/of 2 weeks*]_ _ **and will be entitled to any commissions or fees earned, as stated in Section _ _, for a period of _ _**[*specify time period*]_ _ **after termination.**

Comment: These provisions may be tied to all early terminations or only an early termination resulting from a specific event such as the employee's death.

If an employer discharges an employee, any earned and unpaid wages are due immediately. Lab C §201. If an employee not having a written contract for a definite period quits employment, his or her wages are due not later than 72 hours thereafter, unless the employee has given 72 hours previous notice of his or her intention to quit, in which case the wages are due at the time of quitting. Lab C §202. On termination of employment, an employer must ordinarily pay an employee for any unused vested vacation time as wages at his or her final pay rate. Lab C §227.3. As these payment obligations are already provided for by statute, they often are not included in employment contracts, but counsel should remain mindful of them when advising employers.

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§6.43 C. Agreements for Use of Money or Property

In agreements providing for the use of money or property, such as loans, leases, licenses, easements, property management agreements, and sales agreements, there is a cost-benefit aspect of deciding whether the term should be short or long. A short term gives both parties the opportunity to adjust to changing economic circumstances, while a long term provides more certainty.

A long-term agreement can provide for some flexibility; *e.g.,* the rental rate under a long-term lease can be tied to economic indicators such as the Consumer Price Index, or the interest rate under a long-term loan can be made adjustable according to specific standards such as prime rates. A long-term contract that allows early termination under specified circumstances can give the parties the best of both worlds.

If an easement or a similar property interest is created by agreement, counsel should specify the term of the interest either as perpetual, for a term of years, or based on an event, such as the lifetime of the dominant or servient owner. Some lease terms are restricted by statute. See, *e.g.,* CC §§717-719 (leases for agricultural purposes; leases for town or city lots); Govt C §§37380-37396 (city property leases); Pub Res C §6505.5 (grazing and recreational leases); Pub Res C §7057 (city property leases for minerals, oil, or gas).

Under statutory law, the hirer of property may terminate the hiring before the end of the term agreed on when the property has been substantially destroyed by any cause other than the want of ordinary care of the hirer. CC §1932(2). The hiring of property also terminates on the destruction of the property. CC §1933(4). A waiver of CC §§1932(2) and 1933(4) must be included in the agreement if these statutory rights of termination are not desired.

A lessee's exercise of an option to extend a lease does not override the lessor's right to terminate the lease. *11382 Beach Partnership v Libaw* (1999) 70 CA4th 212, 82 CR2d 533. In *Libaw,* the lease provided that either party could terminate the lease if the premises were destroyed within 2 years before the lease expired. Following the destruction of the premises in the last 2 years of the original term, the lessee immediately exercised an option to extend the lease for 5 years. The court affirmed the lessor's termination of the lease and rejected the lessee's claim that the termination of the lease 2 weeks later by the lessor was invalid because it did not occur within the last 2 years of the term as extended by exercise of the option.

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§6.44 1. Form: Termination Because of Sale or Destruction of Property

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6.44-1 Termination because of sale or destruction

___. *Termination Because of Sale or Destruction.* On the sale _ _[*, condemnation, demolition,*]**_ _ or destruction of the Property, this Agreement terminates, and the parties' obligations under this Agreement cease, _ _**[*e.g., without notice/10 business days after notice from Buyer to Seller*]**_ _.**

Comment: "Condemnation" and "demolition" are appropriately included if the "Property" is real property, but they may be inappropriate for personal property.

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§6.45 2. Form: Waiver of Statutory Rights of Termination

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6.45-1 Waiver of statutory rights of termination

___. *Waiver of Statutory Rights of Termination.* Tenant hereby waives California Civil Code §1932(2) and §1933(4) and any similar law enacted after the date of this Agreement.

Comment: Additional provisions would typically be added on the landlord's obligation to repair or rebuild, on abatement of rent during the interim, and on circumstances under which the landlord or tenant could terminate the lease as a result of the damage or destruction of the leased property.

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§6.46 D. Partnership and Limited Liability Company Agreements

An agreement to pool efforts or for joint ownership of property naturally terminates when the parties have achieved the goal of the agreement. Thus, for example, if a joint venture is formed to acquire and develop a specific piece of property for resale, the agreement should provide that the joint venture terminates on sale of the property.

Under the current "check-the-box" regulations, a business organized as a partnership or a limited liability company will automatically be treated as a partnership (or, in the case of a single member limited liability company, as a sole proprietorship) for federal and California income tax purposes, unless it affirmatively elects to be taxed as a corporation. Rev & T C §23038(b)(2)(B); Treas Reg §§301.7701-1—301.7701-3. Under prior law, a lack of continuity of life was one of the factors supporting classification of an organization as a partnership for income tax purposes, as opposed to an association taxable as a corporation. In any event, counsel no longer need be concerned from a tax standpoint with drafting partnership agreements or limited liability company documents to avoid continuity of life.

Although there no longer are tax reasons for specifying a termination date for a partnership or a limited liability company, counsel should consider whether there are business reasons for doing so. The articles of organization of a limited liability company may, but need not state, the time at which the company is to dissolve. Corp C §17051(c)(3).

A limited partner may withdraw from a limited partnership only at the time of, or on the occurrence of, events specified in the partnership agreement. Corp C §15663. Counsel should therefore include appropriate withdrawal provisions in the partnership agreement.

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§6.47 E. Agreements Creating or Restricting Rights

The need to specify a term is not always clear in agreements creating or restricting ongoing rights, such as easement, buy-sell, and confidentiality agreements. For example, in a corporate buy-out agreement, the parties may want share transfer restrictions to remain in effect indefinitely. Even then, however, logical terminating events should be specified. See Business Buy-Sell Agreements §§3.67, 4.62 (Cal CEB 1991).

The enforceability of certain restrictive agreements, such as confidentiality and noncompetition agreements, may depend in part on the reasonableness of the term of the restrictions. A covenant prohibiting an employee from competing with the employer after termination of employment is generally unenforceable under California law. See Bus & P C §16600. In *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 81 CR3d 282, the California Supreme Court rejected the "narrow-restraint" exception to §16600 recognized in a number of Ninth Circuit cases; see, *e.g., Campbell v Trustees of Leland Stanford Jr. Univ.* (9th Cir 1987) 817 F2d 499. Under the exception, a noncompetition covenant could be valid "where one is barred from pursuing only a small or limited part of a business, trade, or profession." 817 F2d at 502. The *Edwards* court held that a covenant, though limited to preventing an accountant from providing services to certain of his former employer's clients for 12 to 18 months following termination of employment, was unenforceable under §16600. 44 C4th at 948.

In many states, covenants not to compete are much more broadly enforceable than in California. Even in California, however, there are exceptions to the general rule of unenforceability. For example, a noncompetition covenant may be upheld if it is limited to prohibiting the use of the former employer's trade secrets. *Gordon v Landau* (1958) 49 C2d 690, 321 P2d 456. Noncompetition covenants may also be enforceable in connection with the following:

- The sale of the goodwill of a business (Bus & P C §16601);
- The sale of all of a person's interest in a business entity (*i.e.,* partnership, limited liability company, or corporation) (Bus & P C §16601);
- The sale of all or substantially all operating assets together with the goodwill of a business entity (Bus & P C §16601(a));
- The sale of all or substantially all of the operating assets of a division or subsidiary of a business entity together with the goodwill of the division of subsidiary (Bus & P C §16601(b));
- All of the ownership interest of any subsidiary (Bus & P C §16601(c));
- The dissolution of a partnership or the dissociation of a partner from a partnership (Bus & P C §16602); or
- The dissolution of a limited liability company (Bus & P C §16602.5).

A provision in a consulting contract prohibiting a client from hiring any employee of a computer consulting firm for 12 months after termination of the contract has been held unenforceable. The employee of the consulting firm who the client hired during the proscribed 12-month period had not even commenced employment with the consulting firm until after the firm had completed its work for the client. *VL Sys., Inc. v Unisen, Inc.* (2007) 152 CA4th 708, 61 CR3d 818. Although reasonably limited restrictions that tend more to promote rather than restrain trade and business do not violate Bus & P C §16600, the challenged contractual provision was much broader than necessary to protect the consulting firm's interests and was outweighed by the policy favoring freedom of mobility for employees. The question remains open as to whether a no-hire provision limited to employees of the consulting firm who had performed work for the client during the term of the consulting contract would be enforceable.

For a noncompetition provision, see form in §9.11.

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§6.48 F. Fiduciary Agreements

The term of an agreement for holding or managing property in a fiduciary capacity depends on how long the fiduciary's services are needed. The term may be relatively short and tied to consummation of a specific transaction by a specified date, as in many escrow agreements; or the term may be relatively long and tied to the occurrence of events whose timing is unpredictable (*e.g.,* the death of an individual), as in many trust agreements.

In drafting an agreement with a long or an indefinite term, counsel should review the restrictions of the Uniform Statutory Rule Against Perpetuities (Prob C §§21200-21225). Although the rule against perpetuities is particularly relevant for estate planning, it also applies to other agreements, such as leases and options. Under the basic rule, a nonvested property interest is invalid unless either (1) the interest, when created, is certain to vest or terminate no later than 21 years after the death of an individual then alive or (2) the interest vests or terminates within 90 years after its creation. Prob C §21205.

PRACTICE TIP: If there is doubt whether an agreement complies with the rule against perpetuities, a simple strategy for compliance is to provide that any contingent interest will vest (or terminate) within 90 years after its creation. See generally Prob C §§21200-21231. See Prob C §21225 for interests not subject to the rule.

For extensive discussion and forms for complying with the rule against perpetuities, see California Will Drafting, chap 34 (3d ed Cal CEB 1992), Drafting California Irrevocable Trusts §§9.58-9.59, 20.68 (3d ed Cal CEB 1997), and Drafting California Revocable Trusts §§19.10-19.11 (4th ed Cal CEB 2003).

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§6.49 G. Letters of Credit

A letter of credit should state its term and whether it is revocable or may be amended or canceled by the issuer without the consent of the affected parties. See UCC §5-106(a)-(b). A letter of credit with no stated expiration date expires 1 year after its stated date of issuance. UCC §5-106(c). A letter of credit that states it is perpetual expires 5 years after its stated date of issuance. UCC §5-106(d).

A letter of credit that provided that it expired 1 year from its date of issue but would be automatically renewed for additional 1-year periods unless the beneficiary gave notice that it would not require renewal was determined not to be "perpetual" under §5-106(d). *Golden W. Refining Co. v Suntrust Bank* (9th Cir 2008) 538 F3d 1233. The letter of credit remained in effect when the beneficiary attempted to draw on it 7 years after its issuance, even though the successor to the issuer previously had attempted to cancel the letter of credit because it was not secured. *Golden West* highlights the need to take great care in defining the term of a letter of credit and the conditions, if any, on which it can be canceled. See §§8.19-8.20. See also Financing and Protecting California Businesses, chap 9 (Cal CEB 2006).

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7

Factual Basis of the Agreement: Recitals, Representations, and Warranties

Michael J. Ram
Benjamin A. Ram

I. CHECKLIST: FACTUAL BASIS §7.1

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- E. Form: Sample Provisions for Other Contractual Representations or Warranties §7.9
- F. Disclaiming Warranties §7.10
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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/7 Factual Basis of the Agreement: Recitals, Representations, and Warranties/§7.1 I. CHECKLIST: FACTUAL BASIS

§7.1 I. CHECKLIST: FACTUAL BASIS

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- Parties to the agreement (see §§5.10, 5.14)
- Background information (see §§7.3-7.4)
- Representations and warranties regarding the subject of the agreement and the validity of the transaction (see §§7.5-7.9)
- Validity of transaction (see §§7.9)
- Disclaiming warranties (see §§7.10-7.13)

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§7.2 II. GENERAL CONSIDERATIONS

The factual basis of the agreement is set forth in several different sections. The heading or preamble of the agreement contains a brief identification of the parties and, in many instances, its effective date (see chap 5). The recitals (see §§7.3-7.4) and the representations and warranties (see §§7.5-7.13) state the facts underlying the agreement between the parties. Together, these clauses describe the parties' identities, purposes, and motivations, as well as the subject matter of their agreement. Failure to accurately and truthfully state the factual basis of the agreement will, at a minimum, result in disputes between the parties during negotiations. On inconsistent statements, see §7.14.

Clear and explicit language in a contract governs the contract. CC §1638. Ambiguous statements may lead to litigation over the meanings of terms or the parties' contractual intent. In a worst case scenario, the court will ultimately decide the scope of the agreement and the obligations of the parties, perhaps to the dissatisfaction of both sides.

Ambiguities may be construed against the contract drafter. *California Pac. Bank v Small Business Admin.* (9th Cir 1977) 557 F2d 218. "If the terms of a promise are in any respect ambiguous or uncertain, it must be interpreted in the sense in which the promisor believed, at the time of making it, that the promisee understood it." CC §1649. See *Bank of the W. v Superior Court* (1992) 2 C4th 1254, 1264, 10 CR2d 538; *AIU Ins. Co. v Superior Court* (1990) 51 C3d 807, 822, 274 CR 820. The client's interests are not served by half-truths, insupportable representations, warranties that the client intends to avoid, or definitions designed to hide something from the other side.

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III. RECITALS

§7.3 A. Purpose

Although recitals are not necessary to an agreement (*Stone v Jones* (1944) 66 CA2d 264, 152 P2d 19), they are helpful in identifying the parties, explaining the background and purposes of the agreement, and generally setting the stage for what follows. In this way, they protect the operative provisions of the agreement from misinterpretation, because they provide the factual context within which the body of the agreement can be understood.

The recitals may also be used to establish shorthand phrases that are used throughout the agreement in place of lengthy or cumbersome terminology. For further discussion of recitals, see §§5.17-5.21.

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§7.4 B. Sample Recitals

For sample recital provisions, see §5.22.

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IV. REPRESENTATIONS AND WARRANTIES

§7.5 A. General Considerations

A representation is (Black's Law Dictionary 1327 (8th ed 2004)):

> A presentation of fact—either by words or by conduct—made to induce someone to act, esp. to enter into a contract; esp. the manifestation to another that a fact, including a state of mind, exists.

A warranty is a representation made in the context of a sale or lease concerning some aspect of it, such as title to the property sold or leased, or its quality, condition, or amount. See generally California Law of Contracts §§6.2-6.31 (Cal CEB 2007).

There are several distinctions between an action based on breach of warranty and one based on fraudulent misrepresentation. One element of a cause of action for misrepresentation is knowledge of its falsity ("scienter") or negligence in making the representation without reasonable grounds for believing it to be true. No conscious misstatement is required for a warranty; it may be the basis for an action even if made in good faith. Another element of an action based on misrepresentation is intent to defraud. A warranty breach arises without regard to the seller's or lessor's intent. A third distinction is that a breach of warranty claim is contractual in nature, while a misrepresentation gives rise to a claim in tort.

Another element of a cause of action for misrepresentation is reasonable or justifiable reliance on a material misstatement. See *Hinesley v Oakshade Town Ctr.* (2005) 135 CA4th 289, 37 CR3d 364. It is not entirely clear whether the issue of materiality is one of fact or law for purposes of a summary judgment motion. See, *e.g.*, *Engalla v Permanente Med. Group, Inc.* (1997) 15 C4th 951, 976, 64 CR2d 843 (question of fact); *Stevenson v Baum* (1998) 65 CA4th 159, 165, 75 CR2d 904 (question of law). However, even assuming that the issue is one of fact, a claim of materiality may be defeated by showing no reasonable reliance. In *Hinesley v Oakshade Town Ctr., supra,* the tenant did not reasonably rely on oral representations as to future tenants when the shopping center lease stated that the lessor made no representations as to future tenants. Although the clause should have alerted the tenant to the need for clarification, the tenant's failure to seek clarification or confirm the contractual status of the future tenants, inform counsel of the representations, or modify the lease precludes reasonable reliance as a matter of law. 135 CA4th at 298.

The distinction between warranties and representations is less important in the sales of goods, because a defrauded party has available to it the same remedies it might have asserted for breach of warranty, contrary to the limited "out-of-pocket" loss rule normally applied in fraud actions. Com C §2721. See California UCC Sales and Leases §§3.83-3.98 (Cal CEB 2002).

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§7.6 B. Express Warranties

Warranties may be oral or written and either expressed outright or implied by conduct or by law. (See §7.7 for discussion of implied warranties.) In a sale of goods, descriptions or promises that relate to the character, quality, identity, condition, or title to the goods are common examples of express warranties. *Keith v Buchanan* (1985) 173 CA3d 13, 220 CR 392. A statement of fact about the goods may become an express warranty if it forms part of the basis of the bargain, regardless of whether the words "warrant" or "guarantee" are used. CC §1791.2(2)(b); Com C §2313(2); *Hauter v Zogarts* (1975) 14 C3d 104, 120 CR 681. Opinions, recommendations, and affirmations of the value of goods, however, as distinguished from affirmations of fact, are not enforceable warranties. CC §1791.2(2)(b); Com C §2313(2). Compare *Keith v Buchanan, supra* (statement that sailboat was "carefully well-equipped and very seaworthy vessel" held to be affirmation of fact, not opinion, and thus a warranty), with *Williams v Lowenthal* (1932) 124 CA 179, 12 P2d 75 (statement that jukebox was "a good machine" and "would probably not get out of order" was held to be opinion, not fact, and thus not a warranty). See generally California UCC Sales and Leases §§3.8-3.20 (Cal CEB 2002); California Law of Contracts §6.13 (Cal CEB 2007).

It is often difficult to distinguish between fact and opinion. Generally, opinions lack specificity and are made in an equivocal manner or indicate that goods are "experimental" in nature. *Keith v Buchanan, supra*. The modern judicial trend is toward a liberal construction in favor of the buyer (*i.e.,* finding warranty was made). It is the seller's burden to show that a reasonable buyer should have considered the statement to be merely the seller's opinion about the goods and not a statement of fact.

A buyer need not show actual reliance to prove that a statement formed part of the basis of the bargain; nor need it show that the statement was a dominant factor in inducing the purchase. Any statement made by a seller that relates to the goods being sold is presumptively an express warranty. *Keith v Buchanan, supra*. For further discussion, see UCC Sales & Leases, chap 3.

All warranties, both express and implied (see §7.7), are construed as cumulative and consistent if that construction is reasonable. If warranties cannot be construed as consistent, the parties' intentions determine which warranty prevails. Com C §2317.

The drafting attorney should clearly indicate whether the warranties set forth in the agreement are the only ones being made. Warranties made elsewhere, whether orally or in other documents (brochures, catalogs, advertisements, product specifications, etc.) may be enforced by the court unless the parties specifically exclude them. See §§7.10-7.13. See generally UCC Sales & Leases §§3.46-3.69.

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§7.7 C. Implied Warranties

Regardless of whether express warranties are made, certain warranties may be implied terms of the agreement between the parties unless the parties exclude or modify them. See Com C §§2312, 2314-2316.

A sale of goods includes implied warranties of:

- Title (Com C §2312); and
- Fitness for a particular purpose (Com C §2315).

A sale of goods by a seller who is a merchant regularly dealing in goods of the kind includes implied warranties of noninfringement (Com C §2312).

A sale of goods by a seller who is a merchant with respect to goods of the kind includes implied warranties of:

- Merchantability (Com C §2314(1)); and
- Such other warranties as might arise from the parties' course of dealing or the usages of their trade (Com C §2314(3)).

See California Law of Contracts §6.14 (Cal CEB 2007).

Documents of title include implied warranties of genuineness, validity, and title. Com C §§7507-7508.

Similar warranties are implied in the transfer and presentment of negotiable instruments. See Com C §§3416-3417, 4207. A person signing a certificated security as the authenticating party impliedly warrants that the security is genuine, that his or her participation in the transaction is authorized, and that he or she has reasonable grounds to believe that the security is in the form and within the amount the issuer is authorized to issue. Com C §8208(a).

A person guaranteeing the signature of an indorser of a security or the signature of the originator of an "instruction" (see Com C §8305) makes warranties of genuineness, capacity, and, in some instances, the rightfulness of the transfer. See Com C §8306.

Warranties of transfer and presentment are implied in letters of credit. See Com C §5111.

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§7.8 D. Warranties by Description or Sample

If packaging and advertising materials for goods are part of the basis of a bargain, they create a warranty that the product will conform to the description in those materials, just as the product must conform to any other written or oral statement of fact about it made by the seller. Com C §2313(1)(b). Further, a sample or model that is made part of the basis of the bargain gives rise to a warranty that all the goods subject to the contract will conform to the sample. Com C §2313(1)(c). See generally California UCC Sales and Leases §3.20 (Cal CEB 2002).

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§7.9 E. Form: Sample Provisions for Other Contractual Representations or Warranties

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7.9-1 Samples of other contractual representations or warranties

___. *Representations and Warranties.*

[*Add one of the following alternatives*]

[*Alternative 1: Corporate approval*]

The parties have the power to enter into and perform this Agreement, and this Agreement's execution has been duly authorized by all necessary corporate action.

[*Alternative 2: Binding obligation*]

This Agreement constitutes a valid and binding obligation on each party, enforceable in accordance with its terms.

[*Alternative 3: Absence of litigation*]

No suit, action, arbitration, or legal, administrative, or other proceeding or governmental investigation is pending or threatened against or affecting the parties, their business or properties, their financial or other condition, or the transactions contemplated under this Agreement.

[*Alternative 4: No consent*]

No consent or approval of any other person or governmental authority is necessary for this Agreement to be effective _ _[*except* _ _[*specify*]_ _]_ _**.**

[*Alternative 5: No violation*]

Neither the execution or delivery of this Agreement nor the consummation of the transactions contemplated by it would constitute a default or violation of the parties' articles of incorporation, bylaws, or any license, lease, franchise, mortgage, instrument, or other agreement.

Comment: Parties are often asked to give representations or warranties that relate to the validity of the transaction itself, rather than the character or quality of the product sold. Such representations and warranties are typically affirmed by an opinion of legal counsel as well. See chap 12. This form contains sample provisions for these types of representations or warranties.

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§7.10 F. Disclaiming Warranties

Contracts can explicitly disclaim or modify written, oral, or implied warranties. If a contract is governed by the Commercial Code, however, certain warranties such as merchantability or fitness for a particular purpose can be disclaimed or modified only by explicit, conspicuous language. Com C §2316.

To exclude or modify the implied warranty of merchantability, the language must mention merchantability. Com C §2316(2). See §7.11. To exclude or modify any implied warranty of fitness, the exclusion need not mention the warranty of fitness by name, but it must be in writing and must be conspicuous. Language to exclude all implied warranties of fitness is sufficient if it states, *e.g.,* (see Com C §2316(2)):

There are no warranties that extend beyond the description on the face of this agreement.

Unless circumstances indicate otherwise, *all* implied warranties are excluded by the expressions "as is," "with all faults," or other language that in common understanding calls the buyer's attention to the exclusion of warranties and makes it clear that there are no implied warranties. Com C §2316(3).

When the buyer, before entering into the contract, has examined the goods or the sample or model as fully as he or she desires, or has refused to examine the goods, there are no implied warranties on defects that an examination in the circumstances should have revealed. Com C §2316(3).

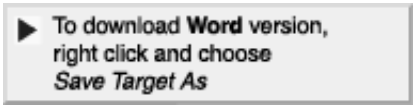
An implied warranty can be excluded or modified by course of dealing or course of performance or usage or trade. Com C §2316(3). Thus, if it is customary in a particular trade for a warranty *not* to be implied regarding certain matters (*e.g.,* the health of young livestock) or if the parties have not recognized certain warranties in the performance of the present contract or in their past dealings with each other (*e.g.,* the buyer has accepted goods that ordinarily would be refused by someone in the trade), these facts may show what warranties, if any, were intended in the transaction.

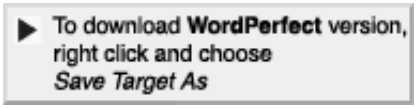
See forms in §§7.12-7.13 for disclaimer of warranties of title and warranty against infringement. See also *Dorman v International Harvester Co.* (1975) 46 CA3d 11, 120 CR 516; California UCC Sales and Leases §§3.46-3.69 (Cal CEB 2002); California Law of Contracts §6.9 (Cal CEB 2007).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/7 Factual Basis of the Agreement: Recitals, Representations, and Warranties/§7.11 1. Form: Disclaimer of Warranties of Merchantability and Fitness for Particular Purpose

§7.11 1. Form: Disclaimer of Warranties of Merchantability and Fitness for Particular Purpose





7.11-1 Disclaimer of warranties of merchantability and fitness

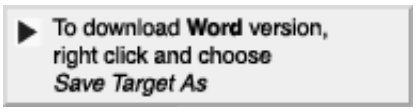
THERE ARE NO WARRANTIES THAT EXTEND BEYOND THE DESCRIPTION OF THE GOODS PROVIDED ON THE FACE OF THIS CONTRACT. SELLER DISCLAIMS ANY WARRANTY OF ANY OTHER KIND, INCLUDING ANY WARRANTY THAT THE GOODS ARE MERCHANTABLE OR FIT FOR A PARTICULAR PURPOSE.

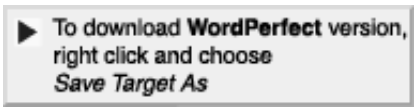
Comment: This language and the style of type are based on Com C §2316(2), which requires disclaimers of the implied warranties of merchantability and fitness to be "conspicuous," as that term is defined in Com C §1201(10). Capital letters and boldface type should be used; the statute is silent on type size.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/7 Factual Basis of the Agreement: Recitals, Representations, and Warranties/§7.12 2. Form: Disclaimer of Warranty of Title

§7.12 2. Form: Disclaimer of Warranty of Title





7.12-1 Disclaimer of warranty of title

___. *Disclaimer of Warranty of Title.* Seller disclaims:

(a) All warranties of title or warranties of Seller's right to transfer the goods;

(b) All warranties that the goods will be free from security interests, liens, or other encumbrances; and

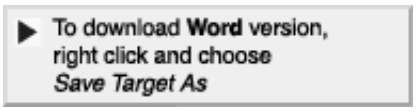
(c) Any warranty that Buyer's possession of the goods will not be disturbed.

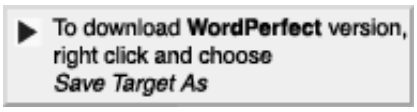
These disclaimers apply whether a warranty arises from California Commercial Code §2312(1), from expressions of Seller, by implication, or from the common law. Seller assumes no responsibility for defending whatever interest is conveyed.

Comment: If the seller is willing to warrant the title for all but a particular encumbrance, or warrant for a particular encumbrance only, the warranty may be modified to do that. Com C §2312(2). The Commercial Code does not require that a disclaimer of the title warranty be conspicuous, but a careful practitioner will make it so.

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§7.13 3. Form: Disclaimer of Warranty Against Infringement





7.13-1 Disclaimer of warranty against infringement

___. Disclaimer of Warranty Against Infringement.

[*Add one of the following alternatives*]

[*Alternative 1: Disclaimer*]

Seller makes no warranty that the goods are or will be delivered free of any person's claim of patent, trademark, copyright, or similar infringement. Buyer assumes all risks (including the risk of suit) that the goods or any use of the goods will infringe existing or subsequently issued patents, trademarks, or copyrights.

[*Alternative 2: Warranty limited to knowledge of facts*]

Seller has no knowledge which would lead it to believe that the manufacture, use, or sale of the goods will result in a claim of infringement of patents, trademarks or copyrights.

Comment: Commercial Code §2312 includes a specific warranty of good title, freedom from a security interest, and absence of a rightful claim of patent infringement. There is no warranty against future infringement, as may result from a later-issued patent. The language in this form excludes or modifies the warranty against infringement.

The Commercial Code does not require that a disclaimer of the warranty of title be conspicuous, but a careful practitioner will make it so. For discussion of the warranty against infringement, see California UCC Sales and Leases §§3.44-3.45 (Cal CEB 2002).

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V. CONSEQUENCES OF INCONSISTENCIES OR FALSE STATEMENTS

§7.14 A. Inconsistencies

Any agreement must be construed as a whole. All parts of the agreement must be considered to ascertain its meaning and the intention of the parties. CC §§1638, 1641, 1645. For example, although recitals are intended to merely set forth the parties' motivations and purposes, they will be considered in combination with all other provisions of the agreement. If the recitals and the operative clauses conflict, one being ambiguous and the other being clear, the clear language, whether in the recitals or the operative clauses, will govern interpretation of the agreement. *Schaffran v Mt. Vernon-Woodberry Mills, Inc.* (3d Cir 1934) 70 F2d 963.

Words in a contract that are wholly inconsistent with its nature, or with the main intention of the parties, will be rejected by a court interpreting the contract. CC §1653. The court will supply missing words, transpose words, or delete language to make the meaning clear. See *Howe v American Baptist Homes of the West, Inc.* (1980) 112 CA3d 622, 169 CR 418; *Heidlebaugh v Miller* (1954) 126 CA2d 35, 271 P2d 557. It will be guided in this process by the principle of construction stated in CC §1652: "Repugnancy in a contract must be reconciled, if possible, by such an interpretation as will give some effect to the repugnant clauses, subordinate to the general intent and purpose of the whole contract."

An extensive body of law discusses parties' mistakes over the meaning of clauses of the agreement. Generally, when there is an agreement between the parties but the written document does not correctly express that agreement, either because of mistake or fraud, the agreement can be reformed as long as the rights of third parties are not prejudiced. *Stafford v California Canning Peach Growers* (1938) 11 C2d 212, 78 P2d 1150; *Lane v Davis* (1959) 172 CA2d 302, 342 P2d 267; *Nunes v De Faria* (1951) 107 CA2d 794, 238 P2d 106. Once the contract is reformed, any duties or remedies in the reformed contract are binding on the parties and any old, deleted language is no longer effective. See generally CC §§3399-3402.

If both parties assume a certain state of facts to exist and enter into a contract on the faith of that assumption, they will be relieved from their bargain if the assumption is erroneous. *Call v Richfield Oil Corp.* (SD Cal 1951) 101 F Supp 972. If the mistake is by one party, however, and the second party is justifiably unaware of the first party's mistake, the contract will be upheld. *Neptune Gunite Co. v Monroe Enters.* (1964) 229 CA2d 439, 40 CR 367.

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§7.15 B. False Statements

Rescission, reformation, or even cancellation with damages may be a consequence of false statements or fraud. Fraud consists of a false representation made with knowledge of the falsity or a negligent representation not warranted by the knowledge of the party making it, coupled with an intent to induce the other party's detrimental reliance. Fraud includes suppression of the truth by one having knowledge of it, or a promise made with no intention to perform it. CC §1572. Even when there is no fraudulent intent, if a party gains an advantage by breach of a duty to the detriment of the other party, "constructive" fraud may be found. CC §1573.

Although knowledge of the false statement is usually required to support rescission or reformation, it is not always necessary. If a party makes a material misrepresentation with an honest and reasonable belief that it is true, and the other party relies on that misrepresentation, rescission may be available as a remedy. *Reliance Fin. Group v Miller* (9th Cir 1977) 557 F2d 674; *Crocker-Anglo Nat'l Bank v Kuchman* (1964) 224 CA2d 490, 36 CR 806. For rescission to be available, however, the misrepresentation must have been material to the agreement. *Reliance Fin. Group v Miller, supra*.

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8

Consideration

David C. Burgess

I. CHECKLIST: CONSIDERATION §8.1

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  - 2. Form of Variable Payment Obligation Under License Agreement Based on Net Sales
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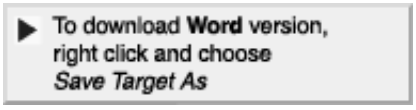
VII. NONMONETARY CONSIDERATION
- A. General Principles §8.35
- B. Form: Performance of Services §8.36
- C. Form: Transfer of Stock §8.37
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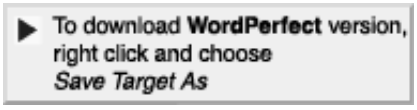
E. Form: Assumption of Liabilities §8.39

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/§8.1 I. CHECKLIST: CONSIDERATION

§8.1 I. CHECKLIST: CONSIDERATION





- Amount of consideration (see §§8.2-8.3, 8.6-8.11)
- Allocation of consideration (see §§8.4-8.5)
- Monetary consideration (see §§8.14-8.36)
- Immediate funds (see §§8.14-8.18)
- Letter of credit (see §§8.19-8.20)
- Deferred payment (see §§8.21-8.34)
- Payments (see §§8.23-8.25)
- Collateral (see §8.26)
- Usury (see §§8.27-8.29)
- Tax implications (see §§8.30-8.33)
- Securities (see §8.34)
- Nonmonetary consideration (see §§8.35-8.39)
- Performance of services (see §8.36)
- Transfer of stock (see §8.37)
- Transfer of assets (see §8.38)
- Assumption of liabilities (see §8.39)

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II. PRINCIPLES OF CONSIDERATION

§8.2 A. Consideration Defined

To be enforceable, a contract must be supported by consideration. Consideration consists of any benefit conferred or prejudice suffered, or agreed to be conferred or suffered, as an inducement for a promise, which benefit or prejudice is not otherwise legally required. CC §1605. Consideration need not be tangible; mutual obligations undertaken by each party under a bilateral contract can constitute sufficient consideration. Moreover, one party's reliance to its detriment on the promise of another can support an agreement under applicable equitable principles such as promissory estoppel.

Consideration can be in a variety of tangible forms:

- Current cash and cash equivalent payment. See §§8.14-8.18.
- Letter of credit. See §§8.19-8.20.
- Deferred money payment (*e.g.,* promissory notes). See §§8.21-8.34. See also chap 21.
- Performance of services. See §8.36.
- Shares of stock. See §8.37.
- Transfer of assets or rights. See §8.38.
- Assumption of liabilities. See §8.39.

See generally California Law of Contracts, chap 3 (Cal CEB 2007).

NOTE: Past consideration is not sufficient to support the obligations under an existing contract. For example, past payments made on a loan obligation would not necessarily be adequate or sufficient consideration for a current loan modification agreement; and past rental payments would not necessarily constitute sufficient consideration for a lease amendment. See Cal Contracts §3.47.

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§8.3 B. Identifying the Consideration

The agreement should identify the type of consideration involved in the transaction and the timing of payment or performance. The parties may also desire to allocate the consideration. See §§8.4-8.5.

NOTE: A written instrument is presumed to be supported by consideration. CC §1614. This is a rebuttable presumption, however, and therefore counsel should identify the consideration in the agreement.

Some agreements state the specific amount of consideration. In others, the payment amount may be adjusted after the agreement is signed. See §§8.6-8.11. In still other transactions, the amount of consideration may be modified by the parties' agreement to prorate various items as of the closing date, *e.g.,* taxes, insurance premiums, rents, utilities charges. See California Real Property Sales Transactions §§4.133, 5.26, 6.23, 15.43, 15.57, 15.68 (4th ed Cal CEB 2007) for discussion of and forms for prorations.

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C. Allocation of Consideration

§8.4 1. General Principles

The allocation of consideration can have important tax consequences. When purchasing the assets of a business, the buyer traditionally tries to allocate as much of the purchase price as possible to (a) noncapital assets (*e.g.,* accounts receivable and inventory) to minimize ordinary income on the collection of receivables or sale of property, and (b) assets that can be expensed, depreciated, or amortized, preferably over a short period, so that the buyer can recover the cost of these assets as soon as possible. In contrast, the buyer typically tries to allocate as little of the purchase price as possible to assets that cannot be written off or that have long recovery periods. Covenants not to compete, goodwill, going concern value, and most other acquired intangibles are ratably amortizable by the buyer over a 15-year period. IRC §197.

The seller's objectives in allocating the purchase price are generally opposite to the buyer's: The seller desires to allocate as much of the purchase price as possible to capital assets so that gains will be treated as capital gains, which typically are taxed at lower rates than ordinary gains.

WARNING: Counsel should review the client's current ordinary income and capital gains tax rates before agreeing to any specific allocation of purchase price.

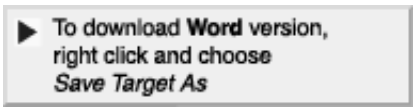
If the parties agree on an allocation of the purchase price, the agreement should include a covenant stating that the parties will report the transaction for income tax purposes in accordance with the allocations stated in the agreement. See IRC §1060. The buyer and seller will each be required to file a Form 8594 with its tax return. Treas Reg §1.1060-1(e)(1)(ii)(A).

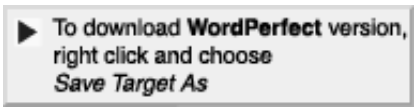
For further discussion of allocation of purchase price, see Sales and Mergers of California Businesses §§3.34-3.38, 11.15 (Cal CEB 2002).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/§8.5 2. Form: Allocation of Purchase Price

§8.5 2. Form: Allocation of Purchase Price





8.5-1 Allocation of purchase price

___. *Allocation of Purchase Price.* The Purchase Price is allocated among _ _[*e.g., the assets sold*]**_ _ as shown on the schedule attached to this Agreement as Exhibit _ _. The parties shall report this transaction for income tax purposes in accordance with that allocation.**

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III. VARIABLE AND CONDITIONAL CONSIDERATION

§8.6 A. Variable Principal Amount

A variable payment obligation is appropriate if the parties desire to make the amount of an obligation dependent on future events or conditions, as in many franchise agreements, license agreements, leases, or profit-sharing agreements. Variable payment amounts could be compounded so that the then-effective rate is multiplied by a set amount. They could also be based on a formula: *e.g.,* 5 percent of annual net sales, or a fixed amount adjusted by changes in the Consumer Price Index.

NOTE: A variable payment may also be subject to a minimum or maximum amount.

The contract should state in detail any formula used, define any relevant terms (*e.g.,* gross sales, net sales, net profits), and provide a mechanism for resolving disputes about the computation of the formula amounts. In lieu of defining relevant terms, the agreement could refer to an established standard, dictionary, or legal source for definitions. If an external index is used, such as the Consumer Price Index for the United States or for the closest metropolitan area, the agreement should precisely identify the index and the reference point (*i.e.,* the year) used in applying the index. Complete historical data regarding the Consumer Price Index can be obtained from the Bureau of Labor Statistics website at http://www.bls.gov/cpi. See form in §8.7 for language modifying rental payment when the Consumer Price Index changes. See forms in §§8.8-8.10 for a formula-based royalty payment.

Agreements for the purchase and sale of a business often provide for a variable purchase price, especially if there are fluctuating assets such as accounts receivable, inventory, or supplies, with the final price determined as of the closing date. The agreement should identify all adjustments that are to be made at or after closing and, if necessary, the procedure for evaluating these amounts (*e.g.,* valuing unsold inventory by appraisal or seller's cost). See §8.11; Sales and Mergers of California Businesses §10.16 (Cal CEB 2002).

The purchase price for a business can also be the sum of a fixed amount and a variable amount determined by the performance of the business over a specified period following closing (the "earn-out" amount). The fixed amount establishes the minimum total consideration to be paid; the parties can also establish a maximum amount to be paid. In drafting earn-out provisions, counsel should specify the standard for measuring the business's performance, the time for measuring performance, the timing of payments, and remedies for defaults in making the payments. For further discussion of earn-out provisions and forms, see Mendoza, *Structuring and Negotiating Earn-Out Arrangements*, 8 CEB Cal Bus L Prac 145 (Summer 1993); Sales and Mergers §4.17.

A shopping center lease may also require both fixed and variable payments. The lease could provide for fixed monthly rent plus an additional rent payment equal to a percentage of gross sales over a designated level. For percentage rent provisions and related comments, see Ground Lease Practice §§2.13-2.19 (Cal CEB 1971).

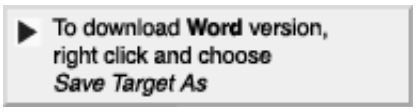
A license agreement should carefully define the kinds of transactions that give rise to a royalty and how the royalty is computed. The royalty contract in *Wolf v Walt Disney Pictures & Television* (2008) 162 CA4th 1107, 76 CR3d 585, did not specify whether nonmonetary consideration was intended to fall under the definition of "gross receipts." The *Wolf* court held that nonmonetary promotional benefits received in exchange for the licensing of cartoon characters did not constitute "gross receipts" for purposes of computing royalty payments.

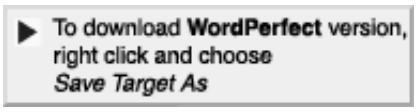
For discussion of variable interest payments, see §8.25.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/§8.7 1. Form: Adjusting Rental Payments Based on Change in Consumer Price Index

§8.7 1. Form: Adjusting Rental Payments Based on Change in Consumer Price Index





8.7-1 Adjusting rental payments based on consumer price index

___. *Adjustments to Rental Payments.* The _ _[*minimum*]_ _ monthly rent provided for in paragraph _ _ of this Agreement (the "Initial Rent") will be subject to adjustment at the commencement of the _ _ year of the term and _ _[*e.g., each year thereafter/every _ _ years thereafter*]_ _ (the "Adjustment Date") as follows:

The base for computing the adjustment is the _ _[*e.g., Consumer Price Index, All Items, U.S. City Average for All Urban Consumers, 1982-1984 equals 100*]_ _, published by the United States Department of Labor, Bureau of Labor Statistics (the "Index"), that is published most immediately preceding the date of this Agreement (the "Beginning Index"). On each Adjustment Date, the minimum monthly rent for the following _ _[*e.g., year*]_ _ until the next rent adjustment will be set by multiplying the Initial Rent by a fraction, the numerator of which is the Index published most immediately preceding the Adjustment Date in question and the denominator of which is the Beginning Index.

[*Add if rent subject to minimum and maximum change*]

In no event, however, may the minimum monthly rent be less than the monthly rent in effect immediately before the Adjustment Date then occurring, nor may the minimum monthly rent be more than _ _[*$_ _[amount*]_ _/_ _ *percent*]_ _ greater than the monthly rent in effect immediately before the Adjustment Date then occurring.

[*Continue*]

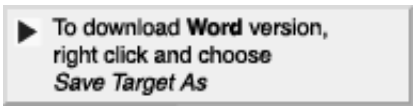
If the Index is changed so that the base year differs from that in effect when the term commences, the Index will be converted in accordance with the conversion factor published by the United States Department of Labor, Bureau of Labor Statistics. If the Index is discontinued or revised during the term, the other government index or computation with which it is replaced will be used to obtain substantially the same result that would be obtained if the Index had not been discontinued or revised. If there is no replacement index, then the parties shall agree on a mutually acceptable substitute index.

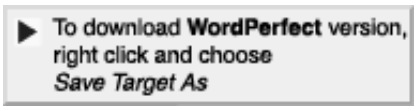
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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/ 2. Form of Variable Payment Obligation Under License Agreement Based on Net Sales/§8.8 a. Form: Amount of Royalty

2. Form of Variable Payment Obligation Under License Agreement Based on Net Sales

§8.8 a. Form: Amount of Royalty





8.8-1 Amount of royalty

____. *Amount of Royalty*.

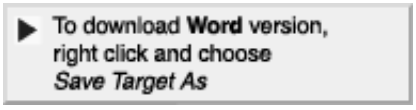
(a) Licensee will pay to Licensor a royalty for all _ _[*e.g., Chips*]_ _ sold by Licensee, in an amount equal to _ _ percent of the Net Sales Price paid to Licensee for the _ _[*e.g., Chips*]_ _.

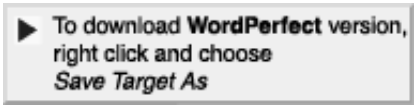
(b) As used in this Agreement, "Net Sales Price" means the amount actually received by Licensee or on Licensee's behalf from the sale of _ _[*e.g., Chips*]_ _, less the amount of all returns and freight paid by Licensee. If Licensee sells the _ _[*e.g., Chips*]_ _ as part of a sale of systems or other accessories, the Net Sales Price of the _ _[*e.g., Chips*]_ _ will be established by Licensee on the basis of the Net Sales Price of comparable _ _[*e.g., Chips*]_ _ sold separately in comparable quantities at approximately the same time.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/§8.9 b. Form: Payment Terms

§8.9 b. Form: Payment Terms





8.9-1 Payment terms

____. *Payment Terms*.

(a) All royalties due to Licensor under this Agreement will be computed _ _[*e.g., quarterly*]_ _**, as of** _ _[*time of computation, e.g., the last day of each calendar year quarter during the term of this Agreement*]_ _**, and will be paid to Licensor** _ _[*time of payment, e.g., no more than 20 days after the end of each such quarter*]_ _**.**

(b) Computation of the royalty due Licensor for any given quarter will be based on the revenues actually received by Licensee during that quarter from the sale of the _ _[*e.g., Chips*]_ _**. If during any quarter Licensee receives only a portion of the total amount due Licensee from a given sale of the** _ _[*e.g., Chips*]_ _**, the royalty due Licensor for that quarter from the sale will be the amount that bears the same relationship to the total royalty due Licensor as a result of the sale as that portion received by Licensee during the quarter bears to the total amount due Licensee as a result of the sale.**

(c) If Licensee is required to refund any revenues that it received in a sale for which royalties were paid under this Agreement, Licensee will be entitled to a refund from Licensor of a portion of the royalties paid as a result of the sale that bears the same relationship to the total royalty paid as a result of the sale as the portion refunded by Licensee bears to the total amount initially received by Licensee as a result of the sale (the "Refund Amount").

[*Add one of the following alternatives*]

[*Alternative 1: Licensor refunds on demand*]

Licensor will pay the Refund Amount to Licensee within _ _[*e.g., 10 calendar days*]_ _ **after receiving notice from Licensee.**

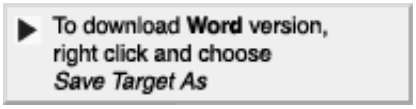
[*Alternative 2: Licensee deducts from next payment*]

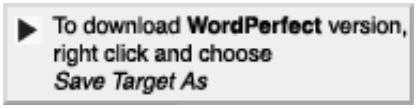
Licensee may deduct the Refund Amount from the next payment of royalties due. If no further payments of royalties are due, Licensor will pay any unpaid portion of the Refund Amount to Licensee within _ _[*e.g., 10 calendar days*]_ _ **after receiving notice from Licensee.**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/§8.10 c. Form: Review of Records to Verify Amount Due

§8.10 c. Form: Review of Records to Verify Amount Due





8.10-1 Review of records

____. *Review of Records.*

(a) Licensee will keep complete records relating to the sale of the _ _[*e.g., Chips*]_ _ by Licensee, including without limitation billing and payment records, throughout the term of this Agreement and for 3 years after termination of this Agreement. Licensee will provide to Licensor, within 20 days after the end of each calendar year quarter during the term of this Agreement, a statement of the sales of the _ _[*e.g., Chips*]_ _ made during such quarter. On written request by Licensor, Licensee will allow Licensor to have access, during ordinary business hours, to such of Licensee's books and financial records as may be necessary to calculate the royalty for any quarter during the term of this Agreement.

(b) On written request by Licensor, Licensee will allow an independent certified public accountant who is mutually acceptable to Licensee and Licensor to have access, during ordinary business hours and for as many days as the accountant requires, to such of Licensee's books and financial records as necessary to calculate the royalty for any quarter during the term of this Agreement. If Licensee and Licensor cannot agree on the selection of an independent accountant, each of them will select a certified public accountant, and the two accountants so selected will choose a third independent certified public accountant who will then review Licensee's books and records to determine the amount of the royalty.

(c) The determination of the amount of the royalty by the accountant will be final and binding on the parties. If the accountant finds any discrepancy between the amount of royalty due and the amount of royalty paid for such quarter, the difference will be paid by Licensee to Licensor, or refunded by Licensor to Licensee, as the case may be, within _ _[*e.g., 3 calendar days*]_ _ after written notice of the discrepancy is given to both parties. If the amount of royalty paid for any quarter is less than _ _[*e.g., 95 percent*]_ _ of the amount due, Licensee will pay all accounting costs; in all other instances, Licensor will pay all accounting costs. Licensee will bear all other costs of access to its books and records.

(d) The accountant will hold Licensee's financial information and trade secrets in confidence and will disclose to Licensor only the amount of the royalty due Licensor.

Comment: Review by an independent certified public accountant can be expensive and disruptive to the licensee. This form is designed to discourage the licensor from making a frivolous request for a review by allocating the expense of the review to the licensor unless the licensee underpaid the royalty by more than a trivial amount (*e.g.,* 5 percent).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/§8.11 3. Form: Adjusting Purchase Price Based on Fluctuating Assets

§8.11 3. Form: Adjusting Purchase Price Based on Fluctuating Assets

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8.11-1 Adjusting purchase price based on fluctuating assets

___. *Adjustments to Purchase Price.* The Purchase Price will be increased by an amount equal to the aggregate of (1) the total of all accounts receivable that are not more than _ _ days old and (2) the cost to _ _[*e.g., Seller*]**_ _ of its inventory and supplies,**

[*Add if maximum amount stated*]

but in no event may the Purchase Price exceed $_ _[*amount*]**_ _.**

[*Continue*]

On the Closing Date, _ _[*e.g., Seller*]**_ _ shall deliver to _ _**[*e.g., Buyer*]**_ _ a schedule of all accounts receivable and their amounts, together with a correct and complete aging of the accounts; and a schedule of all inventories of raw materials, work in process, finished goods, and supplies, together with their cost, all as of the close of business on the last business day before the Closing Date.**

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§8.12 B. Participating Loans

A participating loan is a financing vehicle involving a variable payment obligation. It is a cross between a debt and an equity investment and is most often seen in real estate development projects. Many variations have been established, but a lender under a participating loan is commonly entitled to:

- A minimum fixed rate of interest, payable currently (*e.g.,* 10 percent annually);
- A portion of operating profits, payable currently (*e.g.,* 10 percent of the positive cash flow from the property); and
- A percentage of any appreciation on the property, payable on the earlier of (1) maturity of the loan, based on a then current appraisal, or (2) sale or refinancing of the property, based on the proceeds from the sale or refinancing.

Because it is unclear whether the investor is a lender, a joint venturer, or both, a participating loan raises various tax issues. See California Real Estate Finance Practice: Strategies and Forms §1.52 (Cal CEB 2000); Burnes, *The Shared Appreciation Mortgage—A Joint Venture, a Relationship Between Debtor and Creditor, or Both?* 12 J Real Est Tax 195 (1985); Strauss, *Tax Aspects of Equity Participation Financing*, NYU 41st Inst on Fed Tax'n, chap 21 (1983).

A participating loan also raises usury law issues. See §§8.27-8.28.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/§8.13 C. Conditional Payment Obligations

§8.13 C. Conditional Payment Obligations

The timing of a payment may be based on satisfaction of a specified condition. For example, a loan payment may be required only for months in which the borrower's net profits exceed a designated level. A conditional payment obligation can protect the obligor from contingencies that make fulfilling a fixed payment obligation difficult or impossible. Conversely, an unduly attenuated payment obligation can result in an indefinite deferral of payments, even when the obligor is able to make payments. Therefore, before agreeing to a conditional payment obligation, the obligee should ascertain the likelihood that the specified conditions will occur, the likelihood of payment, and the obligee's own ability to withstand deferral.

PRACTICE TIP: The obligee should include language for independent review and enforcement of the minimum obligation to prevent a failure or unlimited deferral of payment.

Conditional payment obligations may create tax complications. If the conditions are such that payment within a reasonable time is unlikely, the obligation may be recharacterized by the Internal Revenue Service as a gift or, if a shareholder has advanced money to a corporation, as the issuance of stock in the corporation. See IRC §385; Organizing Corporations in California §1.146 (3d ed Cal CEB 2001). In either situation, the parties may suffer adverse tax consequences. Counsel should analyze any conditional payment obligation at the negotiation and drafting stages to plan around any IRS challenges during a tax audit.

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IV. CASH AND CASH EQUIVALENT CONSIDERATION

§8.14 A. General Principles

A party negotiating to receive payment in cash presumably wants to receive it immediately in liquid form. The term "cash," however, encompasses a variety of forms of payment, some of which are more liquid than others. Requiring literal payment of cash is usually impractical unless the payment is quite small; most parties do not want or expect to walk out of closing carrying $200,000 in $10 bills. On the other hand, some forms of payment, although arguably in the category of "cash," are not immediately liquid and may even be uncollectible (*e.g.,* a personal check drawn on an out-of-state bank).

Thus, the agreement should specify the kinds of "cash" payments that are acceptable; *e.g.,* cash, cashier's check, certified check, or wire transfer. See §§8.15-8.18. All these forms of payment meet the party's desire to receive payment in liquid form.

NOTE: Under California law, title companies are required to wait specified periods of time, depending on how funds are deposited with them, before making funds available for disbursal. For example, a title company may make funds available on the day funds are deposited with the title company by wire transfer; the following day if funds are deposited by cashier's or certified check; and 2 to 5 days later in most other cases. Ins C §12413.1.

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§8.15 B. Cashier's Check and Certified Check

A cashier's check is a check drawn on a bank, signed on behalf of the bank, as a direct obligation of the bank, and provided for remittance purposes. 12 CFR §229.2(i). A certified check certifies that the drawer's signature is genuine and that the bank has set aside funds to pay the check on its presentment. 12 CFR §229.2(j). The bank is directly liable on either a cashier's check or a certified check. Both types of checks are usually unstoppable, although a bank may refuse to pay on a cashier's or certified check in certain limited circumstances.

The holder of a cashier's or certified check may encounter a delay of at least several days in receiving payment on the check, particularly if the check is from an out-of-state bank. This potential delay can be avoided by requiring the use of clearinghouse funds in the city where payment is to be made.

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§8.16 C. Wire Transfer Funds

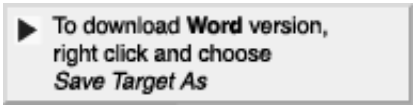
A wire transfer puts money from one account directly into another within several hours, or 1 business day if many transactions tie up the wires. An electronic funds transfer may entail additional expense, which may or may not be offset by the ability to keep the funds in an interest-bearing account for a longer time.

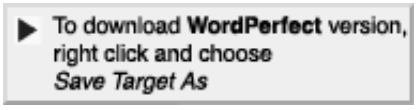
To enable the paying party to make payment by wire transfer, the recipient should provide wire transfer instructions before closing that include the name and address of the receiving financial institution, the routing number, the account number, and other instructions necessary for the funds to be wired. These instructions can be included in the agreement or provided by separate notice before payment is to be made.

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§8.17 D. Form: Payment by Cashier's or Certified Check





8.17-1 Payment by cashier's or certified check

___. *Form of Payment.* At Closing, _ _[*e.g., Buyer*]**_ _ shall pay to _ _**[*e.g., Seller*]**_ _ in cash _ _**[*$_ _*[*amount*]**_ _/the _ _**[*balance of the*]**_ _ Purchase Price*]**_ _ by cashier's or certified check in _ _**[*city and state*]**_ _ clearinghouse funds.**

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§8.18 E. Form: Payment by Wire Transfer

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8.18-1 Payment by wire transfer

___. *Form of Payment.* At Closing, _ _[*e.g., Buyer*]_ _ shall pay to _ _[*e.g., Seller*]_ _ in cash _ _[*$_ _[amount*]_ _/*the _ _[balance of the*]_ _ *Purchase Price*]_ _ by wire transfer _ _. _ _[*e.g., Seller*]_ _ will give wiring instructions to _ _[*e.g., Buyer*]_ _ at least _ _[*e.g., 5*]_ _ days before Closing.

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V. LETTERS OF CREDIT

§8.19 A. General Principles

A letter of credit is a definite undertaking by an issuer, typically a bank, at the request of an applicant to honor a documentary presentation by a beneficiary (the person entitled to draw on the letter of credit) by payment or delivery of an item of value. Com C §5102(a)(10). The issuer generally is required to honor a demand for payment upon the presentation by the beneficiary of required documents that appear on their face strictly to comply with the terms and conditions of the letter of credit. Com C §5108(a). In evaluating a demand, the issuer may consider only the documents presented by the beneficiary, as opposed to the performance or nonperformance of the underlying contract, arrangement, or transaction, or other nondocumentary conditions. Com C §§5108(f)(1), 5108(g). Indeed, the issuer may, and sometimes must, honor a presentation by a beneficiary that appears on its face strictly to comply with the terms and conditions of the letter of credit, even if a required document is forged or materially fraudulent. Com C §5109(a). In certain limited circumstances of alleged forgery or material fraud, an applicant may obtain an injunction preventing the issuer from honoring a demand for payment under a letter of credit. Com C §5109(b). See Weise, *A Primer on Letters of Credit Under New Division 5*, 18 CEB Cal Bus L Rep 176 (Mar. 1997).

Letters of credit can ensure payment, and are often an acceptable cash substitute, in international transactions and in other transactions involving the purchase and sale of goods, especially if the purchaser is not well known to the seller or is not financially reliable. The beneficiary of a letter of credit frequently requires that the letter of credit be irrevocable, *i.e.,* that it can be modified or revoked only with the beneficiary's consent. A letter of credit is irrevocable unless it provides to the contrary. Com C §5106(a). The beneficiary should confirm that the issuer of the credit is financially responsible.

Letters of credit also can be useful in real estate transactions. A letter of credit is sometimes used as security for a tenant's obligations under a commercial lease of real property. Amounts drawn on such a letter of credit have been held to apply to, rather than being independent of, the statutory cap on claims by the landlord against the estate of a bankrupt debtor. *AMB Prop., LP v Official Creditors for the Estate of AB Liquidating Corp. (In re AB Liquidating Corp.)* (9th Cir 2005) 416 F3d 961; *Redback Networks, Inc. v Mayan Networks Corp. (In re Mayan Networks Corp.)* (BAP 9th Cir 2004) 306 BR 295, 298. The result in *Mayan Networks* seemed to depend on the fact that the letter of credit was secured by cash deposits of the tenant. Neither *AB Liquidating Corp.* nor *Mayan Networks* ruled on the issue of whether the landlord's ability to draw on the letter of credit is limited to the amount of the cap, because the amount of the letter of credit in both cases was less than the cap. In light of these cases, counsel should consider bankruptcy issues in advising a landlord on the value of a letter of credit used to secure a tenant's lease obligations.

A lender's draw on a letter of credit given as additional security for a real property loan will not violate California's one form of action or antideficiency rules, whether done before or after the judicial or nonjudicial foreclosure of the mortgage or deed of trust or conveyance in lieu thereof. CCP §580.5; *Western Sec. Bank v Superior Court* (1997) 15 C4th 232, 62 CR2d 243. However, a letter of credit is not enforceable security in certain residential real estate loan transactions. CCP §580.7.

For extensive discussion of letters of credit, see Financing and Protecting California Businesses, chap 9 (Cal CEB 2006).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/§8.20 B. Form: Payment by Letter of Credit

§8.20 B. Form: Payment by Letter of Credit

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8.20-1 Payment by letter of credit

___. *Form of Payment.* At Closing, _ _[*e.g., Buyer*]**_ _ shall deliver to _ _**[*e.g., Seller*]**_ _ an irrevocable letter of credit _ _**[*from _ _*[*identify issuing bank*]**_ _**]**_ _ in the amount of _ _**[*$_ _*[*amount*]**_ _/the _ _**[*balance of the*]**_ _** *Purchase Price*]**_ _ in the form attached to this Agreement as Exhibit _ _.**

Comment: Counsel should carefully review letters issued in the "issuer's form" to verify consistency with agreed on conditions.

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VI. DEFERRED PAYMENT

§8.21 A. General Principles

Consideration under a contract may be continuing. In a contract for the performance of services, for example, payments are usually paid in installments corresponding to specific periods of performance of the services. Similarly, a distribution agreement typically provides that the distributor will pay the supplier at the future times when products are delivered to the distributor. Some of the concerns relating to such future payments are the same as those relating to immediate cash payments or letters of credit. See §§8.14, 8.19. However, additional concerns arise when one party acts currently in return for, or in reliance on, payment that will not be received until some later time.

A deferred payment obligation is usually evidenced by the promissory note of the person required to make payment (the maker or obligor). Counsel should attach the form of promissory note to the agreement and briefly describe the terms of the note in the body of the agreement to give the parties (and any other readers of the contract) a summary description of the payment obligation. On nonpayment of a note, the person to whom the payments are made (the payee or obligee) can sue the obligor for monetary damages, but may not be able to sue for rescission of the underlying agreement, because the obligor arguably fulfilled his or her obligation under the agreement by executing and delivering the promissory note. To preserve the rescission remedy, the payee should require the obligor to agree in the underlying agreement to pay the consideration in accordance with payment terms evidenced by the promissory note.

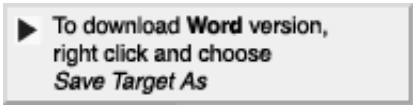
See §§8.21-8.34 for discussion of concepts important in structuring deferred compensation provisions; see chap 21 for forms of notes.

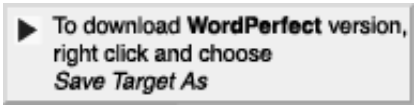
WARNING: A party is not always entitled to sue for monetary damages. The recipient of a note secured by a deed of trust on real property that has nonjudicially foreclosed on the real property generally is precluded from obtaining a deficiency (or monetary) judgment against the obligor under the note. CCP §580d. Deficiency judgments are also prohibited after foreclosure on real property securing a purchase money deed of trust. CCP §580b.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/§8.22 B. Form: Note to be Delivered at Closing

§8.22 B. Form: Note to be Delivered at Closing





8.22-1 Note to be delivered at closing

___. *Delivery of Note.* At Closing, _ _[*e.g., Buyer*]**_ _ shall deliver to _ _**[*e.g., Seller*]**_ _ its executed promissory note, dated as of the Closing Date, in the original principal amount of _ _**[*$_ _*[*amount*]**_ _/the _ _**[*balance of*]**_ _ the Purchase Price*]**_ _ in the form attached to this Agreement as Exhibit _ _ (the "Note").**

[*If applicable, add one or more of the following options*]

[*Option 1: Note secured by deed of trust*]

The Note will be secured by a deed of trust on real property located at _ _[*identify property*]**_ _ in the form attached to this Agreement as Exhibit _ _ (the "Deed of Trust"). _ _**[*E.g., Buyer*]**_ _ shall deliver the duly executed and acknowledged Deed of Trust to _ _**[*e.g., Seller*]**_ _ at Closing.**

[*Option 2: Note secured by guaranty*]

The Note will be guaranteed by _ _[*identify guarantor*]**_ _ (the "Guarantor") pursuant to a guaranty in the form attached to this Agreement as Exhibit _ _ (the "Guaranty"). _ _**[*E.g., Buyer*]**_ _ will cause Guarantor to execute and deliver the Guaranty to _ _**[*e.g., Seller*]**_ _ at Closing.**

[*Option 3: Note secured by letter of credit*]

The Note will be secured by an irrevocable letter of credit _ _[*from _ _*[*identify issuing bank*]**_ _]_ _ in the amount of _ _**[*$_ _ _ _ _ _/the principal amount of the Note/the _ _*[*balance of*]**_ _ the Purchase Price*]**_ _ in the form attached to this Agreement as Exhibit _ _ (the "Letter of Credit"). _ _**[*E.g., Buyer*]**_ _ shall deliver the Letter of Credit to _ _**[*e.g., Seller*]**_ _ at Closing.**

Comment: Other forms of collateral can be used in place of, or in addition to, those identified above.

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§8.23 C. Payment Terms

The terms of a deferred payment obligation vary according to the parties' needs, desires, and abilities. The primary components of the payment obligation are the schedule of payments and the rate of interest. The payments under the note, whether of principal, interest, or both, can be fixed, variable, conditional, or a combination of these.

A loan is presumed to bear interest unless expressly stated otherwise in writing. CC §1914. But see Com C §3112(a) (an instrument is not payable with interest unless otherwise provided in the instrument). Unless otherwise provided, interest on an interest-bearing instrument is payable from the date of the instrument. If the instrument provides for interest but the amount of interest cannot be ascertained, interest is payable at the judgment rate. Com C §3112.

PRACTICE TIP: To avoid ambiguity or misunderstanding, the agreement should expressly state the rate of interest, or the lack of interest if so intended.

An interest rate can be fixed or variable. A fixed interest rate provides certainty and simplicity, while a variable rate allows for adjustments corresponding to changes in economic conditions. For discussion of variable and conditional payment obligations, see §§8.6-8.13.

The Ninth Circuit held that a creditor that imposes a flat finance charge on a tax refund anticipation loan need not refund a portion of the charge as "unearned interest" under 15 USC §1615 when the loan is repaid early because §1615 was not intended to apply to finance charges that do not vary according to the term of the loan. *Davis v Pacific Capital Bank, NA* (9th Cir 2008) 550 F3d 915. It should be noted that whether a charge will be deemed "interest" varies under different statutes, regulations, and case law.

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§8.24 1. Fixed Payment Obligations

Although fixed payment obligations may be with or without interest, the Internal Revenue Service imputes interest on certain deferred payment obligations that do not provide for interest. See IRC §483. For discussion of imputed interest, see §8.31.

The following are four major kinds of fixed payment obligations. Their various features can be combined to create additional alternatives:

(1) A fully amortized obligation provides for equal periodic (*e.g.,* monthly) payments until the obligation is exhausted. Although the periodic payment amounts remain the same, the portion of each payment allocated to principal gradually increases over time, and the portion of each payment allocated to interest gradually decreases over time. Generally, the final payment for a fully amortized obligation is described in terms similar to a balloon payment; *i.e.,* an obligation payable monthly for 5 years could state that the obligee will pay 59 installments of a certain amount "together with a final payment in an amount equal to all amounts due and payable."

(2) Equal principal payments plus interest require the obligor to make periodic payments consisting of a fixed amount of principal, plus the amount of accrued interest then owing. The amount of interest payments gradually decreases over time as the principal balance decreases, so the total amount payable on each payment date also decreases over time.

(3) Scheduled payments are based on a schedule stating a series of payment dates and the amount owing on each date. The schedule can list the exact amount owing or provide a formula for calculating the amount payable (*e.g.,* 10 percent of net operating income). This method can be used to adjust payment dates and amounts to the circumstances of the parties; the size and frequency of payments can be varied, depending on when the obligor expects to be most able to make payments or when the obligee's need for payment is greatest.

(4) "Balloon" payments defer principal (and sometimes interest) until the balloon date, at which time all amounts owing are due and payable. If interest payments made during the course of the obligation are less than the amount of accrued interest, negative amortization occurs, *i.e.,* the outstanding *principal* balance may increase over the term of the obligation. Balloon payment obligations create obvious collection risks for the obligee. Because payment of the full amount of the obligation is based on the obligor's financial condition at a particular time or on the obligor's ability to obtain other financing, it generally presupposes the appreciation of the obligor's property or some other improvement in the obligor's economic situation or cash flow position.

WARNING: The obligee may be required to give special notice of the balloon payment to the obligor if the obligation is secured by residential real property. Failure to give proper notice may result in extension of the due date for the payment. CC §§2924i, 2966.

For form language for each of these payment alternatives, see chap 21.

Although principal and interest payments are usually due on the same date, they do not have to be. For example, a note could provide that accrued interest is payable monthly but principal payments are payable annually.

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§8.25 2. Variable Interest Payments

Common standards for variable interest rates include, among others, the prime rate of a specified bank, the federal discount rate, LIBOR (the London Interbank Offered Rate), or the applicable federal rate in effect under IRC §1274(d). An agreement using a variable interest rate should precisely define the relevant standard and include an alternative standard to be used if the original one is discontinued or amended. The variable interest rate is often calculated as a percentage of the specified standard or several points above or below it.

The agreement should also specify how often the parties will adjust the interest rate and the effect of an interest rate change on the payment schedule. Generally, payments change to reflect interest rate changes. If the interest rate increases but the periodic payment amount remains the same, negative amortization may result.

Because the use of a variable interest rate entails a certain amount of administrative complexity (*e.g.,* recomputations of interest due and the corresponding changes in amounts payable), a variable rate is not always appropriate. The administrative burden may be lessened, however, by adjusting rates relatively infrequently (*e.g.,* annually).

Interest may not be compounded unless an agreement in writing, signed by the party to be charged, provides for compound interest. Cal Const art XV, §1. If the parties desire that interest be compounded, the contract should so specify and should state how often interest will be compounded.

For language to include in a promissory note with a variable interest rate, see forms in chap 21.

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§8.26 D. Protective Provisions

A party accepting a deferred payment obligation can take steps to increase the likelihood of full payment or the availability of adequate remedies if the obligor defaults. The obligee can minimize the amount of the deferred obligation by requiring as large a downpayment as possible. By requiring frequent installments and a short payment term, the obligee can more quickly discover whether the obligor is having financial difficulties. At the first sign of a problem, the obligee can consider available remedies or take other protective actions.

Although full amortization of principal and equal principal payments plus interest are usually desirable from the obligee's standpoint, smaller principal payments coupled with one or more balloon payments may be necessary if the obligor will not be able to make regular principal payments. See §8.24 for discussion of balloon payment risks.

An obligee's most effective protection is adequate security or personal guaranties from parties of adequate means. The value of the security should be evaluated in two ways: First, would the amount actually realized, if the obligee were required to sell the collateral, satisfy the obligation? Second, will the security encourage the obligor to make payments rather than walk away from the transaction if it is financially troubled? For discussion of guaranties, see chap 22. For form language providing a deed of trust, guaranty, or letter of credit as security for a note, see §8.22.

EXAMPLE: The market value of a corporation's assets may not be sufficient to repay the entire obligation. A personal guaranty of a principal of the corporation or a mortgage on the principal's home may be worth less in monetary terms than the corporation's assets, but it may keep the principal interested, cooperative, and working hard to assure that the entire obligation is repaid.

NOTE: Counsel should be aware of the one-form-of-action rule of CCP §726 and the antideficiency rules of CCP §§580b and 580d when structuring a payment obligation secured by real property. See California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 4-5 (4th ed Cal CEB 2009).

An acceleration clause allows the obligee to declare the entire obligation due and payable on a default under the contract. If the obligation does not include an acceleration clause, the obligee can sue only for those installments in default. For example, if payments were due monthly, the obligee would be required to bring a lawsuit each month that a payment is missed. An acceleration clause allows the obligee to immediately pursue the obligor for the entire obligation once the obligor has shown financial weakness or irresponsibility by missing a payment or otherwise defaulting under the agreement. See form in §15.46 for language of an acceleration clause.

PRACTICE TIP: If the property encumbered by a deed of trust contains four or fewer units (or four or fewer units are to be built on the property), then an acceleration clause is not valid unless the clause is stated in its entirety in both the deed of trust and the note. CC §2924.5.

Failure to make payments when due results in increased administrative costs for the obligee, even if legal action is unnecessary. Therefore, the obligee should consider imposing collection costs and penalties (such as late fees, liquidated damages, or higher interest payments) on the obligor, regardless of whether litigation ensues or attorneys assist in collection. The validity of liquidated damage provisions under California law, however, is limited by statute. CC §§1671, 1675-1678. Many other states are less restrictive than California in enforcing liquidated damages clauses. On liquidated damages, see §§15.4-15.5.

EXAMPLE: In *Poseidon Dev., Inc. v Woodland Lane Estates, LLC* (2007) 152 CA4th 1106, 62 CR3d 59, a promissory note provision for a 10-percent late charge on overdue "installments" was held to not apply to the final balloon payment. The court concluded that the parties intended the late-charge provision to apply only to the monthly interest-only payments. Moreover, applying the provision to the balloon payment would have resulted in a late charge of $77,641, which would have been an unenforceable penalty. *Poseidon* highlights the need for counsel to be very precise in preparing late payment provisions and to take into account the legal restrictions on liquidated damage clauses.

NOTE: Interest payments on overdue commercial accounts are not subject to usury laws. *Southwest Concrete Prods. v Gosh Constr. Corp.* (1990) 51 C3d 701, 274 CR 404. For discussion of usury, see §§8.27-8.29.

Alternatively, the parties may want to provide for mandatory alternative dispute resolution to reduce enforcement costs. See chap 16 for discussion of the advantages, disadvantages, and mechanics of different methods of dispute resolution.

Last, an obligee can protect itself by providing that the payment obligation be senior to existing, as well as future, obligations of the obligor, so that the obligee will be paid first if available funds are limited. Existing creditors should agree to subordinate their rights to the new payment obligation before closing.

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E. Usury Law Considerations

§8.27 1. General Rules

The interest rate specified in a contract for a loan or forbearance of money, goods, or things in action for use primarily for personal, family, or household purposes may not exceed 10 percent per annum. For a loan or forbearance of money, goods, or things in action for any other use, the specified interest rate may not exceed the greater of 10 percent per annum, or 5 percent per annum in excess of the rate (the "discount rate") established by the Federal Reserve Bank of San Francisco (FRBSF) on advances to member banks and prevailing on the 25th day of the month preceding the earlier of (1) the date of execution of the contract to make the loan or forbearance or (2) the date of making the loan or forbearance. Cal Const art XV, §1. Both current and prior FRBSF discount rates are available at http://www.frbsf.org/banking/data/discount/index.html. Five percent is then added to the current discount rate to determine the usury limit. Cal Const art XV, §1(2).

Despite a stated usurious interest rate, an obligation is not usurious if the parties intended to limit the interest rate to the highest nonusurious rate. Thus, a savings clause refunding excess interest paid or applying it to the principal balance of the obligation can prevent a finding of usury. See *Smith v Miller* (*In re Dominguez*) (9th Cir 1993) 995 F2d 883. See also the form of savings clause in §8.29. For further discussion of usury laws, see §21.28.

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§8.28 2. Exceptions to General Rules

Many entities are exempt from the general usury law restrictions, including institutional lenders (*e.g.,* banks, savings and loan associations, credit unions), licensed personal property brokers, and licensed real estate brokers. The California Legislature may set the maximum interest rate applicable to these exempt parties. Cal Const art XV, §1. For a list of constitutional and statutory exemptions, see California Real Estate Finance Practice: Strategies and Forms §§3.39-3.40 (Cal CEB 2000).

In addition, not all instruments are subject to the general usury law. For example, debt instruments qualified under Corp C §25116, and those who purchase and hold them, are exempt. Debt instruments, purchasers, and holders that meet specified rating standards are exempt, as are certain qualifying debt instruments if the issuer has any security listed or approved for listing on a national securities exchange or the National Market System of the NASDAQ Stock Market. See Corp C §25117.

Corporations Code §25118(a)-(b) provides two additional usury exemption for certain commercial loans:

(1) Loans to an entity that has total assets of at least $2,000,000 according to its then most recent financial statements prepared either in accordance with GAAP or in accordance with the rules and requirements of the Securities Exchange Commission, and that meets certain other criteria set forth in Corp C §25118, are exempt from California usury laws. The foregoing exemption also applies to loans that are guaranteed by an entity that is an affiliate of the borrower that meets the foregoing test.

(2) Loans aggregating at least $300,000 in original face amount at the time of issuance and loans issued under a written commitment for the lending of at least $300,0000 are also exempt from the California usury laws, provided that the loans meet certain other criteria set forth in Corp C §25118.

These exemptions do not apply to loans made or guaranteed by individuals, a revocable trust having one or more individuals as trustors, or partnerships in which, at the time of issuance, one or more individuals are general partners. Corp C §25118(e)(1). In addition, the §25118 exemptions do not apply unless (1) the lender and borrower (or guarantor) have a preexisting personal or business relationship, or (2) the lender and borrower (or guarantor) by reason of their own business and financial experience or that of their professional advisers, can reasonably be assumed to have the capacity to protect their own interests in connection with the loan transactions. Corp C §25118(f).

Plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001-1461) are exempt from usury restrictions under CC §1917.220. However, it has been held that ERISA preempts §1917.220 but does not preempt the general usury law, with the result that ERISA plans *are* subject to the usury limitations. *Varr v Olimpia* (1996) 45 CA4th 675, 53 CR2d 106.

The sale of property to be paid for in installments is not a "forbearance" of money under the general California usury law; therefore, the seller is not subject to the usury restrictions if the purchase price is paid under a promissory note. See California Real Property Sales Transactions §9.6 (4th ed Cal CEB 2007); California Mortgages, Deeds of Trust, and Foreclosure Litigation §1.21 (4th ed Cal CEB 2009). Other statutes, however, may limit the interest rate charged on a deferred payment sale. See, *e.g.,* Unruh Act (CC §§1801-1812.20) (retail credit and installment sales generally); Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.54) (sales of motor vehicles by commercial sellers).

Interest payments on overdue commercial accounts are also not subject to usury laws. *Southwest Concrete Prods. v Gosh Constr. Corp.* (1990) 51 C3d 701, 274 CR 404.

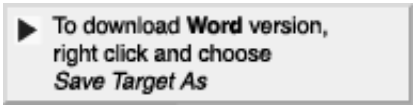
A "shared appreciation loan" is exempt from the usury law. CC §1917.005. A "shared appreciation loan" is a loan secured by an interest in real property that obligates the borrower to pay the lender contingent deferred interest; it does not include a loan secured by an interest in real property containing one to four residential units, at least one of which is or is to be occupied by the borrower at the time the loan is made. CC §1917(b). A participating loan (see §8.12) not meeting the shared appreciation loan requirements nevertheless may be exempt from the usury law under the "interest contingency rule." This rule applies when the lender's return is subject to a contingency, over and above the risk of nonpayment that comes with any loan, that puts the lender's profit wholly or partially in hazard. *WRI Opportunity Loans*

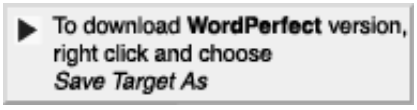
II, LLC v Cooper (2007) 154 CA4th 525, 533, 65 CR3d 205; *Thomassen v Carr* (1967) 250 CA2d 341, 346, 58 CR 297. See §21.28 for further discussion of usury law exemptions.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/§8.29 3. Form: Provision for Usury Limitation

§8.29 3. Form: Provision for Usury Limitation





8.29-1 Usury limitation

___. *Usury Limitation.* Despite anything to the contrary in this Agreement, the total liability for interest payments may not exceed the limits, if any, imposed by the usury laws of the State of California. Any interest paid in excess of those limits will be refunded to _ _[*e.g., Borrower*]_ _ by applying the amount of excess interest paid against any sums outstanding in the order required by _ _[*e.g., Lender*]_ _. If the amount of excess interest paid exceeds the sums outstanding, the portion exceeding those sums will be refunded in cash to _ _[*e.g., Borrower*]_ _ by _ _[*e.g., Lender*]_ _. To ascertain whether any interest payable exceeds the limits imposed, any nonprincipal payment, including without limitation prepayment fees and late charges, will be deemed to the extent permitted by law to be an expense, fee, premium, or penalty rather than interest.

Comment: For a usury savings clause in the context of a promissory note, see §21.29. For a usury savings clause in the context of an equipment lease, see Financing and Protecting California Businesses §10.59 (Cal CEB 2006). For further discussion of usury in California, see Martinson & Jain, *California Usury Law for the Lender's Lawyer*, 20 Cal Bus L Prac 1 (Winter 2005).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/§8.30 F. Tax Law Considerations

§8.30 F. Tax Law Considerations

Some transactions are driven by tax law considerations. Because of the complexity of federal and state tax laws, counsel should consider whether association with a tax law specialist is appropriate. See §2.16.

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§8.31 1. Imputed Interest

The California usury law restricts the *maximum* interest rate that may be charged on a loan or forbearance of money (see §8.27); the Internal Revenue Code establishes limitations on the *minimum* interest rate that may be charged on certain loans and other deferred payment obligations. If the stated interest on the obligation is less than the required minimum, interest income is imputed to the seller (and the buyer is generally entitled to a deduction in the same amount) over the duration of the obligation. See IRC §§1271-1275 (original issue discount (OID) rules); IRC §483 (imputed interest rules); IRC §7872 (specified below-market loans). See also Bilter, *Interest-Free Loans—Boon or Bust?* ¶2300, USC Tax Inst (1985).

NOTE: The minimum federal rates (*i.e.*, the applicable federal rates) are published monthly by the Internal Revenue Service and vary according to the term of the debt obligation (*i.e.,* 3 years or less, more than 3 but not more than 9 years, or more than 9 years). IRC §1274(d). The rates are set forth in monthly revenue rulings and can be obtained by accessing the Internal Revenue Service website at http://www.irs.gov and searching for "applicable federal rates."

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§8.32 2. Deductibility

Interest payments on a deferred obligation are generally fully deductible to the buyer and fully taxable to the seller. However, the Internal Revenue Code makes several exceptions to this rule, which serve to limit or completely deny the buyer's interest deduction in certain cases, *e.g.,* the deduction of personal interest is disallowed and the deduction of investment interest is limited. IRC §§163(d), (h).

PRACTICE TIP: The deductibility or nondeductibility of interest payments may affect the client's determination of the amount of consideration and payment terms. Counsel should discuss this issue with the client.

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§8.33 3. Installment Sales

An installment sale is defined for federal income tax purposes as a disposition of property in which at least one payment is to be received after the year of disposition. Under the installment method of reporting sales, the recipient of payments from an installment sale is allowed to recognize gain on the sale proportionately, according to when payments are received. Installment sales of nondealer real property or nondealer personal property (other than inventory) are automatically treated under the installment method unless the seller elects not to use this method. IRC §453. This election can be made by reporting the entire gain in the year of sale on a timely filed return for the year. Treas Reg §15A.453-1(d). Dealers in real or personal property do not generally qualify for the installment method. IRC §453(b)(2).

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§8.34 G. Securities Law Considerations

A debt instrument or an investment contract may constitute a security. The offer or sale of a security by mail or other means of interstate commerce is unlawful under federal law unless (1) it is registered with the Securities and Exchange Commission or (2) an exemption from registration applies. 15 USC §77e. The offer or sale of a security in California is unlawful under state law unless (a) the security is qualified for sale or (b) the security or transaction is exempted or not subject to qualification. Corp C §§25110, 25120, 25130.

Under California law, a "security" includes, among other items, any note, stock, treasury stock, membership in an incorporated or unincorporated association, interest in a limited liability company and any class or series of such interests (except a membership interest in a limited liability company in which all members are actively engaged in the management of the company), bond, debenture, and evidence of indebtedness. Corp C §25019. This section is not applied literally; whether a "security" exists depends on the particular facts and circumstances of the transaction. For example, not all notes are considered "securities."

A security is present if money is invested in a common enterprise with profits resulting solely from the efforts of others. *SEC v Howey Co.* (1946) 328 US 293, 301, 90 L Ed 1244, 1251, 66 S Ct 1100. California courts have supplemented the *Howey* test with a "risk capital" approach, examining the following factors:

- Are funds being raised for a business venture or enterprise?
- Is the transaction offered indiscriminately to the public at large?
- Are the investors substantially powerless to affect the success of the enterprise?
- Is the investors' money substantially at risk because it is inadequately secured?

Moreland v Department of Corps. (1987) 194 CA3d 506, 519, 239 CR 558. See also *Silver Hills Country Club v Sobieski* (1961) 55 C2d 811, 815, 13 CR 186.

Counsel usually need not be concerned that a promissory note representing a payment obligation in a standard deferred payment sale will be considered a security. However, if the payments are not fixed but depend on revenues or profits of the obligor or similar contingencies, as in a participating loan or certain other variable payment obligations, counsel should ascertain whether a "security" is present. Counsel should also take appropriate action to qualify or register the security as necessary under applicable securities laws, unless exemptions from qualification and registration are available, if there is a significant risk that the transaction may be construed as including a security. See Financing and Protecting California Businesses, chap 20 (Cal CEB 2006).

NOTE: Because of the complexity of securities laws and the importance of securities law considerations in many business transactions, counsel should consider whether association with a securities law specialist is appropriate. See §2.16.

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VII. NONMONETARY CONSIDERATION

§8.35 A. General Principles

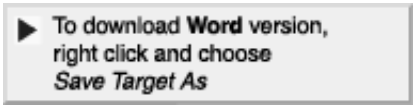
If the consideration is nonmonetary, the agreement should identify the obligations constituting the consideration. The possibilities are almost as great as the number of possible contracts; a party may transfer title to assets, lease property, grant license rights, perform services, provide advertising, convey a security interest, assume liabilities, or forbear from taking legal action. See California Law of Contracts §§3.43-3.44 (Cal CEB 2007). Generally, the performance forms the consideration for the transaction and is stated at the beginning of the agreement.

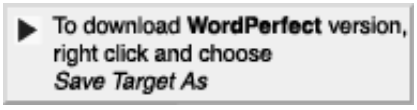
WARNING: If one party is to assume some or all of the other's liabilities, each such liability should be thoroughly reviewed so that the party knows the cost of the assumption.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/§8.36 B. Form: Performance of Services

§8.36 B. Form: Performance of Services





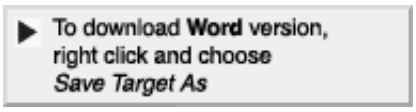
8.36-1 Performance of services

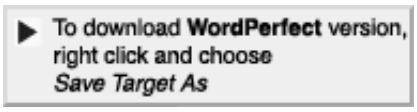
___. *Performance of Services.* Subject to the terms and conditions of this Agreement, _ _[*e.g., Employee*]_ _ will serve _ _[*e.g., Employer*]_ _ as _ _[*identify capacity*]_ _ and have the authority and responsibilities as _ _[*e.g., Employer*]_ _ may reasonably determine from time to time. _ _[*e.g., Employee*]_ _ shall perform any other duties reasonably required by _ _[*e.g., Employer*]_ _ without additional compensation. Throughout the duration of this Agreement, _ _[*e.g., Employee*]_ _ will devote _ _[*his/her*]_ _ entire working time, energy, skill, and best efforts to the performance of the duties stated in this Agreement in a manner that will faithfully and diligently further the business and interests of _ _[*e.g., Employer*]_ _.

Comment: Counsel may describe the services to be performed in greater detail if warranted by the job description.

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§8.37 C. Form: Transfer of Stock





8.37-1 Transfer of stock

___. *Transfer of Stock.* Subject to the terms and conditions of this Agreement, on the Closing Date, _ _[*e.g., Seller*]**_ _ will transfer and convey to _ _**[*e.g., Buyer*]**_ _, and _ _**[*e.g., Buyer*]**_ _ will acquire from _ _**[*e.g., Seller*]**_ _, _ _**[*number*]**_ _ shares of _ _**[*identify shares*]**_ _, _ _**[*having a par value of $_ _*[*amount*]**_ _ per share*]**_ _.**

[*Add one of the following alternatives*]

[*Alternative 1: Seller issues its own stock*]

_ _[*E.g., Seller*]**_ _ will issue these shares as follows: _ _**[*Indicate exact name of issuee and number and type of shares to be included in each certificate*]**_ _.**

[*Alternative 2: Seller transfers stock of third party*]

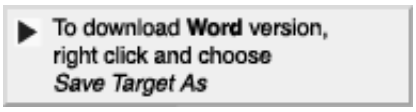
At the Closing, _ _[*e.g., Seller*]**_ _ shall deliver or cause to be delivered to _ _**[*e.g., Buyer*]**_ _ Share Certificate No. _ _ of _ _**[*name of issuer*]**_ _ representing these shares, duly endorsed for transfer to _ _**[*e.g., Buyer*]**_ _.**

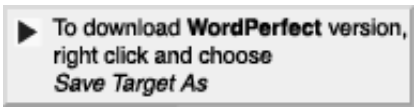
Comment: In some transactions, a buyer might issue some of its stock to the seller as part of the purchase price. Stock transfer provisions should generally be accompanied by covenants on the part of the recipient supporting exemptions from registration or qualification under securities laws. See Sales and Mergers of California Businesses, chap 4 (Cal CEB 2002).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/§8.38 D. Form: Transfer of Assets

§8.38 D. Form: Transfer of Assets





8.38-1 Transfer of assets

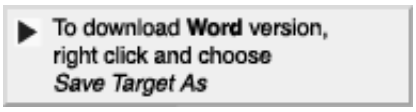
___. *Transfer of Assets.* Subject to the terms and conditions of this Agreement, on the Closing Date, _ _[*e.g., Seller*]**_ _ will sell, transfer, convey, assign, and deliver to _ _**[*e.g., Buyer*]**_ _, and _ _**[*e.g., Buyer*]**_ _ will acquire from _ _**[*e.g., Seller*]**_ _, _ _**[*identify assets transferred*]**_ _ (the "Assets"). At the Closing, _ _**[*e.g., Seller*]**_ _ shall deliver to _ _**[*e.g., Buyer*]**_ _ a bill of sale for the Assets, duly executed by _ _**[*e.g., Seller*]**_ _, in the form attached as Exhibit _ _. At the Closing and at any time or from time to time after the Closing, _ _**[*e.g., Seller*]**_ _ will execute and deliver any further instruments of sale, conveyance, transfer, and assignment, and take such other action as _ _**[*e.g., Buyer*]**_ _ may reasonably request to more effectively sell, convey, transfer, and assign to _ _**[*e.g., Buyer*]**_ _ any of the Assets, to put _ _**[*e.g., Buyer*]**_ _ in actual possession and operating control of the Assets, to confirm the title of _ _**[*e.g., Buyer*]**_ _ to the Assets, or to assist _ _**[*e.g., Buyer*]**_ _ in exercising rights with respect to the Assets.**

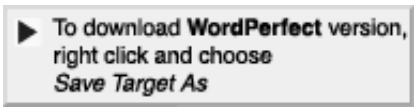
Comment: For sale of all assets of a business, see Sales and Mergers of California Businesses §11.5 (Cal CEB 2002).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/8 Consideration/§8.39 E. Form: Assumption of Liabilities

§8.39 E. Form: Assumption of Liabilities





8.39-1 Assumption of liabilities

___. *Assumption of Liabilities.* Subject to the terms and conditions of this Agreement, on the Closing Date, _ _[*e.g., Buyer*]_ _ will assume those _ _[*contracts/liabilities*]_ _ listed on Exhibit _ _. _ _[*E.g., Buyer*]_ _ will not be liable for any obligations or liabilities of _ _[*e.g., Seller*]_ _ of any kind or nature other than those specifically assumed by _ _[*e.g., Buyer*]_ _ under this paragraph.

Comment: The parties may also want to provide that each party indemnifies the other for obligations or liabilities that occur during the indemnifying party's period of responsibility under the relevant contract. For discussion of indemnification, see §§11.13-11.39. For further discussion of assumption of liabilities and form language for assuming all liabilities of the other party, see Sales and Mergers of California Businesses §11.12 (Cal CEB 2002).

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9

Covenants

Vincent W. Thorpe
Justene M. Adamec

I. CHECKLIST: COVENANTS §9.1

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- A. Covenants Distinguished From Conditions §9.3
- B. Covenants Distinguished From Representations §9.4
- C. Classification of Covenants §9.5

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- C. Loan and Financing Agreements §9.8
- D. Agreements for Sale of Shares or Assets; Merger Agreements §9.9
- E. Covenants Not to Compete
  - 1. Limitations on Enforceability §9.10
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- F. Employment Agreements §9.12
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- D. Where Will Performance Occur? §9.19
- E. Does Performance Need to be Defined? §9.19A
- F. Are All Cross-References Precise? §9.20
- G. Consequences of Breach §9.21

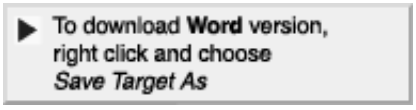
V. IMPLIED COVENANTS §9.22
- A. Good Faith and Fair Dealing §9.23
- B. Construction Contracts §9.24
- C. Obligation to Remain in Business §9.25
- D. Continuing Employment §9.26
- E. To Perform With Skill, Care, and Knowledge §9.27
- F. Work and Goods Must Be Fit and Proper §9.28

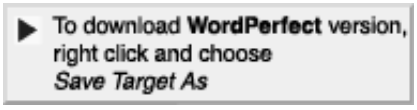
VI. ISSUES OF STYLE
- A. A Promise Should Look Like a Promise §9.29
- B. Separation of Covenants and Conditions §9.30

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/9 Covenants/§9.1 I. CHECKLIST: COVENANTS

§9.1 I. CHECKLIST: COVENANTS





- Function of provision—covenant, condition, or representation (see §§9.2-9.4)
- Topics covered in covenants
- Sales and lease agreements (see §9.6)
- Distribution agreements (see §9.7)
- Loan and financing agreements (see §9.8)
- Sales of shares or assets (see §9.9)
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- Employment agreements (see §§9.12-9.14)
- Information included in express covenants (see §§9.15-9.21)
- Obligor (see §9.16)
- Date of performance (see §9.17)
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- Effect of nonperformance (see §9.21)
- Implied covenants (see §§9.22-9.28)
- Good faith and fair dealing (see §9.23)
- Construction issues (see §9.24)
- Remain in business (see §9.25)
- Continuing employment (see §9.26)
- Perform with skill, care, and knowledge (see §9.27)
- Work and goods fit and proper (see §9.28)

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§9.2 II. COVENANTS DEFINED

The term "covenant" is simply a traditional word for a promise; specifically, a promise by a party to a contract that something either will or will not be done.

The covenants are the heart of every contract. They are the promises of performance that each party makes to the other. This part of the contract calls for specific drafting of each party's promises to perform based on an understanding of the client's needs and the dynamics of the negotiating relationships. Failure to keep one of those promises is a breach that, if material, entitles the nonbreaching party to damages (CC §3300) and may excuse further performance by the nonbreaching party. Whether the breach is sufficiently material to justify damages or to excuse performance may depend on how the covenant and related conditions are drafted.

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§9.3 A. Covenants Distinguished From Conditions

The drafting attorney must understand the difference between a covenant and a condition, and when to use one and not the other. The difference may be illustrated by the following hypothetical three-sentence sales agreement:

1. Seller agrees to deliver 1000 cases of Product to Buyer's office by July 3.

2. Buyer agrees to pay Seller $2000 within 10 days after delivery.

3. Delivery of the 1000 cases of Product to Buyer by Seller before July 3 is a condition precedent to Buyer's duty to pay the agreed purchase price.

The first sentence is a covenant that imposes a duty on the seller to deliver the product. The second sentence is a covenant that imposes a duty on the buyer to pay the seller. If either party materially fails to perform its duty as expressed in those covenants, the other party would be entitled to damages.

The third sentence does not create a duty for anyone. It establishes a "condition." In this simple case, if the condition does not occur, *i.e.,* if the cases of product are not delivered before July 3, then the buyer's duty to perform is excused. Whether the addition of such a condition is appropriate depends on other facts which the attorney should know. For example, if the products were fireworks for a Fourth of July extravaganza, the condition would be required. If the products were toys to be warehoused for Christmas sales, the condition might be unnecessary.

On conditions, see chap 10.

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§9.4 B. Covenants Distinguished From Representations

Both covenants and conditions must be distinguished from "representations." A representation is "a presentation of fact—either by words or by conduct—made to induce someone to act, esp. to enter into a contract; esp. the manifestation to another that a fact, including a state of mind, exists." Black's Law Dictionary 1327 (8th ed 2004). Drafting attorneys sometimes confuse matters by trying to use a representation of a future event to create a covenant. For example:

"Seller represents that it will deliver 1000 cases of Product on July 3."

This type of sentence presents enforcement problems. It does not clearly create a duty, although one might be implied from the representation. It is also inadequate for establishing delivery by July 3 as a condition to the buyer's duty to pay. Arguably, it is merely a statement of the seller's intent at the time of drafting. It is the lawyer's function to avoid potential ambiguity by carefully separating and clearly stating covenants, conditions, and representations.

For discussion of representations, see chap 7.

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§9.5 C. Classification of Covenants

Covenants can be classified in a variety of ways. Some examples are (Black's Law Dictionary 391-393 (8th ed 2004)):

- **Absolute or conditional.** An absolute covenant is one that is not qualified or limited by any condition. Performance of a conditional covenant is excused if the condition fails to occur.
- **Affirmative or negative.** An affirmative covenant is a promise to perform some act, while a negative covenant is a promise not to perform some act.
- **Dependent, concurrent, or mutual and independent.** Covenants are dependent when one party's performance is conditioned on another party's performance. When covenants are concurrent, both parties perform at the same time, and if one party is ready and offers to perform, and the other neglects or refuses to perform, the party who is ready may maintain an action for the other's default. When covenants are mutual and independent, either party may recover damages from the other for breach, and performance by one party does not depend on performance by the other. These distinctions may raise important questions for the drafting attorney in complex transactions. When does one party's failure to perform excuse the other party's duties, as distinguished from only creating a right to damages? The answer may be obvious in a simple sale of goods for money. In a contract involving continuing or repeated performances and mutual duties, however, it is not obvious and will require specific drafting. See §9.18 and chap 14 for specific default provisions.
- **Express or implied.** The former is created by the parties' express words; the latter may reasonably be inferred from the whole agreement and surrounding circumstances. See §§9.22-9.28 for discussion of implied covenants.
- **Continuing.** A continuing covenant is one that requires the performance of certain acts successively or as often as the occasion demands, such as covenants to pay rent, to keep premises in repair, *etc.*

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III. DRAFTING COVENANTS FOR SPECIFIC TYPES OF AGREEMENTS

§9.6 A. Commercial Sales and Lease Agreements

In an agreement for the sale or lease of goods, the covenants' major function is to define the quality and quantity of the product, and the place and manner of delivery. Depending on whether the product is a simple garden tool or a sophisticated electronic part, the covenants on product quality may range from a single sentence to many pages of design specifications incorporated by reference.

NOTE: California law includes specific requirements for certain types of business contracts, typically involving consumer transactions. The statutes may require specific contract terms, disclosures, and rights of rescission or cancellation. For a chart correlating the applicable Civil Code statutes to types of contracts or business, consult California Law of Contracts §6.39 (Cal CEB 2007).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/9 Covenants/§9.7 B. Distribution Agreements

§9.7 B. Distribution Agreements

Although agreements between a manufacturer and its distributors also involve the sale of products, the focus shifts to defining the distributor's duties in handling and selling the product.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/9 Covenants/§9.8 C. Loan and Financing Agreements

§9.8 C. Loan and Financing Agreements

In a commercial financing agreement, the key covenants relate to the borrower's conduct of its business during the period that the loan is outstanding. The covenants are designed to provide security to the lender and for use as an adjunct to the default sections of the contract; *i.e.,* if the borrower fails to conduct its business in the manner promised, the covenant is breached, which triggers a default in the loan. Commonly, the default accelerates the duty to pay all amounts due and may trigger a condition excusing further advances by the lender. See also Financing and Protecting California Businesses (Cal CEB 2006).

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§9.9 D. Agreements for Sale of Shares or Assets; Merger Agreements

In a business acquisition agreement, a period of time is usually provided between the agreement's signing and the closing date, when the business is transferred. The primary function of covenants in these agreements is to specify how the seller's business will be conducted between the signing of the agreement and the closing of the sale. Those covenants are normally designed to trigger conditions that excuse the buyer's duty to purchase if a covenant is breached. For example, the seller may covenant to maintain a certain volume of sales during the period between the execution of the agreement and the closing and transfer of the business. *If* it fails to do so (condition), the buyer is excused from concluding the sale. See also Sales and Mergers of California Businesses (Cal CEB 2002).

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E. Covenants Not to Compete

§9.10 1. Limitations on Enforceability

Noncompetition covenants, although generally invalid by statute (Bus & P C §16600), are common in connection with the sale of a business or an interest in a business as a result of specific exceptions to the statute, including the following:

- The sale of a business's goodwill. Bus & P C §16601.
- The sale or other disposition of a business owner's ownership interest or equity in the business entity. Bus & P C §16601. See *Vacco Indus. v Van Den Berg* (1992) 5 CA4th 34, 6 CR2d 602.
- The sale of all or substantially all operating assets of a corporation or its subsidiary or division, together with its goodwill. Bus & P C §16601. See *Vacco Indus. v Van Den Berg, supra*.
- The dissolution of a partnership or the termination of a partner's interest. Bus & P C §16602.
- The sale of the covenantor's interest in a limited liability company. Bus & P C §16602.5.
- The dissolution of a limited liability company. Bus & P C §16602.5.

Employers often unsuccessfully attempt to extend the application of noncompetition covenants to employees, particularly sales representatives and those developing intellectual property. In light of the clear language of the statute, courts consistently reject such attempts. See *Kolani v Gluska* (1998) 64 CA4th 402, 75 CR2d 257. See also *VL Sys., Inc. v Unisen, Inc.* (2007) 152 CA4th 708, 61 CR3d 818 (refusing to enforce consulting contract provision barring client from hiring any of firm's employees for 12 months after contract terminated; newly hired former employee had not begun employment with firm until after contract work was done). Some confusion may arise with out-of-state employers on this issue because some other states allow limited restrictions on employees.

PRACTICE TIP: Business and Professions Code §16600 does not prevent California employers from protecting their interests with confidentiality and nondisclosure covenants. See §9.12.

Even in transactions for which a covenant not to compete is enforceable, the covenant must be drafted carefully to meet the applicable statutory exception to Bus & P C §16600. Most importantly, the drafter must put a reasonable time limit on the covenant and must define the business and the geographic area to which it will apply.

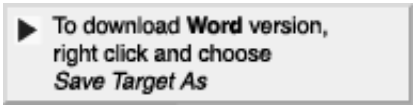
In defining the business to which the covenant applies, the drafter should specify the activities in which the business is engaged and the markets in which it operates. *Monogram Indus. v Sar Indus.* (1976) 64 CA3d 692, 134 CR 714. In defining the geographic area, the drafter should identify the cities or counties in which the covenant will apply. A reference to the entire state or even a larger geographic region might be upheld (*Vacco Indus. v Van Den Berg* (1992) 5 CA4th 34, 6 CR2d 602 (covenant extended to continental United States)), but it is good practice to draft, and easier to interpret and enforce, a covenant that specifies in detail the covered territory. Although a court may "blue pencil" a noncompetition covenant with overbroad geographic or time restrictions, it will not rewrite an overbroad noncompetition covenant to save an otherwise illegal contract. *Strategix, Ltd. v Infocrossing West, Inc.* (2006) 142 CA4th 1068, 1074, 48 CR3d 614 (refusing to limit overbroad covenant to former employees and customers).

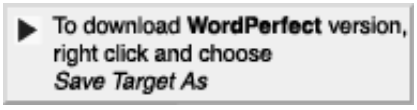
NOTE: For further discussion of covenants not to compete, see California Business Litigation §§3.10-3.14 (Cal CEB 2002) and California Law of Contracts §6.38 (Cal CEB 2007).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/9 Covenants/§9.11 2. Form: Covenant Not to Compete

§9.11 2. Form: Covenant Not to Compete





9.11-1 Covenant not to compete

___. *Covenant Not to Compete.* **_ _**[*E.g., Seller*]**_ _ agrees not to compete in California directly or indirectly with _ _**[*e.g., Buyer*]**_ _ or to own any interest in or participate in any business that competes with _ _**[*e.g., Buyer*]**_ _ in _ _**[*specify field of business—e.g., manufacturing or selling cellular telephone switching equipment*]**_ _. This covenant continues for as long as _ _**[*e.g., Buyer*]**_ _ conducts a like business, but not more than _ _**[*e.g., 5 years*]**_ _.**

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§9.12 F. Employment Agreements

In contracts for personal services, covenants are normally geared to defining the employee's duties and to establishing the salary, benefits, and working conditions that the employer agrees to provide.

Litigation often arises over a disputed claim that a vaguely drafted employment agreement is subject to an implied covenant of continued employment, subject to discharge only for good cause. See §9.26. To reduce this risk, the contract should contain an express clause on termination. See form in §9.13.

In some employment agreements, the employer may wish to include a covenant of nondisclosure and confidentiality. This covenant is particularly important if the employee may acquire sensitive information about customers, confidential business procedures, or technical data that is not subject to patents but is a trade secret or proprietary. Drafting such covenants requires care because they are limited by a test of reasonableness. See *Monogram Indus. v Sar Indus.* (1976) 64 CA3d 692, 134 CR 714, for discussion of the reasonableness test.

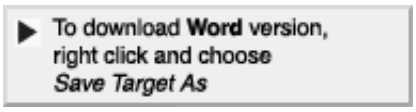
Employers often wish to include a covenant not to compete in employment agreements. Terminating an employee for refusing to agree to such a covenant may be tortious wrongful termination. *D'Sa v Playhut, Inc.* (2000) 85 CA4th 927, 102 CR2d 495.

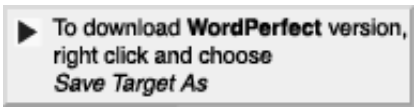
Although covenants not to compete are generally unenforceable against employees in California (*Morris v Harris* (1954) 127 CA2d 476, 274 P2d 22; see §9.10), an employer may protect its trade secrets from being used by a former employee on behalf of a competitor. *Muggill v Reuben H. Donnelley Corp.* (1965) 62 C2d 239, 242, 42 CR 107. Any attempt to protect confidential information or trade secrets must be carefully tailored so that the clause only protects that information. An overbroad provision will be invalidated rather than rewritten so that it is confined to protectable information. See *Kolani v Gluska* (1998) 64 CA4th 402, 75 CR2d 257. See also Advising California Employers and Employees §11.5 (Cal CEB 2005).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/9 Covenants/§9.13 1. Form: At-Will Employment

§9.13 1. Form: At-Will Employment





9.13-1 At-will employment

___. *Employment At Will.* The parties agree that either party may terminate this employment agreement at any time with or without cause. This employment is "at will" and there is no express or implied agreement for a definite period of employment.

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§9.14 2. Form: Nondisclosure Covenant

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9.14-1 Nondisclosure covenant

___. *Nondisclosure Covenant.* During the term of employment and for _ _[*e.g., 2 years*]_ _ after termination of employment, Employee agrees to safeguard and, except for the benefit of the Company, not to disclose to anyone outside the Company any proprietary or confidential information acquired while working for the Company. Such information includes, without limitation, business plans, customer lists, operating procedures, trade secrets, design formulas, know-how and processes, computer programs and inventions, discoveries, and improvements of any kind.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/9 Covenants/§9.15 IV. CHECKLIST FOR COMPONENTS OF COVENANTS

§9.15 IV. CHECKLIST FOR COMPONENTS OF COVENANTS

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The drafting attorney should make certain each individual covenant in an agreement adequately covers the following points:

- Who is required to perform? See §9.16.
- When is the performance due? See §9.17.
- What is the order of performance? See §9.18.
- Where will performance occur? See §9.19.
- Are all cross-references in the covenants precise? See §9.20.
- What are the consequences of a breach? See §9.21.

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§9.16 A. Who Is to Perform?

A covenant must state which party is responsible for performing under the covenant. A common error in drafting is to state expectations in general language, as in the following:

"The parties understand that the Product will meet applicable industry specifications."

This sentence fails to define the obligor and is vague about what specifications the product must meet. In addition, the word "understand" may have some function in the recitals to an agreement (see §7.3), but it has no place in a sentence designed to create a covenant. This example may be difficult if not impossible to enforce: Whose responsibility is it if the product does not meet a design requirement? Who determines the "applicable industry specifications?" Is it the buyer's duty to provide the seller with those specifications, or is the seller supposed to obtain them independently?

Every covenant should state explicitly what is being promised and identify the party who has the obligation of performance. A better covenant would read:

Seller agrees that the Product when delivered will conform to the specifications attached to this Agreement as Exhibit A.

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§9.17 B. When Is Performance Due?

For every covenant, the drafter must specify the date by which, or dates between which, performance must be completed. It is not sufficient for the seller merely to agree to pay $100 per product, or for the borrower to agree to deliver its annual financial statements to the lender. If the covenant does not specify a time for performance, the "reasonable" time rule will apply, and disputes become almost inevitable. Often, the date of performance depends on other events. If so, those events must be precisely specified.

EXAMPLE 1: Buyer shall make payment within 10 days after delivery.

EXAMPLE 2: Seller shall deliver Product to Buyer within 30 days after Seller's receipt of a purchase order.

EXAMPLE 3: Borrower shall deliver annual financial statements to Lender within 45 days after the end of Borrower's fiscal year.

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§9.18 C. What Is the Order of Performance?

If performance by one party requires a prior performance by the other party, or if some event must first occur, the drafter must state that explicitly. Usually, this is done by combining a condition with the covenant.

EXAMPLE 1: Buyer will have access to Target Company's financial records only after Buyer has delivered to Seller an executed copy of the confidentiality agreement attached as Exhibit D to this Agreement.

EXAMPLE 2: Seller shall deliver 1000 cases of Product to Buyer on July 3, subject to the condition that Buyer deliver final design specifications to Seller before April 15.

On conditions, see chap 10.

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§9.19 D. Where Will Performance Occur?

As with other details of performance, the drafter should not leave the place of performance to speculation. The covenant should explicitly state where the product should be delivered, where the inspection will take place, or the location of any other required performance. Failure to specify a place of performance may lead to unintended results if a court has to settle a dispute between the contracting parties. For example, a buyer of goods may be surprised to discover that, if the parties' agreement does not specify a place of delivery, it is the seller's place of business. Com C §2308(a). See California UCC Sales and Leases §4.60 (Cal CEB 2002).

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§9.19A E. Does Performance Need to be Defined?

Many covenants in the contract do not need a detailed definition of what constitutes performance. These include, *e.g.*, the promise to pay or the promise to deliver standardized or common goods or services. However, if the contract calls for specialized products or services, all parties are better served if the written contract includes clear specifications.

Building construction contracts achieve the goal of clear specifications by cross-referencing a specific set of the architect's plans and specifications. In the same manner, contracts for specialized equipment, machinery, and other comparable products should include or cross-reference similar specifications. Difficulties arise in contracts such as software development or licensing when physical description of the product may not be useful or feasible. In such situations, the drafter should consider performance-based specifications. See Trade Secrets Practice in California (2d ed Cal CEB 1996).

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§9.20 F. Are All Cross-References Precise?

Ambiguous cross-references are a prolific source of litigation. Two common situations in which this problem arises are in financing and acquisition agreements, which often refer to obligations created under ancillary documents. If an agreement requires performance of a duty that is described in another document, the agreement should include a cross-reference to the precise section in the other document where the duty is described. For example, a provision in a promissory note that allows acceleration of the entire debt if the borrower defaults "under the Loan Agreement" is more likely to be the subject of a dispute over interpretation than would a similar provision that refers to "Events of Default as defined in Section 6.1 of the Loan Agreement." The parties' intentions are clearer and the room for interpretation narrower when specific cross-references are used.

Other types of agreements that often involve disputes over interpretation are agreements for construction or engineering work. Typically, such agreements require compliance with plans and specifications. When a dispute arises, it often happens that more than one set of plans existed or that changes were made to the original plans. One party claims it was relying on the original set of plans, while the other claims it was relying on the later set. The careful lawyer will always attach the plans and specifications to the agreement, if possible. If that is not possible because of their bulk, the agreement should identify the documents precisely by date, author, number of pages, and any other characteristics that will distinguish the operative set of plans from others.

Even if the parties are careful to identify specific documents or make specific cross-references to sections in those documents, there is a danger that in the course of negotiating a group of related documents, section numbers will change or the contents of sections will be modified. To avoid mistake and ambiguity, the drafter should double-check cross-references in all documents for accuracy and consistency.

For further discussion of cross-references, see §5.5.

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§9.21 G. Consequences of Breach

The breach of a contractual covenant generally entitles the nonbreaching party to compensation for the foreseeable damages caused by the breach. The breach may or may not excuse the nonbreaching party from further performance, depending on whether the breach is "material." The drafting attorney can reduce uncertainty about materiality and possibly avoid a dispute altogether by addressing, in the agreement, the consequences of breaching its covenants.

EXAMPLE 1: In a sale of goods, if the seller is late in one delivery, should the buyer be obligated to rely on the seller for timely future deliveries, or should the buyer be free to terminate the contract and obtain supplies from another seller? If the buyer does terminate, should it also be able to collect damages from the seller for the one late delivery? What about the buyer's additional costs in obtaining the product from a different seller?

EXAMPLE 2: In a business acquisition, if the seller agrees that the acquired company will not enter into any new leases pending the closing of the sale, but in breach of that covenant the company renews a lease of property owned by relatives of its shareholders, what should the buyer's remedy be? Should the buyer be allowed to cancel the sale? Should damages also be allowed?

As these examples illustrate, the drafter should review each covenant and analyze how it might be breached and what remedy the client should reasonably expect. In both examples, a drafter representing the buyer should consider coordinating a covenant with a condition. The covenant would state the seller's duty; the condition would provide that if that covenant is breached the buyer is excused from its duty to further perform. If the buyer wishes to be able to withdraw from the sale and also to seek damages, the agreement should expressly state that the excuse of performance is without prejudice to the buyer's remedies for breach of the covenant.

If the drafter included only the covenant in the agreement, the nondefaulting party would be in a difficult position when it learned of the breach. Whether the breach was sufficiently material to justify a party's suspension of performance would depend on many factors on which reasonable minds might differ. How long was the delay in delivery? How significant in the overall transaction was the renewed lease? If the drafter failed to provide for an agreed remedy for breach, the nondefaulting party might have a right to damages but it may not be able to cancel the agreement without risking a countersuit.

One party may not agree to all the covenants the other party wants. There may be situations that are significant to one party but that are beyond the other party's control. They might agree that, if one of those situations occurred, the party could cancel the agreement but not receive damages. In that instance, the issue would be drafted as a *condition* to performance but not as a binding *covenant*. See also chap 15.

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§9.22 V. IMPLIED COVENANTS

One seldom drafts a contract that spells out in detail every act that every party must perform. From the earliest days of contract law, courts have used the doctrine of implied covenants to fill the gap between what is expressed in a written contract and additional elements of performance that one party may reasonably expect from the other. California law provides that, unless stated otherwise, terms that "are necessary to make a contract reasonable, or conformable to usage, are implied" in every contract. CC §1655.

Under both case law and statute, each party's duty to perform in conformance with "customary practice" or "usage of trade" is implied in each contract, if not inconsistent with its express terms. CC §1656; Com C §§1303(d), 2202; *California Lettuce Growers v Union Sugar Co.* (1955) 45 C2d 474, 289 P2d 785. But see *Heggblade-Marguleas-T'enneco, Inc. v. Sunshine Biscuit, Inc.* (1976) 59 CA3d 948, 954, 131 CR 183 (a quantity, though expressly stated in requirements contract, was held to be estimate because of custom and practice in industry).

PRACTICE TIP: The drafting attorney must know the customary practices of the industry or trade to which the contract relates. The careful drafter ensures that all the client's requirements are set forth and that no unwanted obligation is implied in the contract. When the client assumes an obligation or attempts to impose an obligation on the other party that is a departure from the customary practices of the parties' trade, that obligation should be expressly stated. The drafting attorney needs to consider potential implied covenants when preparing the recitals section of the contract because courts look at that section when considering whether to add an implied covenant. See chap 5 generally and §§5.17-5.22.

Courts are generally reluctant, however, to add terms by implication in the absence of obvious necessity. *Walnut Creek Pipe Distrib. v Gates Rubber Co.* (1964) 228 CA2d 810, 39 CR 767. Covenants are implied only if the following factors are present (*Third Story Music, Inc. v Waits* (1995) 41 CA4th 798, 804, 48 CR2d 747):

- The implication arises from the language used or is indispensable to give effect to the parties' intention;
- It appears from the language used that the implied covenant was so clearly within the parties' contemplation that they deemed it unnecessary to express it;
- It can be assumed that the covenant would have been included if the parties' attention had been drawn to it;
- The subject is not completely covered by the contract; and
- The covenant can be justified on the ground of legal necessity.

The following sections provide some examples of how a covenant may be implied. Because implied covenants are generally transaction specific, no list of examples can be complete. The drafting attorney must consider the contracting parties' relationship and whether their contractual expectations differ from those one would commonly expect in similar relationships.

NOTE: For further discussion of implied covenants, see California Law of Contracts §6.33 (Cal CEB 2007).

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§9.23 A. Good Faith and Fair Dealing

The covenant of good faith and fair dealing is described in the case law as follows (*Harm v Frasher* (1960) 181 CA2d 405, 417, 5 CR 367):

> There is implied in every contract a covenant by each party not to do anything which will deprive the other parties thereto of the benefits of the contract.... [T]his covenant not only imposes upon each contracting party the duty to refrain from doing anything which would render performance of the contract impossible by any act of his own, but also the duty to do everything that the contract presupposes that he will do to accomplish its purpose.

See also Com C §§1201(b)(20), 1304. As good practice, the drafter should not assume that this covenant will protect the client when there are gaps in the contract or when rights that would appear to conflict with the good faith covenant are expressly conferred on a party to the contract. As a general rule, implied terms will not be read to vary the express terms of a contract unless the contract terms are contradictory or ambiguous. *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 6 CR2d 467; *Third Story Music, Inc. v Waits* (1995) 41 CA4th 798, 806, 48 CR2d 747.

Although the covenant of good faith and fair dealing cannot be waived or disclaimed, commercial parties may, within reasonable limits, agree on the standards for measuring good faith performance. Com C §1302(b). The Commercial Code defines good faith for most transactions as "honesty in fact and the observance of reasonable commercial standards of fair dealing." Com C §1201(b)(20). Article 5, dealing with Letters of Credit, limits the definition to "honesty in fact." Com C §5102(a)(7). A drafter relying on implied covenants of good faith should be aware of any differences in application that may apply to a particular transaction. See generally California UCC Sales and Leases, chap 1 (Cal CEB 2002).

NOTE: For further discussion of the implied covenant of good faith and fair dealing, see California Law of Contracts §§6.34-6.37 (Cal CEB 2007).

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§9.24 B. Construction Contracts

In a construction contract, the owner impliedly promises that the contractor will be permitted to proceed with construction without interference by the owner. A contractor who accepts a subcontractor's bid for part of the work impliedly promises to commence construction within a reasonable time. Every construction contract contains an implied covenant that the owner will furnish the selected site of operations to the contractor in order to enable it to adequately carry on construction and complete the agreed-on work. See *Gray v Bekins* (1921) 186 C 389, 199 P 767; *Kenworthy v State* (1965) 236 CA2d 378, 46 CR 396.

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§9.25 C. Obligation to Remain in Business

The existence of an implied covenant to remain in business in "output" or "requirements" contracts and percentage leases is the subject of many confusing and conflicting decisions. If this issue is important to the client, it is best to express the obligation and to specify exactly what the client expects. See *Lippman v Sears, Roebuck & Co.* (1955) 44 C2d 136, 280 P2d 775; *Professional Bldg. of Eureka, Inc. v Anita Frocks, Inc., No. 6* (1960) 178 CA2d 276, 2 CR 914. Regarding output and requirements contracts generally, see California UCC Sales and Leases, chap 4 (Cal CEB 2002).

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§9.26 D. Continuing Employment

An employee's action for wrongful discharge is a common application of the implied covenant of good faith and fair dealing in employment contracts. Often, the vague wording of an employment contract and company practices combine to give rise to an implied covenant of continuing employment, so that good cause is required to discharge an employee. If the employer wishes to avoid such an implied covenant, the initial employment contract should specifically allow the employer to terminate employment with or without cause. The contract should state that employment is at will and may thus be terminated by either party at any time on notice. See *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 254 CR 211. See also Advising California Employers and Employees §§17.1-17.28 (Cal CEB 2005).

See forms in §§6.37-6.42 for termination of employment contracts.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/9 Covenants/§9.27 E. To Perform With Skill, Care, and Knowledge

§9.27 E. To Perform With Skill, Care, and Knowledge

The law implies an obligation to perform with skill, care, reasonable expedience, and faithfulness. This rule applies to anyone who by contract undertakes professional or business engagements requiring the exercise of skill, care, and knowledge. *Roscoe Moss Co. v Jenkins* (1942) 55 CA2d 369, 130 P2d 477.

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§9.28 F. Work and Goods Must Be Fit and Proper

The obligation that work performed must be fit and proper for its intended use is implied in all contracts. See *Kuitems v Covell* (1951) 104 CA2d 482, 231 P2d 552. This is analogous to the implied warranty of merchantability, which includes the notion that goods sold be fit and proper for their intended use. See chap 7. If the client is contracting to perform work or provide a product, it is prudent to describe the manner of performance or intended use of the product and to identify any risks or limitations, so the contracting parties' expectations are clear. The implied warranty of merchantability, however, can be expressly disclaimed. See §§7.10-7.11.

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VI. ISSUES OF STYLE

§9.29 A. A Promise Should Look Like a Promise

When drafting a covenant, the lawyer is memorializing something that one party is "promising" to do under penalty of a damage claim. The words must make it clear that a promise is being stated, not merely a prediction, a hope, or even an "understanding."

The covenant should *not* state:

The parties understand that the Product will be painted red;

The parties expect that the Product will be painted red; *or*

The parties agree that the Product will be painted red.

But rather *should* state:

Seller agrees to paint all Products red;

Seller promises that all Products will be painted red; *or*

Seller agrees that when delivered all Products will meet the color specifications set forth in Exhibit X.

Modern courts prefer that contracts be written in simple English rather than legalese. See CC §1644; *Cedars-Sinai Med. Ctr. v Shewry* (2006) 137 CA4th 964, 41 CR3d 48 (words of contract to be understood in ordinary sense). See also §2.8. Therefore, counsel should use the word "promise" or "agree" instead of "covenant."

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§9.30 B. Separation of Covenants and Conditions

In shorter agreements, the drafter might combine a covenant and a condition in one paragraph. In a longer agreement, it is usually better to separate covenants and conditions into different sections with captions identifying them. This procedure helps to clarify in the drafter's mind what promises are being made and what gaps may exist in the performance each party expects. It also aids the parties, who must refer to the contract for guidance, and the court, which must interpret what the parties intended. It is especially helpful to devote a separate section to each party's covenants. When this is done, it is prudent not to attempt to restate the covenant in the condition section, which could lead to inadvertent omissions or inconsistencies in wording. Rather, counsel should refer to the covenant in the conditions section by cross-reference.

EXAMPLE: "The performance by Seller of the covenants in Section 2 of this Agreement is a condition precedent to the obligation of Buyer to perform under sections 4 and 5 of this Agreement."

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10

Conditions

Vincent W. Thorpe
Justene M. Adamec

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.1 I. CHECKLIST: CONDITIONS

§10.1 I. CHECKLIST: CONDITIONS

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- Must an act or event occur before a party is obligated to perform? (see §§10.4, 10.16-10.42)
- Will a party be excused from performing if some act or event occurs in the future? (see §§10.5-10.6)
- Are there any acts or events that must occur simultaneously in the transaction? (see §10.7)
- Does any party's duty to perform depend on their being satisfied (or a third person being satisfied) with another party's performance? (see §§10.10-10.11)
- If so, what is the standard for determining satisfaction—subjective good faith, or the reasonable person standard? (see §10.10)
- Conditions should be clearly drafted (see §10.9)
- Consider using a condition to excuse performance if an unwanted event occurs between signing and closing (see §10.12)
- Consider tying conditions to representations, warranties, and covenants (see §§10.13-10.14)

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§10.2 II. SCOPE OF CHAPTER

Conditions are typically used in business agreements as an adjunct to covenants, but they have a very different purpose and legal effect. See chap 9 on covenants. This chapter discusses different types of conditions (see §§10.2-10.8) and provides examples of their use in business agreements (see §§10.17-10.42).

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§10.3 III. CONDITIONS DEFINED

A condition is a fact or an event, the occurrence or nonoccurrence of which creates or extinguishes a promisor's duty.

EXAMPLE: The contract states: "If the Dodgers win the pennant, Seller agrees to deliver 20 cases of champagne to the stadium." The condition—winning the pennant—must happen before the covenant—delivery of champagne—becomes a duty.

A condition either occurs or does not occur. Unlike a covenant, its failure to occur is not a breach and does not by itself create a right to damages. In the example above, the champagne company is not liable for failure to deliver champagne if the Dodgers do not win the pennant. It becomes liable for damages only if it breaches the covenant after the condition occurs.

A condition can be distinguished from a covenant by the legal consequences of its failure to occur or failure to be performed:

- The *failure of a condition to occur* creates or excuses a duty to perform.
- The breach of a covenant gives the nonbreaching party a right of action for damages and may excuse a duty to perform if the breach is sufficiently serious.

On the distinction between covenants and conditions, see §9.3.

For drafting purposes, it is convenient to classify conditions into three categories: conditions precedent (see §10.4), conditions subsequent (see §10.5), and concurrent conditions (see §10.7).

For additional discussion of conditions, see California Law of Contracts, chap 10 (Cal CEB 2007).

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§10.4 A. Conditions Precedent

The condition precedent is the most frequently used condition in business agreements. Its function is to identify an act or an event that must occur before a right accrues or a duty of performance arises. See CC §1436; *Sosin v Richardson* (1962) 210 CA2d 258, 26 CR 610. For example, a common condition precedent is a provision requiring the delivery of goods by a given date as a condition to the buyer's duty to accept and pay for them.

Civil Code §1436 provides that a "condition precedent is one which is to be performed before some right dependent thereon accrues, or some act dependent thereon is performed." As stated by the California Supreme Court in *Platt Pac., Inc. v Andelson* (1993) 6 C4th 307, 313, 24 CR2d 597, "a condition precedent is either an act of a party that must be performed or an uncertain event that must happen before the contractual right accrues or the contractual duty arises." See also *Realmuto v Gagnard* (2003) 110 CA4th 193, 198, 1 CR3d 569.

Because the failure of a condition may result in a party's losing a right or being excused from performing, a contract provision will not be construed as a condition precedent in the absence of language plainly requiring that construction. *Rubin v Fuchs* (1969) 1 C3d 50, 81 CR 373. The courts may reject even a clearly drafted condition if it works an unreasonable hardship. For example, California courts have rejected "pay if paid" provisions in construction subcontracts whereby payment by the owner to the general contractor was made an express condition precedent to the general contractor's obligation to pay a subcontractor for work performed. The condition was rejected on public policy grounds. *William R. Clarke Corp. v Safeco Ins. Co.* (1997) 15 C4th 882, 64 CR2d 578. See California Law of Contracts §6.43 (Cal CEB 2007).

PRACTICE ADVICE: A condition precedent should begin with a phrase such as "subject to," "provided," "on the condition that," "contingent on," or "if." Even these phrases, however, will not create a condition precedent if the court's examination of the contract as a whole reveals that the parties intended otherwise. *Diepenbrock v Luiz* (1911) 159 C 716, 115 P 743.

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§10.5 B. Conditions Subsequent

Less commonly used, but often necessary, the condition subsequent is a method of terminating a duty. A condition subsequent refers to a future event, on the happening of which an obligation is no longer binding on the other party, if that party chooses to avail itself of the condition. CC §1438; *Call v Alcan Pac. Co.* (1967) 251 CA2d 442, 59 CR 763 (contractor could terminate subcontract if subcontractor failed to supply sufficient number of workers during course of project); *Lowe v Copeland* (1932) 125 CA 315, 13 P2d 522 (inventor transferred patent rights to corporation on condition that it manufacture and sell at least 5000 of invented products each year; if corporation failed to do so, rights would be reassigned). See §10.6. See also California Law of Contracts §6.45 (Cal CEB 2007).

An indemnification provision is often subject to a condition subsequent that the duty to indemnify is discharged on any claim unless written notice of that claim is provided within a stated time period. See §§11.25, 11.35.

A noncompetition covenant is often made subject to the condition subsequent that the beneficiary of the covenant continue the same type of business. For example, the seller of a business promises not to compete with the buyer, and this duty comes into existence with the closing of the sale, but the duty ceases if the condition occurs; *i.e.,* the buyer discontinues operations in that type of business. See §9.11.

Conditions subsequent are also disfavored and strictly construed by the courts, particularly when they work to create a forfeiture. See *Hawley v Kafitz* (1905) 148 C 393, 83 P 248. Although no precise words are necessary, the intent to create a condition subsequent must appear expressly or by clear implication. *Langford v Eckert* (1970) 9 CA3d 439, 88 CR 429.

When the occurrence of a future event is used as a condition subsequent to terminate performance or to discharge a duty, a definite or ascertainable time period or duration must be clear from the contract.

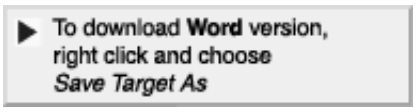
EXAMPLE: If the contract provides: "Seller will provide hot dogs every day until the last game of this year's World Series," the exact date is not certain but nevertheless there is a clearly defined duration for the seller's duty and the hot dog seller will be bound until the condition occurs, *i.e.,* until the World Series is over.

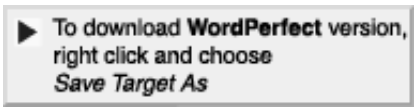
Problems arise when the drafter uses an event that is more difficult to tie down in time. Thus, when a company's duty to continue a specific employment policy was subject to the condition subsequent that "business conditions did not substantially change," the result was litigation and a 4-3 split in the California Supreme Court, with the majority holding that the time period was indefinite rather than definite. *Asmus v Pacific Bell* (2000) 23 C4th 1, 96 CR2d 179. Because the attorney drafting a contract normally would want to avoid litigation, the attorney should clearly identify the future event to which the duty of performance or its termination is tied.

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§10.6 C. Form: Condition Subsequent





10.6-1 Condition subsequent

[*Add one of the following alternatives*]

[*Alternative 1: Termination of rights*]

___. *Termination of Rights.* If _ _[*describe condition, e.g., Secured Lender does not consent to the sale of the Assets to Buyer*]**_ _, then this Agreement is void, and all rights granted by this Agreement are terminated and forfeited.**

[*Alternative 2: Reassignment of rights*]

___. *Termination of Rights.* If _ _[*describe condition, e.g., the patent for the Product does not issue*]**_ _, then _ _**[*describe result, e.g., all patent rights assigned to Assignee by this Agreement will automatically be reassigned to Assignor*]**_ _, this Agreement is void, and all rights granted by this Agreement are terminated and forfeited.**

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§10.7 D. Concurrent Conditions

Concurrent conditions are conditions precedent that are mutually dependent and are to be performed at the same time. CC §1437. The only important difference between a concurrent condition and a condition precedent is that the condition precedent must occur or be performed before a duty arises, but if conditions are concurrent, one party's *being ready to tender performance* will give rise to the other party's duty. If both parties fail to tender performance of concurrent conditions when the contract requires, the result is that both parties' duty to perform is discharged. *Pittman v Canham* (1992) 2 CA4th 556, 3 CR2d 340. See also California Law of Contracts §6.44 (Cal CEB 2007).

In sales agreements and real estate transactions particularly, delivery of the product or deed and payment are treated as concurrent conditions unless the agreement states otherwise. See, *e.g.,* Com C §§2507(1), 2511(1) (sale of goods); *Kossler v Palm Springs Dev.* (1980) 101 CA3d 88, 161 CR 423 (sale of real property). A careful drafter will specify the time for delivery and the time for payment; otherwise, delivery and payment will be treated as concurrent conditions, and the client may have to tender performance before it can sue the other party for breach. As one court stated: "All promises in a bilateral contract will be regarded as mutually dependent whenever it is possible so to interpret them." *Katemis v Westerlind* (1953) 120 CA2d 537, 546, 261 P2d 553.

In bilateral contracts, when performance by one party is in exchange for performance by the other and the duties are to be performed or can be performed at the same time and place, the law ordinarily infers concurrent conditions (or dependent covenants), making each party's obligation depend on the other's performance or tender of performance. *McDorman v Moody* (1942) 50 CA2d 136, 122 P2d 639 (seller of stock could not enforce buyer's duty to pay without also tendering shares to be purchased).

If the promises are to be performed at different times, they are generally deemed independent covenants and not concurrent conditions. For example, in *Starr v Davis* (1930) 105 CA 632, 288 P 706, plaintiff sold his business to defendant, receiving as consideration a note payable in 1 year. Plaintiff agreed not to engage in a similar business for 2 years. In plaintiff's suit to collect the note, defendant asserted that plaintiff had breached the covenant not to compete. The court held that plaintiff could recover despite his breach because the promises were independent.

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§10.8 E. Implied Conditions

Because no contract can cover all possible future events, courts may read implied conditions into a contract on a limited basis. Courts are reluctant to imply conditions, however, so the drafting attorney should not rely on this possibility.

Implied conditions may be either implied in fact, implied by interpretation of the agreement, or implied by law to avoid injustice. See, *e.g., Wal-Noon Corp. v Hill* (1975) 45 CA3d 605, 119 CR 646 (lessee denied reimbursement of costs of repairing roof because, although lease stated lessor was responsible for those costs, lessee had fixed roof on its own initiative without first notifying lessor; court held notice condition "implied").

The law refuses to read into contracts anything by way of implication except on grounds of obvious necessity. *Walnut Creek Pipe Distrib. v Gates Rubber Co.* (1964) 228 CA2d 810, 39 CR 767.

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IV. DRAFTING CONSIDERATIONS

§10.9 A. Courts Require Clear Language to Enforce Conditions

A condition, as compared with a covenant, may have a drastic effect in a contract. Therefore, conditions are not favored by the law and are strictly construed against the party attempting to rely on one, particularly if that party drafted the agreement. A contract provision will not be interpreted as a condition precedent unless it contains "language plainly requiring such construction." *Rubin v Fuchs* (1969) 1 C3d 50, 53, 81 CR 373.

If the words in the contract could be interpreted as a condition but also may be interpreted as a covenant, the courts will tend to stretch, if possible, to interpret the words to create mutual dependent and concurrent promises. *Ballard v MacCallum* (1940) 15 C2d 439, 444, 101 P2d 692.

PRACTICE ADVICE: The agreement should be clear and should not leave the issue open to interpretation. If the parties intend that one party's performance be contingent on an event happening or on the other party's performance, the drafting attorney must use clear words of condition. To avoid ambiguity, the drafting attorney should use clear conditional words such as "condition precedent," "subject to," or "contingent upon."

Conditions subsequent are the subject of some confusion. Often, a condition which terminates a duty is effectively the same as a condition precedent to continuation of the duty. See Restatement (Second) of Contracts §224, Comment e and §227(3), Comment e (1981). If the parties intend to create a condition subsequent to terminate a duty, the drafting attorney should use equally clear language, such as an "if … then" construction.

Example:

If Buyer stops selling Widgets in the defined territory, then Seller is released from its noncompetition covenant.

Choosing whether to draft a condition as a condition precedent or a condition subsequent affects the burden of proof if litigation ensues. The party claiming a duty was breached normally has the burden of proving the occurrence of a condition precedent. A party subject to a duty normally has the burden of proof if it contends the duty was extinguished by the occurrence of a condition.

In the above example, the burden of proving that the buyer had ceased selling widgets would be on the seller in a lawsuit. If the same provision had been drafted as a condition precedent, *e.g.,* "continuation of the widget sales in the defined territory is a condition to seller's obligation not to compete," then the burden of proof of continued sales would have been on the buyer.

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§10.10 B. Consent or Satisfaction as a Condition

Parties often want to provide conditions requiring that consent must be given before rights may be exercised (*e.g.*, "Tenant may not assign the lease without Landlord's consent") or that the party be "satisfied" with a product or performance before payment or other action is due (*e.g*., "Publisher will market Author's text if Publisher is satisfied with its content"; "Developer will buy Land if satisfactory zoning is obtained"). These conditions are the source of much litigation. A party may claim that the condition effectively makes the contract illusory or at least subject to the implied covenant of good faith and fair dealing. See *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 6 CR2d 467; *Kendall v Ernest Pestana, Inc.* (1985) 40 C3d 488, 220 CR 818; *Third Story Music, Inc. v Waits* (1995) 41 CA4th 798, 48 CR2d 747.

To increase the likelihood that these conditions will be enforced, the contract should contain a clear statement of the standard for consent or satisfaction. Two common standards for determining satisfaction are the subjective, good faith test and the objective, reasonable person test. Under the subjective good faith test, the party receiving performance is the sole judge of his or her satisfaction, but only if he or she acts in genuine good faith. See *Locke v Warner Bros., Inc.* (1997) 57 CA4th 354, 66 CR2d 921. Reasonableness is not required if the decision is made in good faith. In contrast, the reasonable person test is objective, allowing dissatisfaction to excuse a party's performance only if a reasonable person in the circumstances would also have been dissatisfied.

If the satisfaction clause fails to specify a standard, the courts will impose one based on the parties' constructive intent, as derived from the circumstances surrounding the contract and the nature of the performance involved. Generally, without an express standard or a clear indication in the contract, courts prefer the reasonable person standard to the subjective standard. See *Leboire v Royce* (1960) 53 C2d 659, 2 CR 745; *Kadner v Shields* (1971) 20 CA3d 251, 97 CR 742. If no other standard is specified, the reasonable person standard governs satisfaction clauses in contracts involving commercial quality or value, mechanical utility, or operative fitness. *Collins v Vickter Manor, Inc.* (1957) 47 C2d 875, 306 P2d 783.

When the condition of satisfaction involves matters of taste, fancy, or judgment, however, the subjective good faith standard will be applied. *Mattei v Hopper* (1958) 51 C2d 119, 330 P2d 625. This category includes contracts for creative works and personal services. See *Baker v Kale* (1947) 83 CA2d 89, 189 P2d 57.

Failure to act in good faith in rejecting a proposed performance can be grounds for a damage claim. *Locke v Warner Bros., Inc., supra*. A court that interprets the promisor's decision under the reasonable objective standard may not consider whether the promisor has acted in good faith. *Storek & Storek, Inc. v Citicorp Real Estate, Inc.* (2002) 100 CA4th 44, 59, 122 CA2d 267.

Unfortunately, this neat division between the two types of contracts and their corresponding standards for satisfaction is unpredictable in application. "In truth, the difference between contracts in this respect is almost wholly one of degree, and in most cases, it is out of the question to decide upon which side of the line a given case falls until the highest court has passed upon the case." *Kadner,* 20 CA3d at 259.

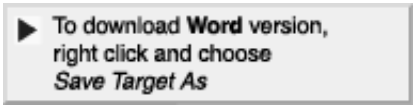
If a contract requires performance to the satisfaction of a *third party*, the third party's judgment is conclusive, barring proof of fraud or gross mistake. *C.J. Wood, Inc. v Sequoia Union High Sch. Dist.* (1962) 199 CA2d 433, 18 CR 647.

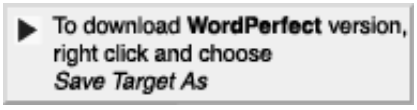
The contract can provide that disputes over whether the condition of satisfaction has been met will be settled by arbitration or other method of alternative dispute resolution. See chap 16.

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§10.11 C. Form: Satisfaction as a Condition





10.11-1 Satisfaction as condition

___. *Obligation Conditioned on Satisfaction.*

[*Add one of the following alternatives*]

[*Alternative 1: Subjective standard*]

The obligation of _ _[*name of party*]**_ _ to _ _**[*describe performance that is conditional; e.g., finance production of Prototype A*]**_ _ is conditioned on its satisfaction with _ _**[*describe performance, characteristic, or event that must be satisfactory; e.g., Prototype A's ability to perform the operations specified in Exhibit 1 to the Research and Development Agreement*]**_ _. _ _**[*Name of party*]**_ _ will make this determination in its sole discretion and according to its own standard of satisfaction with _ _**[*e.g., Prototype A's performance*]**_ _, as long as _ _**[*name of party*]**_ _ acts in good faith.**

[*Alternative 2: Objective standard*]

The obligation of _ _[*name of party*]**_ _ to _ _**[*describe performance that is conditional; e.g., finance production of Prototype A*]**_ _ is conditioned on its satisfaction with _ _**[*describe performance, characteristic, or event that must be satisfactory; e.g., Prototype A's ability to perform the operations specified in Exhibit 1 to the Research and Development Agreement*]**_ _. _ _**[*Name of party*]**_ _ will make this determination in good faith and as a reasonable person would under the circumstances.**

[*If applicable, add the following option to Alternative 1 or 2*]

[*Option: Settle disputes by arbitration*]

Any dispute about _ _[*name of party*]**_ _'s determination that _ _**[*e.g. Prototype A is unsatisfactory*]**_ _ will be settled by arbitration, in accordance with the procedures outlined in Section _ _.**

[*Alternative 3: Satisfaction of third party*]

All work under the _ _[*e.g., Research and Development Agreement*]**_ _ must be performed to the satisfaction of _ _**[*name of third party*]**_ _, and _ _**[*his/her*]**_ _ determination of adequacy or inadequacy is conclusive and binding on the parties.**

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§10.12 D. Using Conditions to Cover Time Between Signing and Closing

In many business transactions, the parties reach an agreement and execute a contract, but a period of time occurs before the date of closing or product delivery. For example, in a contract for the sale of a business, a period of time after execution of the contract is often provided for the buyer to complete its investigation of the seller's business and complete financing arrangements. The buyer usually wants protection during that period if circumstances change or the investigation reveals new information. See, *e.g., Beverly Way Assoc. v Barham* (1990) 226 CA3d 49, 276 CR 240 (contract for purchase of real property; buyer's obligation was conditioned on approval of certified survey of property).

Without an express condition in the contract, the buyer incurs a substantial risk. If it discovers information or a change occurs in the condition of the business between the execution of the contract and the closing, the buyer must decide whether to proceed or cancel. If the contract has no express condition allowing the buyer to cancel, it risks a lawsuit for breach if it cancels. The judge or jury may not consider the change in circumstances sufficiently material to justify cancellation. To avoid putting the client in that position, the careful buyer's lawyer will insist that the contract include a condition that excuses the buyer's duty to close if a material change of circumstances occurs. See form in §10.14.

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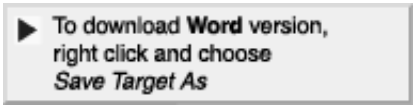
§10.13 E. Representations and Covenants Restated as Conditions

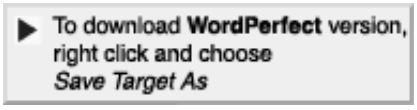
Business acquisition agreements commonly include a section titled "Conditions Precedent to Buyer's Duty To Close" or a similar title, which lists a series of events that must occur before the buyer has to pay the purchase price and close. The provision commonly states that one of the conditions precedent to closing is that all representations in the "representations and warranties" section of the agreement be true as of the closing date. See chap 7 on representations and warranties. Also, the seller's performance of all covenants required to be performed by it under the agreement is often made a condition precedent to closing. This is the technique by which representations and covenants are tied together and repeated as conditions.

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§10.14 F. Form: Sample Provision for Closing Subject to Conditions





10.14-1 Sample provision for closing subject to conditions

___. *Conditions for Closing.* The Buyer's duty to purchase and pay for the Shares and to assume the liabilities described in this Agreement is subject to the following conditions:

(a) Seller's representations and warranties in Section 3 of this Agreement are true and correct as of the Closing Date.

(b) Seller has performed all covenants required to be performed by it before the Closing Date, and all conditions required to have occurred as of the Closing Date have occurred.

(c) No material adverse change in the financial condition or business affairs of Seller has occurred between the date of the financial statements attached as Exhibit A to this Agreement and the Closing Date. (For purposes of this provision, "material adverse change" is defined as one or more of the following: _ _[*specify*]_ _.)

(d) Seller has delivered to Buyer the following certificates and documents required by this Agreement.

Comment: The agreement should then list the items that must be delivered to the buyer. If possible, both the representations and warranties and "material adverse change" should be quantified. For example, a specified percentage drop in monthly receipts may be defined as material.

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§10.15 G. Time Is Not Always a Condition

In a covenant, time of performance often looks like a condition precedent, since performance is not required until a given date. Because dates are absolute, however, a statement that performance is due on a certain date is not, by itself, a condition. There is, for example, no reasonable chance that July 4 will not occur; therefore, a promise to deliver 1000 products on July 4 is not conditional. On the other hand, performance by a given date may be an event that is used as a condition to payment or some other reciprocal performance. A specification of time also becomes a condition if it is tied to an uncertain event.

The following sample provisions show how time can be used as a condition:

Example 1—Condition to payment:

Delivery of 1000 products by July 4 is a condition to Buyer's duty to accept and pay for the products.

Example 2—Condition to performance:

If Contractor fails to complete construction and obtain a certificate of occupancy by July 4, the contract price will be reduced by 2 percent for each week or portion of a week until a certificate of occupancy is obtained.

Example 3—Condition tied to event:

If the Dodgers are leading their division on July 4, Seller will increase its daily delivery of hot dogs by 25 percent.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.16 H. Conditions to Performance

§10.16 H. Conditions to Performance

Most contracts provide for each side to perform covenants. Commonly, one side provides goods, services, financing, etc. and the other side provides payment in some form. Counsel for both sides should prepare a checklist of conditions that must occur before each party is obligated to perform. See §10.17. Once that is done, each condition should be stated clearly and separately in the contract. For forms of conditions typically used in a contract for the purchase of the assets of a business, see §§10.17-10.42. See also Sales and Mergers of California Businesses, chap 11 (Cal CEB 2002). These forms can be adapted to various kinds of agreements.

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V. BASIC CONDITIONS FOR BUSINESS AGREEMENTS

§10.17 A. Conditions to Performance

Before starting to draft a contract, counsel should review each duty the client will assume under the proposed contract and use that review to create a checklist to identify the conditions that should be added to the contract as prerequisites to the duties assumed.

Counsel representing the party who pays for goods or services should consider including an express condition describing what performance must be rendered before payment is due. For example:

- Manufacturing goods under contract specifications;
- Packaging duties;
- Delivering by a specified date to a specified place or by a specified method; or
- Performing the services in a satisfactory manner (on satisfaction as a condition, see §10.10).

Just as the attorney for the buyer must analyze what protections the buyer needs before it makes payment, the attorney for the seller of goods or services must ascertain whether anything is required to make performance possible. For example:

- Delivery of final plans and specifications in ample time for production;
- Availability of scarce raw materials for manufacturing (the price of the materials could be a condition in a price escalation provision); or
- Access to the site where the contract will be performed, when the buyer has control of the location.

The conditions to each party's performance in any transaction vary, depending on the facts and the bargaining power of the parties. See §§10.17-10.42 for a more complete set of conditions precedent to the buyer's and seller's performance. See also California UCC Sales and Leases, App A (Cal CEB 2002).

The forms in §§10.18-10.42 are especially useful for the sale of a business. Some of the provisions may need to be modified for use in documents for other types of transactions. For further discussion and forms for the sale of businesses, see Sales and Mergers of California Businesses (Cal CEB 2002).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/ B. Conditions Precedent to Buyer's Performance/§10.18 1. Form: Introductory Language for Conditions Precedent to Buyer's Performance

B. Conditions Precedent to Buyer's Performance

§10.18 1. Form: Introductory Language for Conditions Precedent to Buyer's Performance

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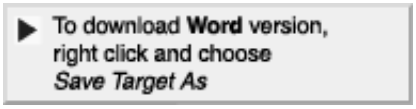
10.18-1 Introductory language for conditions precedent to buyer's performance

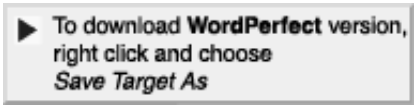
___. *Conditions for Buyer's Performance.* Buyer's obligations to purchase the _ _[*e.g., Assets*]_ _ under this Agreement are subject to the satisfaction, at or before Closing, of all conditions set forth below. Buyer may waive any or all of these conditions in whole or in part without prior notice, except that no waiver of a condition constitutes a waiver by Buyer of any of its other rights or remedies, at law or in equity, if Seller is in default of any representation, warranty, or covenant under this Agreement.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.19 2. Form: Accuracy of Seller's Representations and Warranties

§10.19 2. Form: Accuracy of Seller's Representations and Warranties





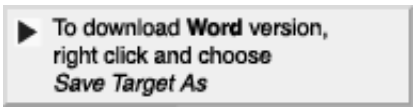
10.19-1 Accuracy of seller's representations

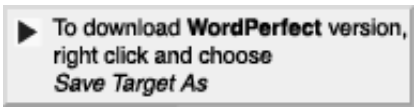
_ _[*Except as otherwise permitted by Section _ _ of this Agreement*]_ _**, all representations and warranties by Seller in this Agreement, or in any written statement delivered to Buyer under this Agreement, are true** _ _[*in all material respects*]_ _ **on and as of the Closing Date as though those representations and warranties were made on and as of that date.**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.20 3. Form: Performance by Seller

§10.20 3. Form: Performance by Seller





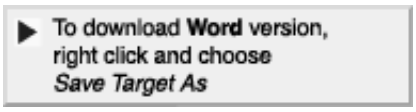
10.20-1 Performance by seller

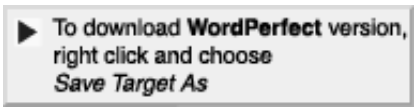
Seller has performed, satisfied, and complied _ _[*in all material respects*]_ _ with all covenants, agreements, and conditions that it is required by this Agreement to perform, satisfy, or comply with on or before the Closing Date.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.21 4. Form: No Material Adverse Change

§10.21 4. Form: No Material Adverse Change





10.21-1 No material adverse change

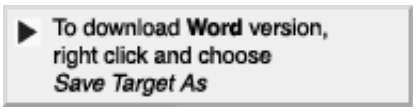
During the period from _ _[*date of most recent financial statement*]_ _ to the Closing Date, there are not any material adverse changes in Seller's financial condition or the results of its operations and Seller has not sustained any material loss or damage to its assets, whether or not insured, that materially affects its ability to conduct a material part of its business.

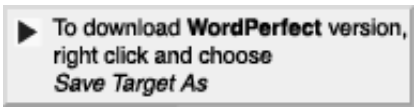
Comment: To the extent possible, materiality should be defined. If not possible, the general form can be used, but it may be left to a trier of fact to determine what is material. For further discussion, see California Law of Contracts §6.47 (Cal CEB 2007).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.22 5. Form: Certification by Seller

§10.22 5. Form: Certification by Seller





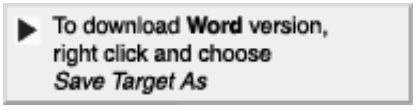
10.22-1 Certification by seller

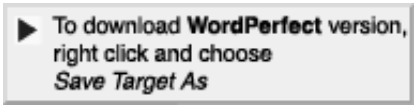
Buyer has received a certificate, dated the Closing Date, signed and verified by Seller's president or vice president and its treasurer or assistant treasurer, certifying, in as much detail as Buyer and its counsel may reasonably request, that _ _[*to the best of their knowledge*]_ _ the conditions specified in _ _[*list paragraphs*]_ _ have been fulfilled.

Comment: For further discussion, see California Law of Contracts §6.46 (Cal CEB 2007).

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§10.23 6. Form: Opinion of Seller's Counsel





10.23-1 Opinion of seller's counsel

Buyer has received from _ _[*name*]_ _, counsel for Seller, an opinion dated the Closing Date, in form and substance satisfactory to Buyer and its counsel, to the effect that:

(a) Seller is a corporation duly organized, validly existing, and in good standing under the laws of the State of California, and has all requisite corporate power to own its properties as now owned and operate its business as now operated and perform its obligations under this Agreement.

(b) Seller does not own, directly or indirectly, any equity security of any corporation _ _[*except _ _ _ ("Subsidiary"). All of Subsidiary's issued and outstanding shares of capital stock are owned of record and beneficially by Seller and are validly issued, fully paid, and nonassessable. To counsel's best knowledge and belief, there are no outstanding subscriptions, options, rights, warrants, convertible securities, or other Agreements or commitments obligating Subsidiary to issue or transfer from its treasury any additional shares of its capital stock of any class*]_ _.

(c) This Agreement has been duly and validly authorized and, when executed and delivered by Seller, will constitute legal, valid, and binding obligations of Seller, enforceable in accordance with their terms, except as limited by bankruptcy and insolvency laws and by other laws affecting the rights of creditors generally.

(e) Except as set forth in Exhibit _ _ to this Agreement, counsel knows of no suit, action, arbitration, or legal, administrative, or other proceeding or governmental investigation pending or threatened against or affecting Seller, or any of its businesses or properties, or its financial or other condition.

(e) Neither execution nor delivery of this Agreement, nor consummation of the transaction contemplated in this Agreement, will constitute (a) a default or an event that would, with notice or lapse of time or both, constitute a default under, or violation or breach of, Seller's articles of incorporation or bylaws, or any indenture, license, lease, franchise, mortgage, instrument, or other Agreement to which any Seller is a party or by which it or its properties may be bound; (b) an event that would permit any party to any Agreement or instrument to terminate it or to accelerate the maturity of any indebtedness or other obligation of Seller; or (c) an event that would result in the creation or imposition of any lien, charge, or encumbrance on any asset of Seller.

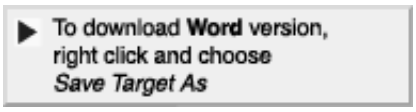
(f) Seller has good and marketable title to all its assets and properties, including those described in the exhibits to this Agreement, free and clear of all liens, encumbrances, equities, conditional sales contracts, security interests, charges, and restrictions, except as set forth in this Agreement or its exhibits.

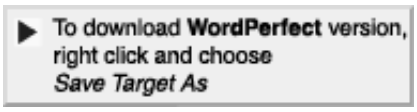
Comment: See chap 12 for further discussion of the contents of a requested legal opinion.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.24 7. Form: Absence of Litigation

§10.24 7. Form: Absence of Litigation





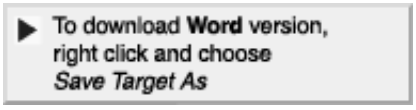
10.24-1 Absence of litigation

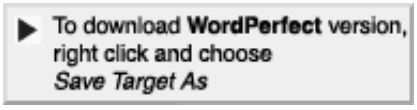
No action, suit, or proceeding before any court, private tribunal, or governmental body or authority, pertaining to the transaction contemplated by this Agreement or to its consummation, has been instituted or threatened on or before the Closing Date.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.25 8. Form: Letter Regarding Changes

§10.25 8. Form: Letter Regarding Changes





10.25-1 Letter regarding changes

Buyer has received from Seller's _ _[*chief financial officer/independent public accountant*]**_ _ a letter, dated the Closing Date, stating that:**

(a) The _ _[*chief financial officer/independent public accountant*]**_ _**

(1) has conducted a limited review (but not an audit) of Seller's latest available accounting records,

(2) has conducted with Seller's other responsible officers, as necessary, and

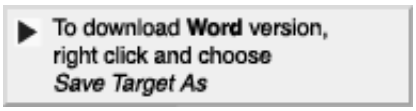
(3) has made any other pertinent inquiries that the _ _[*chief financial officer/independent public accountant*]**_ _ may deem necessary, and**

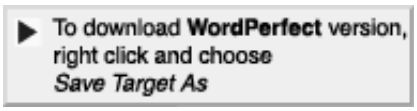
(b) on the basis of the foregoing, the _ _[*chief financial officer/independent public accountant*]**_ _ has no knowledge or reason to suspect that during the period from _ _**[*date of latest audited financial statement(s)*]**_ _ to a specified date no more than 5 business days before the Closing Date, any change occurred in Seller's financial condition or the results of its operations, except changes incurred in the ordinary and usual course of their respective businesses during that period that in the aggregate are not materially adverse, and except any other changes or transactions contemplated by this Agreement. _ _**[*For purposes of that letter, "materially adverse" will be deemed to be an increase in liabilities equal to or greater than $_ _*[*amount*]*_ _ without a corresponding increase in assets, or a reduction in monthly operating revenues during that period of $_ _*[*amount*]*_ _ or more.*]**_ _**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.26 9. Form: Corporate Approval

§10.26 9. Form: Corporate Approval



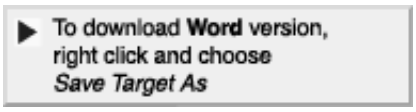


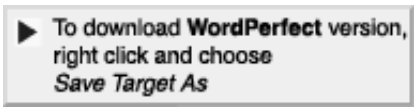
10.26-1 Corporate approval

The execution and delivery of this Agreement by Seller and the performance of its covenants and obligations under it, has been duly authorized by all necessary corporate action, and Buyer has received copies of all resolutions pertaining to that authorization, certified by Seller's secretary.

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§10.27 10. Form: Deeds and Title Policies





10.27-1 Deeds and title policies

Buyer has received from Seller

(a) grant deeds, dated no later than the Closing Date, in form and content reasonably satisfactory to Buyer, transferring to Buyer fee simple title to all of Company's real property (other than that held only as lessee) described in Exhibit _ _, and

(b) the escrow instructions, appropriately countersigned by _ _[*name of title company*]**_ _, or other written documentation, as is reasonably satisfactory to Buyer to evidence a commitment by _ _**[*name of title company*]**_ _ to issue title insurance policies at _ _**[*specify*]**_ _'s expense, insuring the fee simple title of Buyer to all that real property, subject only to**

(1) the lien, if any, of current real property taxes, payment of which is not delinquent;

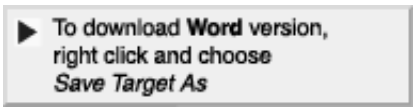
(2) liens and encumbrances referred to in Seller's consolidated balance sheet as of _ _[*date of last audited balance sheet*]**_ _, attached as Exhibit _ _; and**

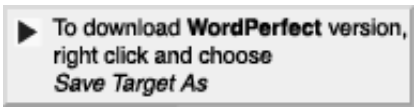
(3) objections and exceptions noted in any preliminary title reports that Buyer has approved in writing. The commitment will include liability coverage under the title insurance policies at least equal to the sums set forth in Exhibit _ _. _ _[*The commitment will provide for title policies in Form No. _ _ with endorsement(s) no(s). _ _*]**_ _**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.28 11. Form: Franchise Tax Board Clearance

§10.28 11. Form: Franchise Tax Board Clearance





10.28-1 Franchise Tax Board clearance

Buyer has received tax clearance certificates, as of a date not more than _ _[*number*]_ _ days before the Closing Date, of the California Franchise Tax Board for Seller.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.29 12. Form: Employment Development Department's Release

§10.29 12. Form: Employment Development Department's Release

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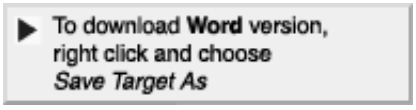
10.29-1 Employment Development Department's release

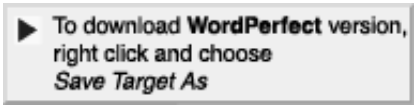
Buyer has received a Certificate of Release from the California Employment Development Department stating, as of a date not more than _ _[*number*]_ _ days before the Closing Date, that no contributions, interest, or penalties are due to the Employment Development Department from Seller.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.30 13. Form: Sales and Use Tax on Prior Sales

§10.30 13. Form: Sales and Use Tax on Prior Sales





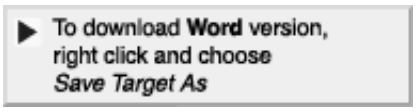
10.30-1 Sales and use tax on prior sales

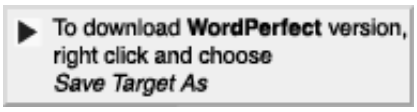
Buyer has received a clearance certificate from the California Board of Equalization and any related certificates that Buyer may reasonably request as evidence that all of Seller's sales and use tax liabilities accruing before the Closing Date have been fully satisfied or provided for.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.31 14. Form: FIRPTA Withholding

§10.31 14. Form: FIRPTA Withholding





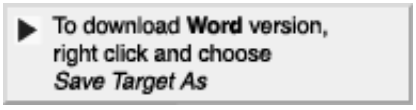
10.31-1 FIRPTA withholding

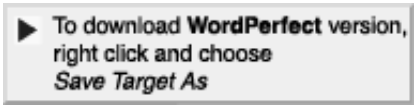
Buyer has received a certificate of Seller in the form of Exhibit _ _ or other evidence as Buyer may in its sole and absolute discretion determine to be adequate to relieve Buyer of any obligation to withhold under Internal Revenue Code §1445 (relating to withholding by buyers of U.S. real property interests, including stock in certain real property holding companies, in connection with Seller's possible liability for income tax under the Foreign Investment in Real Property Tax Act of 1980).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.32 15. Form: Consents

§10.32 15. Form: Consents





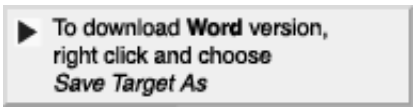
10.32-1 Consents

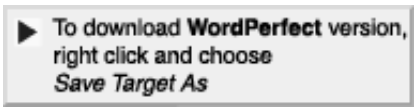
All necessary Agreements and consents of any parties to consummation of the transactions contemplated by this Agreement, or otherwise pertaining to the matters covered by it, have been obtained by Seller and delivered to Buyer _ _[*, including without limitation* _ _[*e.g., all required consents from the California Commissioner of Corporations to transfer the shares of Subsidiary to Buyer as provided for in this Agreement, which transfer will be subject to the restrictions set forth in a permit dated* _ _[*date*]_ _*, issued to Company by the California Commissioner of Corporations*]_ _]_ _**.**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.33 16. Form: Employment Agreement

§10.33 16. Form: Employment Agreement





10.33-1 Employment agreement

_ _[*Name of party*]_ _ has executed and delivered to Buyer an employment Agreement in the form set forth in Exhibit _ _, dated the Closing Date.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.34 17. Form: Approval of Documentation

§10.34 17. Form: Approval of Documentation

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10.34-1 Approval of documentation

The form and substance of all certificates, instruments, opinions, and other documents delivered to Buyer under this Agreement is satisfactory in all reasonable respects to Buyer and its counsel.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/ C. Conditions Precedent to Seller's Performance/§10.35 1. Form: Introductory Language for Conditions Precedent to Seller's Performance

C. Conditions Precedent to Seller's Performance

§10.35 1. Form: Introductory Language for Conditions Precedent to Seller's Performance

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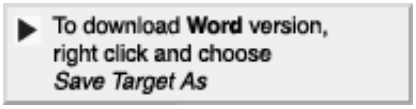
10.35-1 Introductory language for conditions precedent to seller's performance

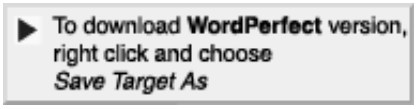
___. *Conditions Precedent to Seller's Performance.* **Seller's obligations to sell and transfer the _ _**[*e.g., Assets*]**_ _ under this Agreement are subject to the satisfaction, at or before the Closing, of all the following conditions. Seller may waive any or all of these conditions in whole or in part without prior notice, except that no waiver of a condition will constitute a waiver by Seller of any of its other rights or remedies, at law or in equity, if Buyer is in default of any of its representations, warranties, or covenants under this Agreement.**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.36 2. Form: Accuracy of Buyer's Representations and Warranties

§10.36 2. Form: Accuracy of Buyer's Representations and Warranties





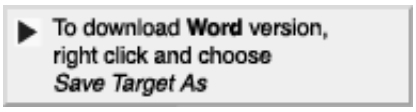
10.36-1 Accuracy of buyer's representations

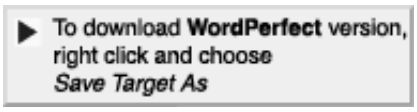
_ _[*Except as otherwise permitted by Section _ _ of this Agreement, all representations and warranties by Buyer in this Agreement*]_ _**, or in any written statement delivered to Seller under this Agreement, are true** _ _[*in all material respects*]_ _ **on and as of the Closing Date as though those representations and warranties were made on and as of that date.**

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§10.37 3. Form: Buyer's Performance



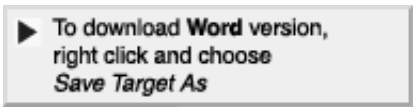


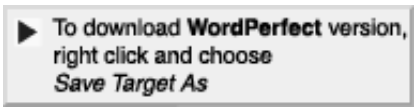
10.37-1 Buyer's performance

Buyer has performed, satisfied, and complied with all covenants, agreements, and conditions that it is required by this Agreement to perform, satisfy, or comply with on or before the Closing Date.

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§10.38 4. Form: Opinion of Buyer's Counsel





10.38-1 Opinion of buyer's counsel

Seller has received from _ _[*name*]_ _, counsel for Buyer, an opinion dated the Closing Date, in form and substance satisfactory to Seller and its counsel, to the effect that:

Comment: On the contents of a requested legal opinion, see chap 12.

(a) Buyer is a corporation duly organized, validly existing, and in good standing under the laws of the State of California and has all requisite corporate power to perform its obligations under this Agreement;

(b) All corporate proceedings required by law or by this Agreement to be taken by Buyer on or before the Closing Date, in connection with the execution and delivery of this Agreement and the consummation of the transactions contemplated by this Agreement, have been duly and validly taken;

(c) Buyer has the corporate power and authority to acquire the Assets for the consideration set forth in this Agreement;

(d) Every consent, approval, authorization, or order of any court or governmental agency or body that is required for the consummation by Buyer of the transactions contemplated by this Agreement has been obtained and will be in effect on the Closing Date;

(e) Buyer's promissory notes to be delivered at the Closing have been duly executed and, when delivered as provided in this Agreement, will constitute legal, valid, and binding obligations of Buyer, enforceable in accordance with their terms, except as limited by bankruptcy laws and insolvency laws and by other laws affecting creditors' rights generally;

(f) The shares of Buyer's common stock to be issued and delivered under this Agreement will be, when delivered, validly issued, fully paid, nonassessable, and in full compliance with all federal and state securities laws; and

(g) Neither execution nor delivery of this Agreement, nor consummation of the transaction contemplated in this Agreement, will constitute

(1) a default or an event that would, with notice or lapse of time or both, constitute a default under, or violation or breach of, Buyer's articles of incorporation or bylaws, or any indenture, license, lease, franchise, mortgage, instrument, or other Agreement to which any Buyer is a party or by which it or its properties may be bound;

(2) an event that would permit any party to any Agreement or instrument to terminate it or to accelerate the maturity of any indebtedness or other obligation of Buyer; or

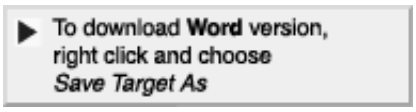
(3) an event that would result in the creation or imposition of any lien, charge, or encumbrance on any asset of Buyer.

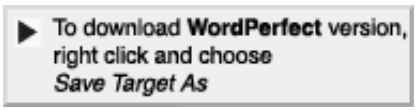
In rendering _ _[*his/her/their*]_ _ opinion, counsel for Buyer may rely on certificates of governmental authorities and on opinions of associate counsel.

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§10.39 5. Form: Buyer's Corporate Approval





10.39-1 Buyer's corporate approval

The board of directors and holders of _ _[*e.g., a majority*]_ _ of the _ _[*outstanding stock/voting power*]_ _ of Buyer has duly authorized and approved the execution and delivery of this Agreement and all corporate action necessary or proper to fulfill Buyer's obligations to be performed under this Agreement on or before the Closing Date.

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§10.40 6. Form: Qualification with California Commissioner of Corporations

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10.40-1 Qualification with California Commissioner of Corporations

The issuance and exchange of Buyer's common stock contemplated by this Agreement has been qualified with the California Commissioner of Corporations in accordance with the California Corporate Securities Law and the Commissioner's Rules and Regulations.

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§10.41 7. Form: Listing of Buyer's Stock

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10.41-1 Listing of buyer's stock

The shares of Buyer's common stock to be issued and delivered under this Agreement has been listed, or listed subject to official notice of issuance, on the _ _[*name*]_ _ Stock Exchange.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/10 Conditions/§10.42 8. Form: Absence of Litigation

§10.42 8. Form: Absence of Litigation

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10.42-1 Absence of litigation

No action, suit, or proceeding before any court, private tribunal or governmental body or authority, pertaining to the transaction contemplated by this Agreement or to its consummation, has been instituted or threatened on or before the Closing Date.

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11

Risk Allocation

Cynthia Caldeira
Victor Hsu

I. CHECKLIST: RISK ALLOCATION DEVICES §11.1

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- B. Defining and Distinguishing Different Risk Allocation Devices §11.3

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.1 I. CHECKLIST: RISK ALLOCATION DEVICES

§11.1 I. CHECKLIST: RISK ALLOCATION DEVICES

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- Contractual allocation of liability (see §§11.4-11.12)
- Indemnification (see §§11.13-11.39)
- Sources of indemnification (see §§11.13-11.15)
- Coverage and limitations (see §§11.16-11.24)
- Restrictions (see §11.18)
- Exculpatory provisions, limitations of liability, and releases (see §§11.40-11.56)
- Coverage and limitations (see §§11.40-11.47)
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- Restrictions (see §11.49)
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- Implied waivers (see §11.57)
- Contractual waivers (see §§11.58-11.60)

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II. RISK ALLOCATION GENERALLY

§11.2 A. Assigning Risk

When negotiating any business transaction, the parties may preserve or alter the risks or duties imposed by law on the proposed arrangement. For example, although a property owner is generally liable for damage caused by hazardous materials on his or her property (42 USC §9607), a potential buyer of real property may be unwilling to purchase the property unless the seller agrees to be financially responsible for any cleanup costs caused by the presence of hazardous materials on the property before the closing date.

The degree to which a court will respect a contractual allocation of duties and obligations may depend on the party's relative position in the transaction. If both parties are major industrial giants, the courts generally respect their ability to evaluate and allocate the risk of a particular transaction. However, if one party is a corporate giant and the other is an average consumer, the courts may subject the risk allocation agreement to heightened scrutiny.

The first step in drafting risk allocation provisions in any agreement is to determine the following:

- What is the general nature of the duty or obligation of concern: is it contractual, tort-based, or statutory?
- Where does the obligation or duty lie in the absence of an agreement?
- What is the scope of the obligation or duty?
- What obligations have the parties assumed, *e.g.,* have any representations or warranties been given?
- To what degree do the parties wish to transfer or eliminate the obligation or duty?
- Should third parties be entitled to rely on the allocation?

Counsel, after resolving these initial questions, can select the appropriate means of allocating the identified risk from one or more of the following risk allocation devices: direct assignment of the risk to one party under the contract (see §§11.4-11.12), indemnification provisions (see §§11.13-11.39), exculpatory provisions or releases (see §§11.40-11.56), or waivers (see §§11.57-11.60).

NOTE: The use of representations and warranties can also shift risks between the parties. For discussion of representations and warranties, see chap 7.

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§11.3 B. Defining and Distinguishing Different Risk Allocation Devices

An agreement can directly allocate risk by naming the party responsible for specific risks or duties. Statutory or common law may generally define the parties' duties and when they shift, without specifically addressing the transaction at issue. To avoid later controversy, counsel should explicitly state in the contract when a duty, an obligation, or a risk of loss transfers from one party to the other. See §§11.4-11.12.

Indemnity is one party's obligation to make good a loss or damage that another party has incurred with respect to a third party. *Rossmoor Sanitation, Inc. v Pylon, Inc.* (1975) 13 C3d 622, 628, 119 CR 449 (quoted in *Kramer v Cedu Found.* (1979) 93 CA3d 1, 155 CR 552). Under an indemnification agreement, the indemnitee remains liable to the injured party but may seek compensation from the indemnitor for the liability. An indemnification therefore protects the indemnified party only to the extent of the indemnitor's financial strength and any assets securing the indemnification. An indemnification can apply to both contract and tort claims. See §§11.13-11.39. See also *Yang Ming Marine Transport Corp. v Okamoto Freighters Ltd.* (9th Cir 2001) 259 F3d 1086 (indemnity covers all losses).

Under an exculpatory agreement, one party expressly agrees to assume the risk of harm arising from another's conduct and to relieve the other party from liability to the other contracting party for the conduct; the injured party is then left without a remedy against the other party. *Knight v Jewett* (1992) 3 C4th 296, 11 CR2d 2; *Ford v Gouin* (1992) 3 C4th 339, 11 CR2d 30. Exculpatory provisions can be complete or partial. A provision that partially relieves a party from liability or is limited by definition is sometimes referred to as a limited liability provision. The most common limited liability provisions limit warranties and the obligations for breach of warranty. Exculpatory provisions can be used to relieve or limit liability for both tort and contract claims. See *Delta Air Lines v Douglas Aircraft Co.* (1965) 238 CA2d 95, 100, 47 CR 518.

A release extinguishes a previously existing obligation or claim owed to the beneficiary. *Delta Air Lines v Douglas Aircraft Co., supra*. Releases are often given in the settlement of actual or threatened litigation; they are also often included in a termination or "bust up" agreement to preclude litigation in the event that a transaction fails to close.

An express assumption of risk is the obverse of a release. One party to the assumption agrees not to expect the other party to act carefully, thus eliminating the other party's duty of care. See *Ordway v Superior Court* (1988) 198 CA3d 98, 243 CR 536; *Coates v Newhall Land & Farming, Inc.* (1987) 191 CA3d 1, 7, 236 CR 181.

Often, exculpatory language, limitations of liability, releases, and assumption of risk provisions are combined. They are discussed together in this chapter. See §§11.40-11.56.

A waiver is the intentional relinquishment of a known right. *BP Alaska Exploration, Inc. v Superior Court* (1988) 199 CA3d 1240, 1252, 245 CR 682. It may apply to future as well as past conduct. A waiver may arise from the agreement of the parties or from waivers implied by conduct (acts of either commission or omission). CC §3513. See §§11.57-11.60.

Parties in a transaction may allocate risk by agreeing to buy their own insurance to protect against certain activities. *Appalachian Ins. Co. v McDonnell Douglas Corp.* (1989) 214 CA3d 1, 30, 262 CR 716. A party can also reduce the risk in a transaction by requiring appropriate security or personal guaranties for the obligations. See chap 22 for discussion of guaranties.

Liability can be limited by (1) placing a monetary cap or threshold on the liable party's exposure for damages, (2) allowing the injured party to recover only certain damages, (3) limiting the remedies available to the injured party, or (4) any combination of these restrictions. See §§11.20-11.21, 11.41. The parties can also specify the timing of defense cost payments. See §11.22.

WARNING: This chapter assumes that the contracting parties are dealing in a commercial context. Additional restrictions on risk transfer may apply in consumer contracts.

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III. CONTRACTUAL TRANSFER OF LIABILITY

A. Transactions for Purchase and Sale of Assets

§11.4 1. Who Has Risk of Loss?

In a purchase and sale agreement of goods or tangible assets, including the sale of the assets of a business, the risk of loss generally remains with the seller until the goods or assets are delivered to the buyer, at which time the risk shifts to the buyer. Com C §2509. This allocation of risk may be modified by agreement of the parties. Com C §2509(4). See §11.5.

Generally, liabilities associated with assets do not transfer to the buyer without the buyer's express or implied assumption of the liabilities. *SMC Corp. v Berkel, Inc.* (1977) 73 CA3d 49, 56, 140 CR 559.

PRACTICE TIP: If the parties intend that the buyer succeed to the seller's liability for the obligations of the business, they should execute a delegation and assumption of these obligations at the closing.

After the sale, however, and even without an assumption, the buyer may be liable for certain of the seller's obligations incurred before the sale, such as payment of payroll and unemployment taxes for the employees of the purchased business and for unpaid sales taxes. Un Ins C §§1731, 13020 (payroll and unemployment tax); Rev & T C §6811 (sales tax).

PRACTICE TIP: To avoid successor liability for these obligations, the buyer should secure tax certificates from the appropriate agencies that these obligations have been paid or, alternatively, the buyer should require that the seller provide indemnification for any liability resulting from nonpayment by the seller.

WARNING: If the seller's principal business is the sale of inventory from stock and more than half of the equipment and inventory is being sold, counsel should review the bulk sales law to see whether it applies and exposes the buyer to additional liability for the seller's obligations. See Com C §§6102(a)(3), 6103.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.5 2. Form: Transfer of Risk of Loss When Property Delivered

§11.5 2. Form: Transfer of Risk of Loss When Property Delivered

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11.5-1 Transfer of risk of loss when property delivered

___. *Liability for Risk of Loss.* Liability for and risk of loss or damage in transit or after transit passes to Buyer when Seller delivers the goods to _ _[*a common carrier for delivery to Buyer/Buyer's facility in _ _[location]_ _]_ _.

Comment: See Com C §§2319-2321 (when risks transfer if goods shipped FOB, CIF, or C & F).

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§11.6 3. Form: No Assumption of Liabilities

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11.6-1 No assumption of liabilities

___. *No Assumption of Liabilities.* In conjunction with its purchase of the Assets, Buyer is not assuming any debt, liability, or other obligation of Seller

[*Add if agreement lists specific obligations assumed*]

, except for the debts, liabilities, or other obligations identified in Exhibit _ _ of this Agreement, which are to be assumed by Buyer under this Agreement.

[*Continue*]

Seller remains liable for all debts, liabilities, and other obligations not assumed by Buyer, and shall indemnify and defend Buyer and hold Buyer harmless from all those debts, liabilities, and other obligations, as provided in Section _ _ of this Agreement.

Comment: The reference in the final paragraph refers to the indemnification section of the agreement, which should address indemnification for liabilities not assumed.

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B. Transactions for Purchase and Sale of Securities

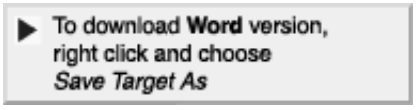
§11.7 1. Who Is Liable?

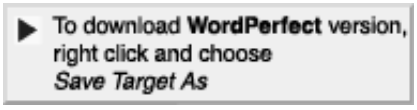
A purchaser who acquires a business by purchasing the shares of common stock or other securities representing ownership of the business acquires the entity once the shares or other securities are acquired. The acquisition of the entity would include acquisition of any of the entity's liabilities. If an entity is so purchased, liabilities cannot be excluded from transfer. However, the seller may agree to compensate the buyer if certain excluded liabilities of the entity exceed a stated amount. The agreement should specifically state the nature and scope of the exclusions. See form in §11.8.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.8 2. Form: Exclusion of Assumption of Liabilities

§11.8 2. Form: Exclusion of Assumption of Liabilities





11.8-1 Exclusion of assumption of liabilities

___. *Exclusion of Assumption of Liabilities.* Notwithstanding Buyer's purchase of all of the outstanding shares of common stock of _ _[*name of subsidiary*]_ _, Seller remains liable for all debts, liabilities, and other obligations of _ _[*name of subsidiary*]_ _ relating to _ _[*e.g., hazardous waste clean-up or remediation*]_ _ to the extent that those debts, liabilities, and other obligations exceed $_ _[*amount*]_ _ (the Retained Liabilities), and Seller shall indemnify and defend Buyer and hold Buyer harmless from all Retained Liabilities, as provided in Section _ _ of this Agreement.

Comment: The reference in the final paragraph refers to the indemnification section of the agreement, which should address indemnification for liabilities not assumed.

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C. Transactions for Purchase and Sale of Real Property

§11.9 1. Who Is Liable?

The seller retains liability and risk of loss for real property until title or possession is transferred to the buyer. After the transfer, risk of loss or destruction of the property and all obligations appurtenant to the land shift to the buyer; the seller's liabilities that are personal in nature are not binding on the buyer unless expressly assumed. CC §§1460, 1662. The parties may want to shift all or part of the risk of loss at an earlier or later point in the transaction. See form in §11.10.

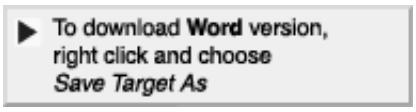
PRACTICE TIP: If the risk of loss shifts to the buyer before title or possession is transferred, the buyer should consider purchasing appropriate insurance to protect its interest.

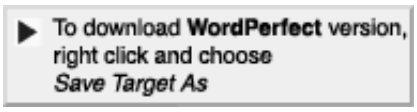
Certain statutory limitations also apply to the transfer of liabilities. For example, a seller retains liability for the cleanup of certain toxic or environmental wastes. 42 USC §9607. The parties can include provisions in the real property sales contract to limit the seller's liability for environmental cleanup, but these provisions apply only to private claims; they do not protect the seller from direct governmental action. *Mardan Corp. v CGC Music, Ltd.* (9th Cir 1986) 804 F2d 1454, 1461.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.10 2. Form: Transfer of Risk

§11.10 2. Form: Transfer of Risk





11.10-1 Transfer of risk

___. *Transfer of Risk.*

[*Add one of the following alternatives*]

[*Alternative 1: Application of CC §1662*]

This Agreement will be governed by California Civil Code §1662 in effect at the date of this Agreement _ _[*except as expressly provided in Section _ _ of this Agreement*]_ _. _ _[*Seller shall promptly vacate the Property on Closing.*]_ _ **Buyer will be relieved from all obligations to pay the Purchase Price if the Property is destroyed or taken by condemnation before Buyer takes possession of, or legal title to, the Property.**

[*Alternative 2: Waiver of CC §1662*]

On execution of this Agreement and the opening of escrow under Section _ _ of this Agreement, Seller may enforce this Agreement and recover the Purchase Price from Buyer if the Property is destroyed or taken by condemnation before Closing. Buyer and Seller expressly waive California Civil Code §1662.

Comment: The exception in Alternative 1 refers to the section in the agreement, if any, discussing risk of loss or right to enforcement after destruction or condemnation.

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D. Real Property Lease Transactions

§11.11 1. Who Is Liable?

In a real property lease, the landlord generally owes a duty to act with reasonable care with respect to the tenant and is liable for any negligence toward the tenant. The landlord is also liable for all risks attendant on the ownership of property, unless the lease provides that the tenant will bear these risks. For example, the landlord may shift the burden of repair and maintenance of the premises to the tenant. See §11.12.

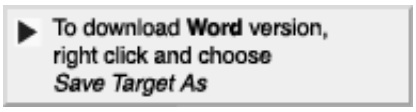
The landlord is generally responsible for maintaining the leased property in tenantable condition, absent the parties' agreement to the contrary. CC §§1941-1942. But the tenant will be responsible even for duties as extensive asbestos removal if the lease provides that the tenant has the duty "to comply with all laws and regulations affecting the premises" and relieves the landlord from any duty of maintenance or repair, and the context supports that result. *Brown v Green* (1994) 8 C4th 812, 35 CR2d 598 (facts supporting tenant's liability included long-term nature of lease, use of property, parties' sophistication, notice of condition, tenant's right to inspect, and cost of repairs). See also *Hadian v Schwartz* (1994) 8 C4th 836, 35 CR2d 589 (lessor liable for earthquake retrofitting because lease had short term, high cost of repairs, and benefits of repairs inured to lessor).

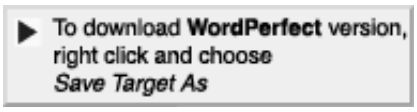
NOTE: Any agreement by a tenant of a dwelling waiving or modifying his or her rights under CC §1941 or 1942 is void as against public policy with respect to any condition that would render the property untenantable. CC §1942.1.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.12 2. Form: Tenant Undertakes Maintenance and Repair (Pro-Landlord)

§11.12 2. Form: Tenant Undertakes Maintenance and Repair (Pro-Landlord)





11.12-1 Tenant undertakes maintenance and repair

1. *Condition of Premises.* Tenant has examined and inspected the Premises, and has consulted with a professional (or made an informed decision not to consult with a professional) with experience in evaluating the condition of the property, including the possible presence of asbestos, hazardous materials, and underground storage tanks. By its entry of the Premises under this Lease, Tenant acknowledges that the Premises are in good order and repair.

2. *Tenant's Obligations.* Tenant, at its own cost and expense, and at no cost and expense to Landlord, will (i) maintain all portions of the Premises in good order and repair, and (ii) make all structural and nonstructural repairs and replacements, both ordinary and extraordinary that may become necessary, whether or not the portion of the Premises requiring repair is reasonably or readily accessible to Tenant and whether or not the need for repairs occurs as a result of Tenant's use, any prior use, the elements, or the age of that portion of the Premises. Tenant's obligation includes, without limitation, all plumbing, heating, air conditioning, ventilating, and electrical systems, lighting facilities, and equipment within the Premises, fixtures, walls (interior and exterior), foundations, ceilings, roofs (interior and exterior), floors, windows, doors, plate glass, and skylights located within the Premises.

3. *Disclaimer of Landlord's Obligations*. Landlord has no obligation to repair or maintain the Premises. Tenant waives the requirements of California Civil Code §§1941 and 1942 or any other statute now or later in effect with respect to Landlord's obligations for tenantability of the Premises and Tenant's right to make repairs and deduct the cost of repairs from rent.

Comment: The effectiveness of this provision in transferring liability for substantial repairs may be limited by the type of property leased, the sophistication of the parties, the cost of repairs, and other aspects of the lease transaction. See §11.11. A waiver of rights under CC §§1941 and 1942, as included in paragraph 3 of this form, is prohibited if the lease is for a dwelling. CC §1942.1.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/ IV. INDEMNIFICATION PROVISIONS/§11.13 A. Sources of Indemnification

IV. INDEMNIFICATION PROVISIONS

§11.13 A. Sources of Indemnification

The duty to indemnify generally arises from one of the following sources:

- Equitable considerations brought into play either by contractual language not specifically dealing with indemnification or by the equities of the particular case. See *Garlock Sealing Technols., LLC v NAK Sealing Technols. Corp.* (2007) 148 CA4th 937, 967, 56 CR3d 177; see §11.14.
- Express contractual language establishing an agreement of one party to save another harmless on the occurrence of specified circumstances. CC §2772. See §11.15.
- Statutory law. Examples include Lab C §2802 (employer must indemnify employees if they acted within the scope of employment and without knowing they were acting unlawfully); Corp C §317 (corporation may indemnify director, officer, employee, or other agent of the corporation); and Corp C §16401 (partnership must indemnify partner for liabilities incurred in the ordinary course of the business of the partnership).

NOTE: An indemnification provision does not absolve the indemnified party from liability but provides instead for another party to pay any amounts due from the indemnified party as a result of that liability. As such, the indemnification is only as valuable as the financial strength of the indemnitor and the security pledged to support the indemnity. See form in §11.39 for language providing the indemnitee with a right of set-off against the indemnitor.

For further discussion, consult California Law of Contracts §6.51 (Cal CEB 2007).

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§11.14 1. Implied Indemnity

If equitable considerations make it just to shift liability from one party to the other, the courts may impose indemnity despite the absence of an express indemnity agreement. *Kramer v Cedu Found.* (1979) 93 CA3d 1, 155 CR 552. Equitable indemnification is a matter of fairness; tortfeasors should share loss in proportion to their culpability, and contracting parties should share loss relative to their breach.

The doctrine of "comparative equitable indemnity" is used to apportion loss among multiple tortfeasors in proportion to their relative culpability. *American Motorcycle Ass'n v Superior Court* (1978) 20 C3d 578, 608, 146 CR 182. "Implied contractual indemnity" apportions foreseeable loss between contractual parties based on the concept that one who enters a contract agrees to perform the work carefully and to discharge foreseeable damages resulting from any breach. *Smoketree-Lake Murray, Ltd. v Mills Concrete Constr.* (1991) 234 CA3d 1724, 1736, 286 CR 435.

There are a number of exceptions to the doctrine of comparable or partial equitable indemnity, including immunity from contribution for parties who enter into good faith settlements and employers who have paid workers' compensation claims. A health care provider may invoke the limits for recovery of noneconomic damages imposed by the Medical Injury Compensation Reform Act (MICRA) to limit its noneconomic damages in an action for partial equitable indemnity based on professional negligence. *Western Steamship Lines, Inc. v San Pedro Peninsula Hosp.* (1994) 8 C4th 100, 32 CR2d 263. Under MICRA, the recovery for noneconomic damages against a health care provider is limited to $250,000. CC §3333.2.

PRACTICE TIP: To avoid the vagaries of implied equitable indemnity, counsel should anticipate the principal areas of risk and allocate that risk by express contractual agreement.

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§11.15 2. Express Indemnity

Express indemnity is a contract by which one party engages to save another from a legal consequence of the conduct of another party, or some other person. CC §2772. If the parties have expressly contracted to indemnify, the extent of the duty to so indemnify is established by the contract, not by relying on the doctrine of equitable indemnity. *Peter Culley & Assoc. v Superior Court* (1992) 10 CA4th 1484, 1492, 13 CR2d 624.

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B. Interpretation and Enforcement of Indemnification Agreements

§11.16 1. Contract Principles

Express contractual indemnity agreements are interpreted in accordance with general contract principles. They are construed with a view to ascertaining the parties' actual intent. *Ralph M. Parsons Co. v Combustion Equip. Assoc.* (1985) 172 CA3d 211, 221, 218 CR 170. Ambiguities in the agreement are construed against the indemnitee and may cause the indemnity to be unenforceable. *Goldman v Ecco-Phoenix Elec. Corp.* (1964) 62 C2d 40, 44, 41 CR 73. If an indemnitor is responsible for the negligent acts of the indemnitee or others over whose conduct it has no control, the language imposing that responsibility should so state, expressly and unequivocally, so that the contracting party is advised in definite terms of the liability to which it is exposed. *Ralph M. Parsons Co. v Combustion Equip. Assoc.* (1985) 172 CA3d 211, 218 CR 170.

NOTE: Because indemnity agreements are generally construed against the indemnitee, counsel representing the indemnitee should specifically provide that the agreement is the result of negotiations in which each party was represented by legal counsel and will not be construed for or against any party by reason of draftsmanship or otherwise. See §§17.23-17.24.

For further discussion, consult California Law of Contracts §6.51 (Cal CEB 2007).

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§11.17 2. Scope of Agreement

The specificity of the language used in the indemnity agreement is a key factor in establishing its scope. A specific enumeration of the circumstances covered by the indemnification aids in its enforcement. Because it is not possible to know in advance every possible area for which indemnification may be sought, however, coverage should be expressed using inclusive terms such as "all" or "of every kind, nature, and description." This clarity may refute a claim that unnamed events, by implication, are excluded. See *Ralph M. Parsons Co. v Combustion Equip. Assoc.* (1985) 172 CA3d 211, 221, 218 CR 170. When specific language is lacking, the courts look to evidence, including surrounding circumstances, that the act for which indemnification was sought was specifically considered and bargained for by the contracting parties. *Rossmoor Sanitation, Inc. v Pylon, Inc.* (1975) 13 C3d 622, 633, 119 CR 449.

PRACTICE TIP: To avoid application of the equitable principle that examples limit and define the rule, the drafter could use the language "including without limitation…" or "including but not limited to…." Alternatively, counsel can simply use the word "including" and then define the term as not limiting. See form in §17.8.

An indemnity agreement that does not specifically address the indemnitee's negligence is a "general indemnity agreement," indemnifying only for the indemnitee's passive negligence. A general indemnity agreement does not provide indemnification for the indemnitee's active negligence, unless the circumstances of the case and the language of the agreement evince a different intent by the parties. *Rossmoor Sanitation, Inc. v Pylon, Inc.* (1975) 13 C3d 622, 629, 119 CR 449; *McCrary Constr. Co. v Metal Deck Specialists, Inc.* (2005) 133 CA4th 1528, 1538, 35 CR3d 624; *Peter Culley & Assoc. v Superior Court* (1992) 10 CA4th 1484, 1492, 13 CR2d 624 (compare *Culley* with *Morton Thiokol, Inc. v Metal Bldg. Alteration Co.* (1987) 193 CA3d 1025, 238 CR 722). See *Sanchez v Bally's Total Fitness Corp.* (1998) 68 CA4th 62, 79 CR2d 902. To obtain indemnification for active negligence, the agreement should state that the indemnitee is entitled to indemnification even if he or she acted negligently.

If, after request, the indemnitor neglects to defend the indemnitee, a *recovery by judgment* against the indemnitee is conclusive as against the indemnitor. CC §2778(5). See *Peter Culley & Assoc. v Superior Court, supra*. A *settlement* by the indemnitee, however, is merely presumptive, but not conclusive, evidence of liability and the amount of that liability. This presumption may be overcome by proof of no liability or proof that the settlement was unreasonable. 10 CA4th at 1497. Consequently, an indemnity agreement should address settlements as well as judgments.

NOTE: Some clients, especially those that are local governmental entities, routinely require indemnification from their attorneys for any losses arising from the attorneys' provision of legal services. This contractual indemnity is in addition to the duties of care and loyalty that attorneys already owe their clients as a matter of professional responsibility. The intent is to obligate the attorneys to cover the cost of defending the client against any lawsuit brought by a third party in connection with the representation, regardless of whether the attorneys actually committed malpractice. Attorneys must treat requests to indemnify their clients with great caution. Some malpractice insurance carriers, such as Attorneys' Liability Assurance Society Ltd., do not provide coverage based on contractual indemnities that expand the attorneys' scope of liability for malpractice. Instead, their policies cover attorneys solely for claims made on account of alleged acts or omissions arising out of professional conduct. If a contractual indemnity were in place, and the client made a claim against the attorneys for professional negligence, such an insurance carrier might try to deny coverage based on its exclusion for contractual indemnities.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.18 C. Indemnification Restrictions

§11.18 C. Indemnification Restrictions

Before negotiating any express contractual indemnification, counsel should ascertain whether statutes, case law, or public policy limit the indemnification sought, *e.g.:*

- An indemnification is subject to all defenses against any contract (*e.g.,* unconscionability). *Appalachian Ins. Co. v McDonnell Douglas Corp.* (1989) 214 CA3d 1, 262 CR 716.
- An indemnification that requires an employer to indemnify a third party for liability arising out of an action brought by an employee must be executed by the employer and the indemnitee before the injury which gives rise to the action. Lab C §3864; *Hansen Mechanical v Superior Court* (1995) 40 CA4th 722, 47 CR2d 47.
- An indemnification is invalid and unenforceable if it protects a party against his or her own fraud, willful injury to person or property, or willful or negligent violation of law. CC §1668. Such willful or negligent violation of law includes violations of both statutory law and regulatory provisions. *Health Net of Cal., Inc. v Department of Health Servs.* (2003) 113 CA4th 224, 6 CR3d 235.
- Although an agreement cannot provide indemnification for a person's knowing commission of an unlawful act in the future, it may indemnify a person against a past unlawful act, as long as it was not a felony. CC §2774.
- Subject to limited exceptions, an indemnity provision in a construction contract may not provide indemnification for injury or loss due solely to the indemnitee's negligence or willful misconduct; such provisions are against public policy and as such are void and unenforceable. CC §2782. Indemnification may be available, however, if loss or injury is due only *in part* to the contractor's negligence or willful misconduct. *C.I. Eng'rs & Constructors, Inc. v Johnson & Turner Painting Co.* (1983) 140 CA3d 1011, 1018, 189 CR 824.
- Special rules govern indemnification provisions limiting or eliminating the liability of carriers, warehouses, innkeepers, and bailees. CC §2784.5 (hauling, trucking, or cartage contracts); Com C §§7204, 7309.
- Insurance companies may not grant indemnity for intentional torts or criminal conduct. Ins C §533.
- A corporation's indemnity of its officers, directors, or agents is subject to certain requirements and limitations. Corp C §§317, 5238, 7237, 12377.
- Certain disclosure requirements apply to indemnification of officers and directors of nonprofit corporations. Corp C §§6322, 8322, 12592.

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D. Indemnity Provisions

§11.19 1. Scope of Coverage

When a claim is brought, all potential parties are usually named. The indemnification provisions can protect only one or more specified parties, or they can be broadly drafted to provide indemnification to persons who are not parties to the underlying transaction. Often, the language of the agreement provides that a party's officers, directors, employees, shareholders, agents, and affiliates could also seek indemnification.

To describe properly the scope of the indemnification, counsel should consider the following points:

- Counsel should identify each individual or entity to be indemnified.
- Counsel should consider including a reference to parent or subsidiary companies.
- Counsel should specify the recoverable fees and expenses, including fees and expenses incurred in enforcing the indemnity provisions and in any appeal concerning such enforcement.
- If a particular consequence is foreseeable, counsel should consider providing for loss of profits and consequential damages.

For further discussion, consult California Law of Contracts §6.51 (Cal CEB 2007).

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§11.20 2. Money Limits, Thresholds, Caps, and Other Limitations

The indemnitor wants to limit the amount of money for which it may be liable. There are different approaches to reaching this result:

- The provision may set a threshold, stating that the indemnitor is obligated only for an individual claim that exceeds a certain amount and for any claims that in the aggregate exceed a certain amount. Once the threshold limits are surpassed, the indemnitor is liable for all future losses of any amount and may (or may not) be liable for all amounts making up the threshold. See form in §11.36.
- The provision may state that the indemnitee bears the liability up to a certain limit, similar to a deductible in an insurance policy, and the indemnitor is liable for all amounts (or a percentage of all amounts) that exceed the limit. See form in §11.37.
- The provision could cap the indemnitor's liability at a set dollar amount for any individual claim or for all claims in the aggregate. See form in §11.38.
- The agreement can limit the indemnitor's liability to an amount equal to the consideration the indemnitor received under the agreement.
- The agreement can reduce the indemnitor's liability by an amount equal to any benefits that the indemnitee may recover, such as insurance proceeds, tax savings, or other windfalls.

There are several other ways to limit the indemnitor's exposure:

- The agreement can limit available remedies. See §11.21.
- The agreement can limit the representations and warranties in the agreement and how long they survive closing or termination of the agreement. See §§11.24, 11.28-11.30.
- The agreement can limit the time for bringing claims. See §§11.29-11.31.
- The agreement can prohibit indemnification if the indemnitee had actual knowledge of a misrepresentation or breach of warranty before the closing.
- The agreement can provide terms for payment, *e.g.,* payment by note, by offset, or with stock.
- The agreement can limit the types of claims indemnified, *e.g.,* indemnification for antitrust liability only.

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§11.21 3. Exclusive Remedy

The indemnitor's counsel should attempt to provide that claims for indemnification are the sole remedy for breach of representations and warranties, so that the indemnitee cannot circumvent negotiated limitations under the indemnity provisions by bringing a direct claim for breach of warranty.

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§11.22 4. Defense and Defense Costs

The indemnitor must pay the costs of defense or assume the defense if so requested (CC §2778(3)-(4)). The duty to defend under CC §2778(4) is independent of the issue of liability and does not depend on the outcome of the litigation. *Crawford v Weather Shield Mfg.* (2008) 44 C4th 541, 558, 79 CR3d 721.

The issue of control of the defense is often hotly negotiated. The indemnitor wants to control the defense and the issues regarding settlement or prosecution of the case, to limit its expense and exposure. But because litigation could affect the indemnitee's ongoing business, involve its management team, and be time-consuming, the indemnitee may wish to control the defense to be able to settle quickly with the least amount of disruption. The indemnitee has the right to control the defense of the action if it chooses to do so, unless the parties agree otherwise. CC §2778(4). If the parties intend that the indemnitor have the right to control the defense, counsel should clearly state that intention in the agreement to prevent application of §2778(4) (with or without also granting the indemnitee the right to hire separate counsel at its own cost).

If the agreement does not specify that the indemnitee must tender the defense of the matter to the indemnitor, then the indemnitee has the choice either to tender the defense or to not tender and conduct its own defense, and in either case the costs of defense are to be paid by the indemnitor. *City of Watsonville v Corrigan* (2007) 149 CA4th 1542, 58 CR3d 458. See CC §2778(3), (4).

Counsel for the indemnitee should make sure that the agreement states an obligation to defend and pay for the defense that is in addition to, and separate from, the obligation to indemnify. Otherwise, the indemnitee may be unable to recover its defense costs until a settlement is reached or a final determination of liability is made. As a corollary issue, the parties should also specify the timing of the payment of defense costs, *e.g.,* whether the costs should be advanced or paid only after liability has been ascertained.

A provision stating that the defense of an action is a loss is not a provision for attorney fees in an action to enforce the indemnification provisions. The plaintiff cannot collect attorney fees if the agreement does not include a clause granting them to the prevailing party. *Otis Elevator Co. v Toda Constr.* (1994) 27 CA4th 559, 32 CR2d 404. In *Toda,* the court declined to follow *DeWitt v Western Pac. R.R.* (9th Cir 1983) 719 F2d 1448 (which held that CC §2778(3) permitted recovery of attorney fees incurred in prosecution of indemnification claim).

NOTE: The court may award attorney fees to a party who prevails on claims for implied indemnity. CCP §1021.6. Without a provision awarding attorney fees to the prevailing party, attorney fees are not recoverable for an appeal of a claim for indemnity. *Hillman v Leland E. Burns, Inc.* (1989) 209 CA3d 860, 870, 257 CR 535. For discussion of attorney fees in general, see §§16.58-16.60. See form in §16.62 for language awarding attorney fees to the prevailing party.

For further discussion, consult California Law of Contracts §6.55 (Cal CEB 2007).

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§11.23 5. Third Party Claims

Indemnification is commonly provided for claims arising out of the transaction that the indemnitee may suffer from third parties. For example, a buyer may be concerned that the seller is subject to previous contractual arrangements that could expose the buyer to liability. Often, the due diligence in a transaction reveals areas for which one party may wish to be specifically indemnified. A general indemnity provision can extend indemnification to unspecified claims, but enforcement may be enhanced to the extent that issues of concern are specified and addressed. Representations and warranties provide a method for identifying specified items.

Absent clear intent to the contrary, an ordinary indemnification provision will not be interpreted as an exculpatory clause protecting the indemnitee from claims of the indemnitor, but rather will be construed as only protecting the indemnitee against third party claims. *Queen Villas Homeowners Ass'n v TCB Prop. Mgmt.* (2007) 149 CA4th 1, 5, 56 CR3d 528.

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§11.24 6. Indemnification for Misrepresentations and Breach of Warranties

In most business contracts, such as stock purchase agreements, asset acquisition agreements, and merger agreements, misrepresentations and breaches of warranties are often enforced through indemnification provisions. Counsel can limit exposure for indemnification by limiting either the survival of representations and warranties (see §§11.29-11.30) or the time within which the indemnitee can bring claims for indemnification (see §11.31). The language of survival clauses must be specific. In *Western Filter Corp. v Argan, Inc.* (9th Cir 2008) 540 F3d 947, a stock purchase agreement stated that certain representations and warranties would survive the closing for 1 year. When the plaintiff sued for breach of the representations and warranties, the district court held that claims brought after the 1-year survival period were time barred. The Ninth Circuit reversed, holding that the survival clause's ambiguous language did not create a 1-year limitation period.

Agreements for the sale of goods commonly limit warranties to very short periods of time (*e.g.,* 30 to 90 days) because defects are normally revealed within that time. For most other transactions, a short survival period is less than a year after the transaction closes. Periods of 1 or 2 years are common—any longer period would likely be controlled by the statute of limitations.

NOTE: The agreement may provide different survival periods to different representations and warranties. For example, a 30-day warranty may apply to equipment, with other representations and warranties surviving for 1 year.

PRACTICE TIP: If counsel does not provide that the representations and warranties survive the closing, the indemnitee may argue that the representations and warranties were extinguished at the time of closing. This issue is of particular concern for transactions involving the transfer of title to real property.

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§11.25 7. Notice

Counsel representing the indemnitor should carefully analyze provisions covering the time and manner of giving notice of a potential claim. Prompt notice is necessary to give the indemnitor sufficient time to analyze the potential liability, determine whether tender of defense is appropriate, and preserve its defenses.

The notice provision should establish what information must be included in the notice so that the indemnitor receives sufficient information to make the necessary analysis. The provision should also require the indemnitor to reply to the indemnitee within a set time period, indicating whether it is willing to indemnify the indemnitee and assume defense of the claim.

It may be a condition of indemnification that the indemnitee give prompt notice of any potential claim so that the indemnitor may act to limit its exposure. The indemnity may provide for the indemnitor to be relieved from the obligation to indemnify to the extent that it is prejudiced in its defense of the action by the indemnitee's failure to give notice.

See the form in §11.35 for procedures triggering indemnification.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/ E. Indemnification Forms/§11.26 1. Form: Indemnification for Specific Third Party Claims (Pro-Indemnitee)

E. Indemnification Forms

§11.26 1. Form: Indemnification for Specific Third Party Claims (Pro-Indemnitee)

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11.26-1 Indemnification for specific third party claims

___. *Indemnification for Third Party Claims.* Indemnitor shall indemnify, defend, and hold harmless _ _[*name of indemnified party*]**_ _, and its officers, directors, shareholders, employees, agents, and representatives (collectively, "Indemnitee"), against all liability, demands, claims, costs, losses, damages, recoveries, settlements, and expenses (including interest, penalties, attorney fees, accounting fees, and expert witness fees) incurred by Indemnitee ("Losses"), known or unknown, contingent or otherwise, directly or indirectly arising from or related to (a) the suits, actions, and claims described in Exhibit _ _; (b) the contracts and agreements described in Exhibit _ _ and any related agreements; and (c) _ _**[*specify other specific concerns, e.g., any agreements or arrangements with _ _*[*identify party*]*_ _ to pay any sum as a result of a merger, consolidation, sale of all or substantially all its assets or capital stock, or public offering of Indemnitor*]*_ _***.**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.27 2. Form: Indemnification for Specific Third Party Claims (Pro-Indemnitor)

§11.27 2. Form: Indemnification for Specific Third Party Claims (Pro-Indemnitor)

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11.27-1 Indemnification for specific third party claims

___. *Indemnification for Third Party Claims.* Indemnitor shall indemnify, defend, and hold harmless _ _[*name of indemnified party*]**_ _, and its officers, directors, shareholders, employees, agents, and representatives (collectively, "Indemnitee"), against all liability, claims, costs, damages, and expenses (including reasonable attorney fees) incurred by Indemnitee ("Losses") arising from or related to (a) the suits, actions, and claims described in Exhibit _ _; (b) the contracts and agreements described in Exhibit _ _ and any related agreements; and (c) _ _**[*specify other specific concerns, e.g., any agreements or arrangements with _ _*[*identify party*]*_ _ to pay any sum as a result of a merger, consolidation, sale of all or substantially all its assets or capital stock, or a public offering of Indemnitor*]**_ _. Any claim for indemnification for any Losses under this Section _ _ will be reduced by any amount that Indemnitee (a) receives from any insurance policy regarding those Losses or (b) realizes as tax savings because of such Losses.**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/ 3. Misrepresentation or Breach of Warranty/§11.28 a. Form: Indemnification for Misrepresentation or Breach of Warranty (Pro-Indemnitee)

3. Misrepresentation or Breach of Warranty

§11.28 a. Form: Indemnification for Misrepresentation or Breach of Warranty (Pro-Indemnitee)

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11.28-1 Indemnification for misrepresentation or breach of warranty

___. *Indemnification for Misrepresentation or Breach of Warranty.* **Indemnitor shall indemnify, defend, and hold harmless _ _[*name of indemnified party*]_ _, and its officers, directors, shareholders, employees, agents, and representatives (collectively, "Indemnitee"), against all liability, demands, claims, costs, losses, damages, recoveries, settlements, and expenses (including interest, penalties, attorney fees, accounting fees, and expert witness fees) incurred by Indemnitee ("Losses"), known or unknown, contingent or otherwise, directly or indirectly arising from or related to any misrepresentations, or breach of any warranties or agreements, made by Indemnitor in this Agreement.**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.29 b. Form: Time Limitations on Survival of Representations, Warranties, and Agreements

§11.29 b. Form: Time Limitations on Survival of Representations, Warranties, and Agreements

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11.29-1 Time limits on survival of representations, warranties, and agreements

___. *Time Limits on Survival of Representations, Warranties, and Agreements.* All representations, warranties, and agreements in this Agreement survives Closing for _ _[*specify time period*]_ _, unless expressly stated otherwise in this Agreement. All statements in any certificate, schedule, or exhibit delivered by any party under this Agreement or in connection with the transactions contemplated by this Agreement constitute representations and warranties by that party under this Agreement.

Comment: The second sentence decreases the indemnitor's liability by putting a time limit on the survival of statements delivered in connection with the transaction.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.30 c. Form: No Time Limitations on Survival of Representations, Warranties, or Agreements

§11.30 c. Form: No Time Limitations on Survival of Representations, Warranties, or Agreements

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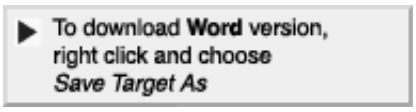
11.30-1 No time limits on survival of representations, warranties, or agreements

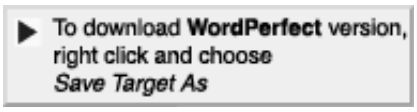
___. *No Time Limits on Survival of Representations, Warranties, and Agreements.* All representations, warranties, and agreements in this Agreement survive indefinitely until, by their respective terms, they are no longer operative or are otherwise limited by an applicable statute of limitations. All statements in any certificate, schedule, or exhibit delivered by any party under this Agreement or in connection with the transactions contemplated by this Agreement constitute representations and warranties by that party under this Agreement.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.31 d. Form: Limitation on Time to Bring Action

§11.31 d. Form: Limitation on Time to Bring Action





11.31-1 Limit on time to bring action

___. Time Limits on Bringing Actions.

[*Add one of the following alternatives*]

[*Alternative 1: Same time limit for all actions*]

Any claim for indemnification under this Agreement must be brought within _ _[*specify time period*]**_ _ after Closing _ _**[*in accordance with the procedures stated in Section _ _*]**_ _. After this time period, the indemnification provisions of this Agreement terminate and have no further force or effect.**

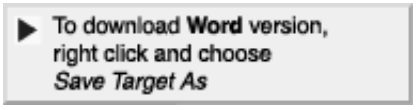
[*Alternative 2: Different time limits for different actions*]

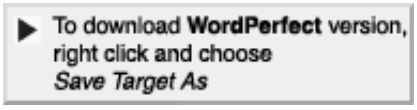
Any claim for indemnification under this Agreement _ _[*e.g., based on Section 4, "Defects in Furniture, Fixtures, and Equipment"*]**_ _ must be brought within _ _**[*specify time period*]**_ _ after Closing _ _**[*in accordance with the procedures stated in Section _ _*]**_ _. All other claims for indemnification under this Agreement must be made within _ _**[*specify time period*]**_ _ after Closing _ _**[*in accordance with the procedures stated in Section _ _*]**_ _. After these time periods, the indemnification provisions of this Agreement terminate and have no further force or effect.**

Comment: Alternative 2 allows the parties to vary the time to bring claims based on different representations and warranties. If the agreement includes a procedure for bringing claims (see §11.35), that procedure should be cross-referenced in this provision.

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§11.32 4. Form: Indemnification Provision in Agreement for Sale of Business





11.32-1 Indemnification provision in sales agreement

1. *Indemnification of Seller.* Buyer shall indemnify, defend, and hold harmless Seller and its officers, directors, shareholders, employees, agents, and representatives against all liability, demands, claims, costs, losses, damages, recoveries, settlements, and expenses, including without limitation claims based in tort or for personal injury (including interest, penalties, attorney fees, accounting fees, and expert witness fees) ("Losses") incurred by Seller, known or unknown, contingent or otherwise, directly or indirectly arising from or related to (i) any material misrepresentations, or breach of any warranties or agreements, made by Buyer in this Agreement; or (ii) the use, occupation, or ownership of the Real Property or the Personal Property after Closing.

2. *Indemnification of Buyer.*

(a) Except as provided below, Seller shall indemnify, hold harmless, and defend Buyer, and its officers, directors, shareholders, employees, agents, and representatives, against all Losses incurred by Buyer, known or unknown, contingent or otherwise, directly or indirectly arising from or related to (i) Seller's acts occurring before Closing, (ii) the breach of any agreement that Seller may have with a third party, which breach occurs before Closing, or (iii) the pending litigation listed in Exhibit _ _.

(b) Seller's total maximum liability under Section 2(a) of this Agreement, for any reason, is $_ _[*amount*]_ _ in the aggregate, and Buyer specifically assumes all risks for any Losses in excess of $_ _[*amount*]_ _.

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§11.33 5. Form: Indemnification Provision in Lease Agreement for Hazardous Materials (Pro-Indemnitee)

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11.33-1 Indemnification provision for hazardous materials in lease agreement

___. *Indemnification for Hazardous Materials.* Tenant shall indemnify, defend, and hold harmless Landlord and its officers, directors, shareholders, employees, agents, and representatives against all liability, demands, claims, costs, losses, damages, recoveries, settlements, and expenses, including without limitation claims based in tort or for personal injury (including interest, penalties, attorney fees, accounting fees, and expert witness fees) incurred by Landlord, known or unknown, contingent or otherwise, directly or indirectly arising from or related to the acts and omissions of Tenant and its officers, directors, shareholders, employees, agents, representatives, contractors, subcontractors, subtenants, and invitees with respect to:

(a) The generation, manufacture, operations involving, transport, treatment, storage, handling, production, processing, disposal, release, or threatened release of any Hazardous Materials, as defined in _ _[*specify where term is defined*]_ _ that are on, from, or affecting the Premises, including without limitation the soil, water, vegetation, buildings, and improvements on the Premises;

(b) Any personal injury (including wrongful death) or property damage (real or personal) arising from or related to such Hazardous Materials;

(c) Any lawsuit brought or threatened, settlement reached, or governmental order relating to such Hazardous Materials; and

(d) Any violations of laws, orders, regulations, requirements, or demands of government authorities, or any reasonable policies or requirements of Landlord, that are based on or in any way related to such Hazardous Material, including without limitation attorney and consultant fees, investigation and laboratory fees, court costs, and litigation expenses.

This indemnification survives the termination of this Lease and includes indemnification for the negligent acts of Landlord.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.34 6. Form: Indemnification Provision for Patent or Copyright Infringement (Pro-Indemnitor)

§11.34 6. Form: Indemnification Provision for Patent or Copyright Infringement (Pro-Indemnitor)

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11.34-1 Indemnification provision for patent or copyright infringement

1. *Indemnified Claims.* Indemnitor shall indemnify, defend, and hold harmless _ _[*name of indemnified party*]**_ _ and its officers, directors, shareholders, employees, agents, and representatives (collectively, "Indemnitee") against all liability, claims, costs, damages, and expenses incurred by Indemnitee ("Losses"), based on a claim that the Products furnished by Indemnitor under this Agreement and distributed by Indemnitee without modification constitute an infringement of any United States patent or copyright, as long as Indemnitor is (i) notified in writing within _ _**[*30 calendar days*]**_ _ after commencement of any suit or proceeding and (ii) given authority, information, and assistance by Indemnitee to defend or settle the suit or proceeding. Indemnitor will indemnify Indemnitee for all reasonable attorney fees, accounting fees, expert witness fees, costs, and expenses incurred in defending any suit or proceeding, and any damages that may be finally awarded against Indemnitee, or settle any such claim on the terms and conditions as it deems advisable. Indemnitee may not settle or otherwise compromise any claim for which it seeks indemnification under this Section 1 without Indemnitor's consent.**

2. *Limitation of Indemnification.* Indemnitor's obligations under Section 1 of this Agreement do not apply to any Products or parts of any Products in systems or methods that (i) were not designed by Indemnitor, (ii) are based on specifications provided by Indemnitee or based on modifications or additions made by Indemnitee or Indemnitee's customers, or (iii) are used in a manner not authorized by Indemnitor. Section 1 applies only to alleged infringement based on Indemnitor's Products within Indemnitee's Territory and applies only during the term of this Agreement and for 1 year thereafter.

3. *ENTIRE LIABILITY; WARRANTY DISCLAIMER.*

[*If applicable, add the following option*]

[*Option: Agreement contains express warranties*]

EXCEPT AS SET FORTH IN SECTION _ _[*indicate section number for express warranty clause*]**_ _,**

[*Continue*]

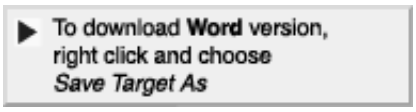
THE FOREGOING STATES INDEMNITOR'S ENTIRE LIABILITY FOR ANY INFRINGEMENT OF ANY PATENT, COPYRIGHT, OR OTHER PROPRIETARY RIGHTS BY THE PRODUCTS OR ANY PART OF THE PRODUCTS. INDEMNITOR MAKES NO OTHER WARRANTIES WITH RESPECT TO THE PRODUCTS, EXPRESSED OR IMPLIED, AND INDEMNITOR DISCLAIMS ANY IMPLIED WARRANTY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTY OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE.

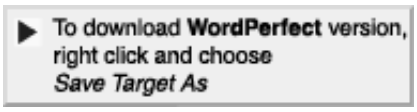
Comment: This form addresses only federal patent and copyright infringement, but it could be modified to include indemnification for common-law infringement claims and trade secret violation claims. Note that the disclaimer language should be printed in conspicuous type. See §15.32.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.35 7. Form: Notice Provision

§11.35 7. Form: Notice Provision





11.35-1 Notice provision

1. *Definitions.* As used in this Agreement, the terms below have the following meanings:

(a) "Injured Party" means the party claiming indemnification.

(b) "Indemnifying Party" means the party against whom claims are asserted.

(c) "Claims" means any claims for indemnification.

***2. Method of Asserting Claims.* All Claims for indemnification by Injured Party will be resolved as follows:**

(a) If any Claim is asserted against or sought to be collected from Injured Party by a third party, Injured Party shall promptly notify Indemnifying Party of the Claim in writing, in reasonable detail (the "Claim Notice"). Indemnifying Party's obligation to indemnify Injured Party is not conditioned on Injured Party's giving the Claim Notice unless the failure to give the Claim Notice prejudiced Indemnifying Party in its defense of the Claim.

(b) Indemnifying Party has _ _[*e.g., 15 calendar days*]_ _ after the mailing of the Claim Notice (the "Notice Period") to notify Injured Party (i) whether Indemnifying Party disputes its liability to Injured Party with respect to the Claim; and (ii) whether Indemnifying Party desires, at its sole cost and expense, to defend Injured Party against the Claim. During the Notice Period, Injured Party may file any motion, answer, or other pleading that it deems necessary or appropriate to protect its interests or those of Indemnifying Party and that is not prejudicial to Indemnifying Party.

(c) If Indemnifying Party notifies Injured Party within the Notice Period that it desires to defend Injured Party against the Claim, Indemnifying Party has the right to defend the Claim by all appropriate proceedings. Injured Party may retain separate counsel to monitor or participate in, but not control, any defense or settlement. Injured Party must cooperate with Indemnifying Party and its counsel in defending against the Claim. No Claim may be settled without Indemnifying Party's consent, which will not be unreasonably withheld or delayed.

(d) If Indemnifying Party fails to defend or indemnify Injured Party after Injured Party gives the Claim Notice, Injured Party may, but is not under any obligation to, in addition to all other rights that Injured Party may have, undertake the defense of, or to compromise or settle, the Claim for the account of and at the risk of Indemnifying Party.

(e) Indemnifying Party shall reimburse Injured Party for its reasonable attorney fees, accounting fees, expert witness fees, costs, and expenses (including Injured Party's fees, costs, and expenses incurred by monitoring, participating in, or cooperating with any action, compromise, or settlement) within _ _[*e.g., 30 calendar days*]_ _ after Indemnifying Party's receipt of a statement of such fees, costs, and expenses. If the Claim cannot be defended solely by Injured Party, Indemnifying Party shall provide, at no cost or expense to Injured Party, all information and assistance that Injured Party may reasonably request.

Comment: The inclusion of reimbursement for counsel employed to monitor the litigation makes this form pro-indemnitee.

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8. Limitations

§11.36 a. Form: Indemnification Threshold; Indemnitor Liable for All Losses After Threshold Reached

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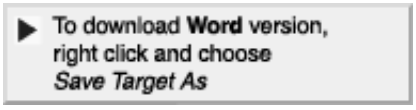
11.36-1 Indemnification threshold; indemnitor liable for losses after threshold reached

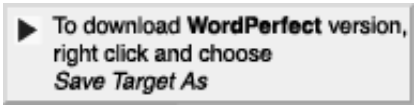
___. *Indemnification Threshold.* Indemnitor will be liable for all Losses that exceed $_ _[*amount*]_ _ individually or $_ _[*amount*]_ _ in the aggregate (the "Aggregate Threshold"). Once the Aggregate Threshold is reached, Indemnitor is liable for all Losses of any amount, including Losses making up the Aggregate Threshold.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.37 b. Form: Indemnification Threshold; Indemnitee Liable for All Losses up to Threshold

§11.37 b. Form: Indemnification Threshold; Indemnitee Liable for All Losses up to Threshold





11.37-1 Indemnification threshold; indemnitee liable for losses up to threshold

___. *Indemnification Threshold.* Indemnitor will be liable for _ _[_ _ *percent of*]_ _ all Losses that exceed $_ _[*amount*]_ _ in the aggregate (the "Aggregate Threshold"). Indemnitee will be liable for all Losses up to the Aggregate Threshold _ _[*and for all amounts remaining after Indemnitor has paid its percentage of the Losses*]_ _.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.38 c. Form: Limited Indemnification Liability

§11.38 c. Form: Limited Indemnification Liability

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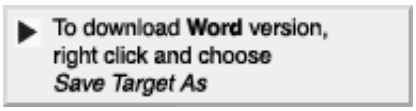
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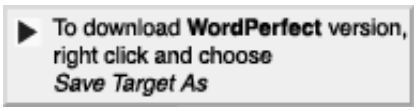
11.38-1 Limited indemnification liability

___. *Limited Indemnification Liability.* Indemnitor's aggregate liability for all claims under this Section _ _ may not exceed _ _[*$*_ _[*amount*]_ _ */the aggregate consideration paid by Indemnitee to Indemnitor for the assets purchased under this Agreement*]_ _**.**

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§11.39 9. Form: Right of Setoff





11.39-1 Right of setoff

___. *Right of Setoff.* If a claim for indemnification is made under this Section _ _, Indemnitee may, at its option, by giving notice to Indemnitor (and without limiting any other rights it may have at law or equity), withhold the claimed amount from any payment due to Indemnitor under this Agreement, pending final adjudication or settlement of the claim. On final adjudication or settlement of the claim in an amount equal to or exceeding the amount withheld by Indemnitee, Indemnitee will retain the amount withheld in full or partial satisfaction of the claim of indemnification, and the retained amount reduces and offsets any other payment due to Indemnitor under this Agreement. Any amount retained by Indemnitee in excess of the amount of the final adjudication or settlement will be paid by Indemnitee to Indemnitor, together with interest at a rate of interest equal to the then current reference rate, as announced from time to time by _ _[*name of lending institution*]**_ _, after the date of offset or withholding.**

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V. EXCULPATORY PROVISIONS AND RELEASES

§11.40 A. Limited Liability for Warranties

An exculpatory provision can limit liability for warranties and other claims made under a contract. This provision generally performs two functions:

- It limits the scope of the parties' responsibility (*e.g.,* to repair or replace goods that do not meet warranted specifications); and
- It specifically excludes all remaining liability. See Com C §2316 for limitation or modification of warranties.

See form in §11.52 for limited warranty and disclaimer of warranty. See also §§15.31-15.32 for further discussion of limiting remedies and disclaiming warranties.

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§11.41 B. Limitation on Remedies

Exculpatory provisions can limit a party's remedies. For example, the courts enforce agreements that limit a purchaser's remedies to the price paid for the products or that limit the purchaser's ability to recover consequential damages, especially if both parties are commercial entities of roughly equal bargaining strength. *Delta Air Lines v Douglas Aircraft Co.* (1965) 238 CA2d 95, 47 CR 518.

WARNING: For transactions involving the sale of goods, an exclusive or limited remedy that fails in its essential purpose allows the injured party to take advantage of the remedies provided in the Commercial Code. Com C §2719(2).

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C. Interpretation and Enforcement of Exculpatory Provisions and Releases

§11.42 1. Contract Principles

Exculpatory provisions, including those limiting liabilities or warranties, and releases are not favored by the courts. As with indemnity agreements, terms are strictly construed against the released party, especially if the released party drafted the provision. *Viotti v Giomi* (1964) 230 CA2d 730, 739, 41 CR 345. When the parties are commercially sophisticated and roughly equal in bargaining power, however, exculpatory provisions and releases are generally upheld, particularly if the contract was the product of mutual negotiations. See *Delta Air Lines v Douglas Aircraft Co.* (1965) 238 CA2d 95, 102, 47 CR 518 (enforced provision exempting airplane manufacturer from all liability, whether or not caused by manufacturer's negligence).

NOTE: An agreement relating to sports or recreational programs or services that purports to release liability for future gross negligence is generally unenforceable as a matter of public policy. Under case law interpreting CC §1668, an exculpatory clause affecting the public interest cannot stand. The distinction between ordinary and gross negligence reflects a policy rule that harsher legal consequences should flow when negligence is aggravated instead of merely ordinary; thus, public policy generally precludes enforcement of an agreement that would remove the duty to adhere to even a minimal standard of care. *City of Santa Barbara v Superior Court* (2007) 41 C4th 747, 62 CR3d 527 (agreement releasing liability for future gross negligence committed against developmentally disabled child at recreational camp designed for disabled children violates public policy and is unenforceable).

As with other agreements, the enforceability of an exculpatory provision or release depends on the satisfaction of the legal requirements for creating a contract (*e.g.,* offer and acceptance, consideration, clear and certain terms). *Hulsey v Elsinore Parachute Ctr.* (1985) 168 CA3d 333, 214 CR 194. An exculpatory provision or release that meets the legal requirements for a contract is enforceable. See, *e.g., Cregg v Ministor Ventures* (1983) 148 CA3d 1107, 196 CR 724 (exculpation clauses upheld in commercial lease). However, an exculpation clause will not be enforced if it is against public policy. See *Pelletier v Alameda Yacht Harbor* (1986) 188 CA3d 1551, 230 CR 253. See §11.49.

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§11.43 2. Clear and Unambiguous Language

Exculpatory provisions and releases, when read as a whole, must notify the potential releasor or indemnitor of the effect of signing the agreement, but "need not achieve perfection." *Randas v YMCA of Metropolitan Los Angeles* (1993) 17 CA4th 158, 162, 21 CR2d 245. Clarity assists in proving that the releasor fully understood the contents of the release at the time of signing. *Megee v Fasulis* (1943) 57 CA2d 275, 289, 134 P2d 815. Therefore, exculpatory provisions and releases of known claims should use simple, clear, and unambiguous language comprehensible to a layperson. *Cohen v Five Brooks Stable* (2008) 159 CA4th 1476, 1487, 72 CR3d 471.

Exculpation provisions and releases should be printed in conspicuous type that can be easily read by persons of ordinary vision. Because typeface smaller than eight point (one-ninth of an inch) provides an "unsatisfactory reading medium," a release using that type size is likely unenforceable. *Conservatorship of Link* (1984) 158 CA3d 138, 141, 205 CR 513. Ten-point type complies with a number of requirements governing other provisions that reduce or eliminate one party's liability (*e.g.,* limitations of liability and disclaimers of warranties). *Hulsey,* 168 CA3d at 339.

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§11.44 3. Consideration

A written release may be granted with or without new consideration, but an oral release must be supported by new consideration. CC §1541. If the parties so intend, a written release will be effective once the releasor executes and delivers it, regardless of whether the stated consideration has been paid or the released party has signed. *Hofland v Gustafson* (1955) 132 CA2d Supp 907, 909, 282 P2d 1039.

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§11.45 4. Release for Negligence

Negligence is "active" if the actor committed an affirmative act of negligence. *Rossmoor Sanitation, Inc. v Pylon, Inc.* (1975) 13 C3d 622, 629, 119 CR 449. An exculpation agreement or release that does not specifically state that it releases the released party from negligence may be construed to shield the party only for passive negligence—it will not release a party from liability for active negligence. *Salton Bay Marina, Inc. v Imperial Irrig. Dist.* (1985) 172 CA3d 914, 938, 218 CR 839. To release a party from active *and* passive negligence, it is better practice for the provision clearly and unequivocally to refer to the released party's negligence. *Sanchez v Bally's Total Fitness Corp.* (1998) 68 CA4th 62, 79 CR2d 902; *Madison v Superior Court* (1988) 203 CA3d 589, 250 CR 299.

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§11.46 5. Known and Unknown Claims

A "general release" covers only existing known claims; it does not extend to claims that, at the time of execution, are unknown to the releasor and that would have materially affected the settlement. CC §1542. The released party can minimize the risk of future litigation, however, by requiring a "specific release," which includes unknown claims within the scope of the release, rather than merely relying on a general release.

PRACTICE TIP: A release of unknown claims should cite and waive the effect of CC §1542 and quote its language. See form in §11.51.

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§11.47 6. Effect of Release on Others

A release given to one party does not release any other party from liability unless its terms so provide. CCP §877(a). The released parties need not be named or specifically identified in any other way if the circumstances to which the release applies are clear and the language of the release is unambiguous. *General Motors Corp. v Superior Court* (1993) 12 CA4th 435, 15 CR2d 622.

An express exculpation or release by an injured party of any negligent liability on the part of the released party is binding on the injured party's heirs, as it would be on the injured party, and provides a complete defense to an action for wrongful death. *Paralift, Inc. v Superior Court* (1993) 23 CA4th 748, 29 CR2d 177.

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§11.48 7. Option of Expanded Coverage

The courts look more favorably on exculpation provisions and releases if the releasing party was offered the option of shifting, or insuring against, the risk. See *Cregg v Ministor Ventures* (1983) 148 CA3d 1107, 1111, 196 CR 724. One means of offering this option is through a two-tiered payment system that permits a party to elect to pay one fee for a contract with the exculpatory language or another, higher fee if the contract does not include exculpatory language. See form in §11.55.

In *McCarn v Pacific Bell Directory* (1992) 3 CA4th 173, 4 CR2d 109, the court upheld a standard preprinted agreement that limited Pacific Bell's liability, despite arguments that the contract should not be enforced, because it was one "affected with a public interest." 3 CA4th at 178. The court held that the exculpatory language was enforceable because it offered the public the opportunity to pay additional charges and not waive liability.

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§11.49 D. Restrictions on Exculpatory Provisions and Releases

An exculpatory provision or release of liability is subject to certain restrictions:

- It is subject to all of the defenses against any contract (*Appalachian Ins. Co. v McDonnell Douglas Corp.* (1989) 214 CA3d 1, 262 CR 716), except that a written release may be given without new consideration. See §11.44.
- It is invalid and unenforceable if it protects a party against his or her own fraud, willful or reckless injury to person or property, or willful or negligent violation of law. CC §1668.
- It is invalid and unenforceable if it protects a party against his or her gross negligence, as opposed to ordinary negligence. *City of Santa Barbara v Superior Court* (2007) 41 C4th 747, 62 CR3d 527.
- It is invalid in contracts that involve the "public interest." CC §1668; *Westlake Community Hosp. v Superior Court* (1976) 17 C3d 465, 131 CR 90; *Tunkl v Regents of Univ. of Cal.* (1963) 60 C2d 92, 32 CR 33; *Health Net of Cal., Inc. v Department of Health Servs.* (2003) 113 CA4th 224, 6 CR3d 235. See also *Cohen v Kite Hill Community Ass'n* (1983) 142 CA3d 642, 191 CR 209. The *Tunkl* court stated that a contract may involve the public interest if the transaction involves some or all of the following characteristics (60 C2d at 98):
- The matter is suitable for public regulation;
- The party seeking exculpation provides an important service to the public;
- The party seeking exculpation holds itself out as willing to perform this service for anyone who seeks it or falls within certain established standards;
- The party seeking exculpation possesses a decisive bargaining advantage against any member of the public who seeks its service;
- There is no provision for the party not seeking exculpation to pay additional reasonable fees and obtain protection against negligence; and
- As a result of the transaction, the person or property at issue is placed under the other's control, subject to the risk of carelessness by such other persons (but see *CAZA Drilling (California), Inc. v TEG Oil & Gas USA, Inc.* (2006) 142 CA4th 453, 48 CR3d 271 (exculpatory provisions in commercial contracts between parties of approximately equal bargaining power would rarely be so affected with the public interest as to justify invalidating such provisions as inconsistent with public policy); *Reudy v Clear Channel Outdoors, Inc.* (ND Cal, Apr. 3, 2007, No. C-02-5438 SC) 2007 US Dist Lexis 26322).
- A general release of liability obtained within 15 days after the beginning of physical confinement in a clinic or health facility or before release from such confinement, whichever occurs first, is presumed to be fraudulent and is unenforceable. Bus & P C §6152(b).

Under these tests, the enforceability of any exculpatory provision or release is uncertain. For discussion of the difficulties of drafting exculpation provisions, see *National & Int'l Bhd. of Street Racers, Inc. v Superior Court* (1989) 215 CA3d 934, 937, 264 CR 44 ("Drafters of releases always face the problem of steering between the Scylla of simplicity and the Charybdis of completeness. Apparently no release is immune from attack.")

NOTE: Organized leisure activities have no compelling public interest. Even broad exculpatory provisions limiting liability for hazardous recreational activities have been upheld in some consumer transactions when properly drafted and executed. See *Hulsey v Elsinore Parachute Ctr.* (1985) 168 CA3d 333, 339, 214 CR 194. A clear, unambiguous, and explicit release of future negligence (active or passive) in connection with hazardous recreational activities is enforceable, even when the release was signed years before the date of injury. *Paralift, Inc. v Superior Court* (1993) 23 CA4th 748, 29 CR2d 177. But see *City of Santa Barbara v Superior Court* (2007) 41 C4th 747, 62 CR3d 527 (in connection with accidental drowning death of developmentally disabled child participating in recreational camp program, parent's agreement to release liability for camp's gross negligence is unenforceable as matter of public policy).

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§11.50 E. Requirements for Valid Exculpatory Provision or Release

A release or exculpation provision for known and unknown claims should include the following:

- A clear and specific reference to claims released, whether known or unknown. See §11.43.
- A statement that the releasor is released from liability for its own negligence, if this is intended. See §11.45.
- The specific language of CC §1542. See §11.46.

The better practice is to also include (1) a statement that the releasor has read and understands CC §1542 and waives its effect and (2) a statement that the releasor is aware of the significance of waiving the statute and is assuming the risk of unknown claims by signing the release.

NOTE: Mere recitals that CC §1542 is waived or that the release covers unknown claims are not necessarily controlling. The releasor's intention to discharge unknown claims is ultimately a question of fact. *Leaf v City of San Mateo* (1980) 104 CA3d 398, 411, 163 CR 711; *Cousins Inv. Co. v Hastings Clothing Co.* (1941) 45 CA2d 141, 149, 113 P2d 878.

No technical language is required; rather, generally speaking, the language of the release must be clear and explicit. "Everyone agrees that drafting a legally valid release is no easy task. Courts have criticized and struck down releases if the language is oversimplified, if a key word is noted in the title but not the text, and if the release is too lengthy or too general, to name a few deficiencies.… However, we must remember that '[t]o be effective, a release need not achieve perfection.… It suffices that a release be clear, unambiguous, and explicit, and that it express an agreement not to hold the released party liable for negligence.'" *Queen Villas Homeowners Ass'n v TCB Prop. Mgmt.* (2007) 149 CA4th 1, 5, 56 CR3d 528, quoting *National & Int'l Bhd. of Street Racers, Inc. v Superior Court* (1989) 215 CA3d 934, 264 CR 44. See *Cohen v Five Brooks Stable* (2008) 159 CA4th 1476, 1488, 72 CR3d 471 ("California courts require a high degree of clarity and specificity in a release in order to find that it relieves a party from liability for its own negligence").

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F. Sample Provisions and Forms

§11.51 1. Form: Sample Mutual General Release Provision in Termination Agreement

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11.51-1 Sample mutual general release in termination agreement

This Termination Agreement and Mutual General Release ("Agreement") is made as of January 1, 1995, between Corporation A and Corporation B.

RECITALS

A. Corporation A and Corporation B entered into a License Agreement dated January 1, 1985 (the "License Agreement").

B. Corporation A and Corporation B have each determined that it is in their best interests to terminate the License Agreement effective as of the date of this Agreement.

C. Corporation A and Corporation B have entered into negotiations for Corporation B's purchase of Corporation A's common stock.

D. Corporation A and Corporation B have each determined that it is in their best interests to terminate these negotiations, effective on the date of this Agreement.

AGREEMENT

NOW, THEREFORE, in consideration of the mutual agreements made in this Agreement and other good and valuable consideration, the receipt and legal sufficiency of which are hereby acknowledged, Corporation A and Corporation B hereby agree as follows:

1. *Termination of License Agreement.* The License Agreement is hereby terminated and canceled and is of no further force or effect, except for Sections 5 and 6 of the License Agreement, which by their specific terms are intended to survive termination of the License Agreement.

2. *Release Respecting License Agreement.* Corporation A and Corporation B, on behalf of themselves and their respective officers, directors, shareholders, option holders, employees, agents, executors, administrators, representatives, successors, and assigns (collectively, "Related Parties") hereby mutually release and discharge each other and their respective Related Parties from all liability, claims, demands, actions, or causes of action of any kind or character, whether fixed or contingent (collectively, "Claims") arising from or relating to the License Agreement, except for any provisions that by their specific terms are intended to survive termination of the License Agreement.

3. *Release Respecting Stock Purchase.* Except as stated in Section 4 of this Agreement:

(a) Corporation A and Corporation B, on behalf of themselves and their respective Related Parties, may not bring any action in any legal forum or by any alternative dispute mechanism against each other or any of the Related Parties arising from or relating to the investigation, negotiation, or proposed purchase of the common stock of Corporation A by Corporation B, including without limitation any Claims arising from or relating to the letter of intent dated July 1, 1994 (the "Letter of Intent"), and the draft Stock Purchase Agreement prepared under that letter of intent (the "Stock Purchase Agreement") and all the agreements referred to in the Stock Purchase Agreement; and

(b) Corporation A and Corporation B, on behalf of themselves and their respective Related Parties, release

and discharge each other and their respective Related Parties from and against any Claims arising from or relating to the investigation, negotiation, or proposed purchase of the common stock of Corporation A by Corporation B, including without limitation any Claims arising from or relating to the Letter of Intent and the Stock Purchase Agreement and all the agreements referred to in the Stock Purchase Agreement.

4. *Exclusion.* Section 3 of this Agreement does not apply to any action for the collection of the Promissory Note for $100,000 dated January 1, 1990, with Corporation A as maker and Corporation B as holder.

5. *Unknown or Unsuspected Consequences.* The parties understand and acknowledge that Sections 2 and 3 of this Agreement apply to and include all unknown or unsuspected consequences or results arising from or relating to the transactions, occurrences, or agreements referred to in those Sections. Corporation A and Corporation B, on behalf of themselves and their respective Related Parties, represent and warrant that they have read the contents of California Civil Code §1542, which provides as follows:

"A general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor."

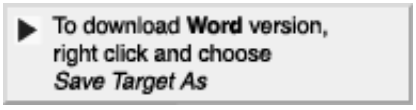
CORPORATION A AND CORPORATION B, FOR THEMSELVES AND THEIR RESPECTIVE RELATED PARTIES, EXPRESSLY WAIVE ANY AND ALL RIGHTS AND BENEFITS UNDER CALIFORNIA CIVIL CODE §1542.

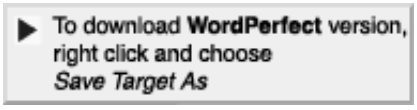
6. *Nature of Release.* Each party hereby acknowledges that it has read this Agreement, that it fully understands the contents of this Agreement, and that THIS IS A SPECIFIC RELEASE GIVING UP ALL RIGHTS WITH RESPECT TO THE TRANSACTIONS OR OCCURRENCES THAT ARE BEING RELEASED UNDER THIS AGREEMENT.

Comment: Counsel should consider and add as appropriate a provision that neither party has assigned any released claim to another party.

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§11.52 2. Form: Limited Warranty for Sale of Goods Provision





11.52-1 Limited warranty for sale of goods

___. *Limited Warranty.* Seller's products have been tested in accordance with Seller's published specifications. Seller warrants that its products will perform in accordance with Seller's published specifications. This warranty is provided only for a period of _ _[*specify*]_ _ after _ _[*e.g., date of purchase/date of shipping/date of installation*]_ _ (the "Warranty Period"). This warranty applies only to the original purchaser unless Buyer is authorized by Seller to resell the goods, in which event this warranty applies only to the first repurchase.

During the Warranty Period, Seller will promptly replace the goods that do not conform to Seller's published specifications or, at Seller's option, refund the purchase price for any nonconforming goods sold to Buyer.

Information in Seller's catalog or any other document is given after the exercise of due care in its compilation, preparation, and issuance; however, SELLER DISCLAIMS ANY LIABILITY RESULTING FROM THAT INFORMATION, except for the obligation under the warranty provided above to replace the product or, at Seller's option, to refund the purchase price to Buyer.

SELLER MAKES NO OTHER WARRANTY, EXPRESS OR IMPLIED, AND SELLER DISCLAIMS ANY WARRANTY OF ANY OTHER KIND, INCLUDING ANY WARRANTY OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE.

BUYER AND SELLER AGREE THAT THE SOLE AND EXCLUSIVE REMEDY FOR NONCONFORMING GOODS IS REPLACEMENT OF DEFECTIVE GOODS OR, AT SELLER'S OPTION, REFUND OF THE PURCHASE PRICE TO BUYER. The parties acknowledge that the price of Seller's products would be much greater if Seller undertook more extensive liability.

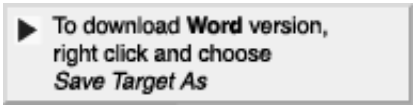
This warranty does not apply to damage resulting from (a) loss or damage in transit, (b) unreasonable use, (c) Buyer's negligence, or (d) accident. Seller reserves the right to examine the alleged defective goods to determine whether the warranty is applicable.

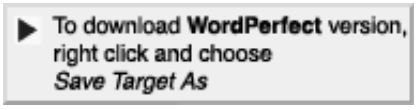
Without limiting the generality of the foregoing, Seller specifically disclaims any liability or warranty for goods resold in other than Seller's original packages, and for goods modified, altered, or treated by customers.

Any action by Buyer for any alleged breach of the warranty stated in this Section must be brought within _ _[*e.g., 90 calendar days*]_ _ after the end of the applicable Warranty Period.

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§11.53 3. Form: Limitation of Remedies





11.53-1 Limitation of remedies

___. Limitation of Remedies. *_ _[EXCEPT AS PROVIDED IN SECTION _ _ RELATING TO _ _[WARRANTIES/INDEMNIFICATION]_ _]_ _*, **BUYER'S SOLE REMEDY FOR** *_ _[E.G., BREACH OF THIS AGREEMENT/NONDELIVERY OF GOODS]_ _* **WILL BE** *_ _[SPECIFY AVAILABLE REMEDIES, E.G., THE DIFFERENCE BETWEEN THE MARKET PRICE AND THE CONTRACT PRICE FOR THE GOODS/THE PURCHASE PRICE OF THE GOODS]_ _*. **SELLER IS NOT BE LIABLE FOR CONTINGENT, INCIDENTAL, OR CONSEQUENTIAL DAMAGES TO PERSONS OR PROPERTY.**

SELLER FURTHER LIMITS ITS LIABILITY OF ANY KIND WITH RESPECT TO THE *_ _[E.G., GOODS]_ _*, **INCLUDING ANY NEGLIGENCE ON ITS PART, TO** *_ _[SPECIFY MAXIMUM LIABILITY, E.G., $_ _ _ _ _ _/THE DIFFERENCE BETWEEN THE MARKET PRICE AND THE CONTRACT PRICE FOR THE GOODS/THE PURCHASE PRICE OF THE GOODS]_ _*.

SELLER'S SOLE LIABILITY AND BUYER'S EXCLUSIVE REMEDIES ARE STATED IN THIS SECTION *_ _ _ _[AND IN SECTIONS _ _[REFER TO WARRANTY AND/OR INDEMNIFICATION PROVISIONS]_ _]_ _*.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.54 4. Form: Exculpation of Landlord

§11.54 4. Form: Exculpation of Landlord

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11.54-1 Exculpation of landlord

___. *Liability of Landlord.* Landlord will not be liable to Tenant, and Tenant waives all claims against Landlord, for any damage to Tenant, to Tenant's property, or to any other person or property arising from any cause, except that Landlord will be liable to Tenant for damage to Tenant arising solely from Landlord's active negligent acts or omissions.

Comment: On release of unknown claims, see §11.46.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.55 5. Form: Option to Expand Liability

§11.55 5. Form: Option to Expand Liability

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11.55-1 Option to expand liability

___*. Option to Expand Liability.* IF RELEASOR DOES NOT DESIRE TO RELEASE ITS CLAIMS OR LIMIT ITS REMEDIES AS PROVIDED ABOVE, RELEASOR CAN AGREE TO PAY ADDITIONAL CHARGES, WHICH WILL BE DETERMINED BY MUTUAL AGREEMENT BETWEEN THE PARTIES TO THIS AGREEMENT. THESE CHARGES WILL BE BASED ON THE RISK FACTORS INHERENT IN _ _[*DESCRIBE PROPOSED TRANSACTION*]_ _. IF THE PARTIES AGREE TO AN APPROPRIATE AMOUNT OF ADDITIONAL CHARGES, THE RELEASOR MAY PURSUE ALL LEGAL REMEDIES ARISING FROM OR RELATING TO THIS AGREEMENT.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.56 6. Form: Exculpation and Release Provision for Hazardous or Recreational Activity

§11.56 6. Form: Exculpation and Release Provision for Hazardous or Recreational Activity

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11.56-1 Exculpation and release for hazardous or recreational activity

1. *Assumption Of Risk.* USER IS AWARE OF THE INHERENT RISKS OF INJURY, DEATH, AND PROPERTY DAMAGE INVOLVED IN _ _[*DESCRIBE ACTIVITY*]_ _, INCLUDING WITHOUT LIMITATION RISKS DUE TO _ _[*LIST KNOWN RISKS*]_ _. USER IS AWARE OF THE RISKS OF INJURY, DEATH, AND PROPERTY DAMAGE THAT MAY RESULT FROM, AMONG OTHER CAUSES, THE ACTIVE OR PASSIVE NEGLIGENCE OF _ _[*NAME OF RELEASED PARTY*]_ _ AND ITS OFFICERS, DIRECTORS, EMPLOYEES, AGENTS, AND _ _[*LIST OTHERS AS APPLICABLE*]_ _ (COLLECTIVELY, "RELEASED PARTIES"), INCLUDING WITHOUT LIMITATION THE RISK OF NEGLIGENT INSTRUCTION OR SUPERVISION. USER IS VOLUNTARILY ENGAGED IN _ _[*DESCRIBE ACTIVITY*]_ _ WITH KNOWLEDGE OF THE RISKS OF INJURY, DEATH, PROPERTY DAMAGE, AND OTHER RISKS, AND ASSUMES ANY AND ALL KNOWN AND UNKNOWN RISKS OF INJURY, DEATH, AND PROPERTY DAMAGE THAT MAY RESULT FROM _ _[*DESCRIBE ACTIVITY*]_ _.

2. *Release Of Liability.* USER RELEASES RELEASED PARTIES FROM ALL LIABILITY TO USER AND USER'S PRINCIPALS, EMPLOYEES, AGENTS, REPRESENTATIVES, GUARDIANS, SUCCESSORS, ASSIGNS, HEIRS, CHILDREN, AND NEXT OF KIN FOR ALL LIABILITY, CLAIMS, DAMAGE, OR DEMANDS FOR PERSONAL INJURY, DEATH, OR PROPERTY DAMAGE, ARISING FROM OR RELATED TO THIS AGREEMENT OR TO _ _[*DESCRIBE ACTIVITY*]_ _, WHETHER THE INJURY, DEATH, OR PROPERTY DAMAGE OCCURS ON OR OFF THE PREMISES. THIS RELEASE INCLUDES, WITHOUT LIMITATION, ANY PERSONAL INJURY, DEATH, OR PROPERTY DAMAGE CAUSED BY THE ACTIVE OR PASSIVE NEGLIGENCE OF ANY OF THE RELEASED PARTIES. USER BEARS SOLE RESPONSIBILITY FOR ANY LOSS.

3. *Knowing And Voluntary Execution.* USER ACKNOWLEDGES THAT _ _[*HE/SHE/IT*]_ _ HAS CAREFULLY READ THIS AGREEMENT, UNDERSTANDS ITS CONTENTS, AND UNDERSTANDS THAT THIS AGREEMENT INCLUDES AN ASSUMPTION OF THE RISK OF THE RELEASED PARTIES' NEGLIGENCE AND A RELEASE OF THEIR LIABILITY. USER ACKNOWLEDGES THAT PROVIDER IS MATERIALLY RELYING ON THIS WAIVER AND IS ALLOWING USER TO ENGAGE IN _ _[*DESCRIBE ACTIVITY*]_ _.

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VI. WAIVERS

§11.57 A. Waivers Implied by Conduct

Although contradictory case law is confusing on the issue of implied waivers, certain uniform rules apply:

- The law disfavors waivers.
- Evidence establishing a waiver must be clear and convincing.
- Doubtful cases will go against a finding of waiver.
- To waive a right, a party must have either constructive or actual knowledge of the existence of the right.

City of Ukiah v Fones (1966) 64 C2d 104, 107, 48 CR 865 (quoting *Church v PUC* (1958) 51 C2d 399, 401, 333 P2d 321); *Medico-Dental Bldg. Co. v Horton & Converse* (1942) 21 C2d 411, 132 P2d 457.

Waiver may be established by either evidence of an actual intent to relinquish a right or conduct that is inconsistent with an intent to enforce the right. The courts differ, however, on the standard of inconsistent conduct required to imply a waiver. Most courts require that the conduct be "so inconsistent with an intent to enforce the right as to induce a reasonable belief that such right has been relinquished." *Harper v Kaiser Cement Corp.* (1983) 144 CA3d 616, 619, 192 CR 720 (citing *Crest Catering Co. v Superior Court* (1965) 62 C2d 274, 278, 42 CR 110).

A few courts have set a higher standard, finding that if proof of intention to waive is to be determined by one's conduct, that conduct should be so manifestly consistent with and indicative of such intent that "no other reasonable explanation… is possible." *Central Bank v Superior Court* (1978) 81 CA3d 592, 601, 146 CR 503 (quoting *Buffum v Chase Nat'l Bank* (7th Cir 1951) 192 F2d 58, 61). However, the leading cases enunciating this stricter standard have been distinguished to the point of eliminating the standard's use. See, *e.g., Rubin v Los Angeles Fed. Sav. & Loan Ass'n* (1984) 159 CA3d 292, 297, 205 CR 455.

Equitable considerations play a crucial role in judicial determinations of implied waiver. Courts are less rigorous in implying a waiver in order to avoid default or forfeiture than in other situations. These equitable considerations may explain the varying standards used to find waivers implied by conduct.

PRACTICE TIP: To avoid the court's finding an unintended implied waiver in a particular transaction, counsel should require that any waivers be in writing. See §§17.27-17.28.

See California Law of Contracts §5.87 (Cal CEB 2007).

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B. Contractual Waivers

§11.58 1. Requirements for Valid Waiver

A contractual waiver is enforceable if the waiving party had actual knowledge and awareness of what was being waived. Doubts are resolved against a finding of waiver. *Cathay Bank v Lee* (1993) 14 CA4th 1533, 1539, 18 CR2d 420. As with most contracts, ambiguous language is construed against the drafter, especially if the right being waived is statutory. 14 CA4th at 1540.

EXAMPLE: Purchaser A bought real property, subject to a detailed "as-is" provision but without specific reference to CC §1102 (which imposes certain disclosure obligations on real property sellers); the courts are unlikely to find that Purchaser A waived its rights to disclosure under §1102. Purchaser B bought real property, acknowledging that it was waiving its right to disclosure under CC §1102; the courts will probably enforce the waiver. See *Loughrin v Superior Court* (1993) 15 CA4th 1188, 1195, 19 CR2d 161 (waiver must be "knowing and explicit" if it is to "insulate the seller from claims based on the disclosure requirements of Section 1102").

If the language of an agreement clearly manifests the parties' express intention, general language in the agreement may be sufficient to "waive" a defense inconsistent with those express intentions. Thus, if guarantors clearly understand that they would remain personally liable on guaranties despite nonrecourse provisions in the note, that is sufficient to waive a defense based on CC §2809 ("the obligation of a surety must be neither larger in amount, nor… more burdensome than that of the principal"). *River Bank Am. v Diller* (1995) 38 CA4th 1400, 45 CR2d 790. The *River Bank* court declined to follow *Cathay Bank v Lee* (1993) 14 CA4th 1533, 18 CR2d 420, noting that, arguably, *Cathay Bank* has been eroded by CC §2856.

PRACTICE TIP: Even though *River Bank* does not adhere to the strict language requirements of *Cathay Bank*, the court nonetheless followed the tenet that a waiver must be based on the intention of the parties, as expressed by the terms of the agreement. Therefore, the agreement should clearly state any waiver of a right or defense, to avoid the need to argue that a waiver was intended based on general language in the agreement. The waiver should also specify the particular occurrence being waived to limit the extent of the waiver, unless the parties desire more general application.

NOTE: A waiver drafted with the recommended language of CC §2856 should be adequate to waive the guarantor's rights and defenses. But see *WRI Opportunity Loans II, LLC v Cooper* (2007) 154 CA4th 525, 545, 65 CR3d 205 (as matter of first impression, guarantors' written waiver of defenses was ineffective regarding their usury defense). However, if the recommended language is not used, potential problems with enforceability may result. See §22.25A.

See California Law of Contracts §5.87 (Cal CEB 2007).

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§11.59 2. Waiver of Statutory Rights

Generally, a party may waive benefits conferred by provisions of law unless the law was enacted for a "public reason." CC §3513. The court uses the standards formulated in *Tunkl v Regents of Univ. of Cal.* (1963) 60 C2d 92, 32 CR 33 (see §11.49), to determine whether a law was enacted for a "public reason." *Loughrin v Superior Court* (1993) 15 CA4th 1188, 19 CR2d 161.

PRACTICE TIP: If a party is granted certain rights or defenses by statute, a specific reference to the statute or an explicit description of the right or defense being waived aids enforcement.

Certain statutory provisions may not be waived, *e.g.,* certain warranty protections and related remedies, and obligations of good faith, diligence, reasonableness, and care in transactions governed by the Commercial Code. See, *e.g.,* CC §§1751, 1792.3, 1801.1, 1804.1, 2983.7; Com C §1302(b). Parties may agree to standards of performance for duties under the Commercial Code that cannot be waived, as long as such standards are not "manifestly unreasonable." Com C §§1302(b), 9501(3).

The protective provisions of CCP §580b, prohibiting certain deficiency judgments, cannot be waived in advance, at the time of creation of a mortgage, or as a condition to renegotiate such an obligation. *DeBerard Props., Ltd. v Lim* (1999) 20 C4th 659, 85 CR2d 292; *Palm v Schilling* (1988) 199 CA3d 63, 76, 244 CR 600.

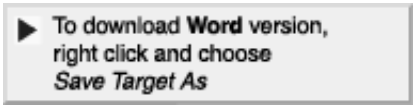
NOTE: Releases as to environmental laws are not effective against government action. *Mardan Corp. v CGC Music, Ltd.* (9th Cir 1986) 804 F2d 1454.

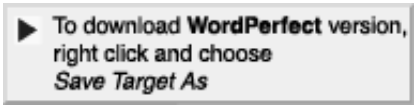
For discussion of waivers in guaranties, see §§22.23-22.29.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/11 Risk Allocation/§11.60 3. Form: Waiver

§11.60 3. Form: Waiver





11.60-1 Waiver

___. *Waiver.* With reference to _ _[*specify agreement, defense, right, or statute affected*]**_ _, the undersigned waives _ _**[*specify default, failure, right, or remedy waived*]**_ _. This waiver applies only to this _ _**[*breach/right/assignment*]**_ _ and is subject to _ _**[*specify required conditions of waiver*]**_ _. No further waiver of any breach, any failure of a term or condition, or any right or remedy contained in or granted by this Agreement will be effective unless it is in writing and signed by the party waiving the breach, failure, right, or remedy. This waiver may not be construed as a waiver of any subsequent breach or failure of the same term or condition or a waiver of any other term or condition in this Agreement. This waiver does not establish or evidence any course of dealing between the parties.**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/12 Legal Opinions/Chapter Outline

12

Legal Opinions

James F. Fotenos

I. CHECKLIST: LEGAL OPINIONS §12.1

II. SCOPE OF CHAPTER §12.2

III. DEFINITION AND USE OF LEGAL OPINIONS
- A. Definition §12.3
- B. Use; Golden Rule §12.4
- C. Liability for Opinion; Misleading Opinions §12.5
- D. Form: Limitation on Use of Opinion §12.6
- E. Form and Content of Opinion §12.7
- F. Reasoned Opinions §12.8
- G. Form: Opinion Condition in Transaction Documents §12.9

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  - 1. Remedies Opinion §12.27
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  - 6. Form: Absence of Litigation Assurance §12.32
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V. BIBLIOGRAPHY §12.37

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§12.1 I. CHECKLIST: LEGAL OPINIONS

- Corporate status (see §§12.17-12.18)
- Good standing; foreign jurisdictions (see §§12.19-12.20)
- Corporate power and corporate authority (see §§12.21-12.22)
- Due authorization (see §§12.23-12.24)
- Capital shares (see §§12.25-12.26)
- Remedies (see §§12.27-12.28)
- No violation (see §§12.29-12.30)
- Absence of litigation assurance (see §§12.31-12.32)
- Consent of governmental authority (see §§12.33-12.34)

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§12.2 II. SCOPE OF CHAPTER

This chapter focuses on legal opinions in one factual situation only—when the furnishing of a legal opinion to a third party is a contractual condition to the closing of a transaction, such as the sale of a business or the making of a loan. A legal opinion delivered in this context is often referred to as a "closing opinion." This chapter addresses the views of both the party requesting the opinion (the "opinion recipient," who usually works through its counsel to review the opinion letter), and the law firm giving the opinion ("opinion giver"), proposing reasonable accommodations between the desires of the opinion recipient and the concerns of the opinion giver. It includes sample provisions for the variety of concerns that the opinion recipient may want the opinion giver to address. The opinion giver's client is referred to in this chapter as the "Company" and the document that is the subject of the opinion (often there is more than one) is referred to as the "Agreement."

This chapter does not discuss how to prepare a legal opinion or the due diligence that the opinion giver should undertake in preparing an opinion. The two primary sources of information—and the essential starting points—for California lawyers regarding preparation of closing opinions are the following:

- 2005 Report, Corporations Committee, State Bar of California, Business Law Section, Legal Opinions in Business Transactions (Excluding the Remedies Opinion) (May 2005, rev'd Oct. 2007), referred to in this chapter as the 2007 Opinions Report, available from the Business Law Section on the State Bar website at http://www.calbar.ca.gov.
- State Bar of California, Business Law Section, Report on Third-Party Remedies Opinions (Sept. 2004, rev'd Sept. 2007), referred to in this chapter as the 2007 Remedies Report, available from the Business Law Section on the State Bar website at http://www.calbar.ca.gov.

As noted in §12.5, there is little reported case law on legal opinions. Legal opinions are nevertheless the subject of commonly understood customary interpretations and due diligence procedures by both opinion givers and opinion recipients among practicing corporate lawyers in the United States. The two State Bar reports are intended to reflect what is customary opinion practice in California. For a list of additional resources providing information on legal opinions, see the bibliography in §12.37.

Further, this chapter does not extensively address provisions that counsel for the opinion recipient might request in an opinion addressing a loan secured by personal property under the Uniform Commercial Code or a loan secured by real property. See 2005 Report, Uniform Commercial Code Committee of the State Bar of California, Legal Opinions in Personal Property Secured Transactions (June 2005), and Legal Opinions in California Real Estate Transactions, contained in State Bar of California, Business Law Section, 2002 California Opinion Reports. Both reports are available online from the Business Law Section on the State Bar website at http://www.calbar.ca.gov.

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III. DEFINITION AND USE OF LEGAL OPINIONS

§12.3 A. Definition

A legal opinion is a formal writing, in the form of a letter from the opinion giver to the opinion recipient, expressing the opinion giver's informed understanding of the legal principles applicable to a specific transaction or an aspect of a transaction. Some of the more common and accepted reasons for the preparation of a legal opinion include:

- Satisfying contractual requirements such as fulfilling a condition in a loan agreement that an opinion of counsel be delivered at closing by borrower's counsel to the lender;
- Providing assurance that an intended course of action is lawful or that certain acceptable legal consequences will follow from an intended course of action (or, conversely, that certain unacceptable legal consequences will not result from the proposed course of action);
- Satisfying regulatory requirements such as a requirement that an issuer file an opinion of counsel with the Securities and Exchange Commission in connection with the public offering of its securities; and
- Providing an opinion on local law to out-of-state counsel.

For further discussion and examples, see 2007 Opinions Report.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/12 Legal Opinions/§12.4 B. Use; Golden Rule

§12.4 B. Use; Golden Rule

Lawyers should not routinely ask for a legal opinion from counsel to the other party in a transaction. Instead, the lawyer should make an informed decision about whether the transaction appropriately calls for an opinion. Counsel for a party that is considering requesting an opinion should consider whether he or she would agree to furnish the opinion-the so-called "Golden Rule" of opinion practice. See 2007 Opinions Report p 13. For example, in a small transaction, furnishing an opinion is likely not cost-effective. The parties may rely instead on representations and warranties and indemnity clauses to provide assurance of regularity and to allocate the risk of breach of representations, warranties, and covenants. On representations and warranties, see chap 7, and on indemnification provisions, see chap 11. Opinions may not serve a useful purpose if the requesting party is familiar with the business, corporate structure, and assets of the other party to the transaction, or is comfortable in proceeding on the basis of its own due diligence.

PRACTICE TIP: Clients may assume incorrectly that a formal attorney's opinion is routine and easily given. Before agreeing to provide an opinion, the attorney should confirm that the client is aware of the potentially substantial legal fees involved in the research and preparation of the opinion.

Counsel should also consider whether providing the opinion would adversely affect the opinion giver's client and, if so, obtain the client's informed consent before rendering the opinion. For example, an opinion giver providing written confirmation concerning pending or "threatened" litigation may have to disclose claims that have not yet been publicly disclosed by the client. See 2007 Opinions Report pp 11, 16.

If a legal opinion is appropriate, counsel should negotiate the form and substance of the requested opinion as early as possible in the transaction, preferably before the parties are committed to proceed with the transaction. A delay in resolving opinion matters may result in a form of opinion based unfairly on the superior bargaining power of one party or a misunderstanding with one's client. See 2007 Opinions Report p 20.

The opinions contained in a third party opinion letter are expressions of professional judgment regarding the legal matters addressed and not guaranties that a court will reach any particular decision. An opinion letter should be read in light of the customary practices of persons giving and receiving opinion letters. Customary practice is based on the practices of lawyers (and their clients) who are knowledgeable about legal opinions of the type being rendered and who regularly give and receive opinions. Customary practice may be varied by a specific understanding between the opinion giver and the opinion recipient to whom the opinion letter is addressed. See 2007 Opinions Report p 8; 2007 Remedies Report p 7 and App 8. See also §12.2.

The recipient of an opinion letter ordinarily may rely on the opinions expressed without taking any action to verify them. An opinion recipient has no right to rely on an opinion if reliance is unreasonable under the circumstances or the opinion is known by the opinion recipient to be false. See Third-Party "Closing" Opinions, Report of the TriBar Opinion Committee §1.6 (1998) (TriBar Report) 53 Bus Law 592 (1998); the report is available at the ABA website (http://www.abanet.org/buslaw/tribar/materials/20050303000003.pdf), and is reprinted in The Collected ABA and TriBar Opinion Reports (2005) (Collected Opinion Reports). See also Ryan, *Recipient Counsel Responsibilities and Concerns,* 62 Bus Law 401 (2007).

NOTE: Legal opinions are not typically requested or given regarding title to assets, fraudulent transfers or other insolvency-related matters, the probable outcome of litigation, issues of significant legal uncertainty, or with respect to financial statements or economic valuations. See 2007 Opinions Report pp 18, 93.

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§12.5 C. Liability for Opinion; Misleading Opinions

Although a third party recipient of a legal opinion does not thereby become a "client" of the opinion giver, the opinion giver has a duty to the opinion recipient to use care in the preparation of the closing opinion. See 2007 Opinions Report pp 7, 11. Reported cases brought by opinion recipients against opinion givers alleging a violation of due care, or negligence, in rendering a closing opinion are rare. See, *e.g., Reich Family L.P. v McDermott* (NY Sup Ct, 101921-03, Oct. 10, 2003), available at http://iapps.courts.state.ny.us/iscroll/SQLData.jsp?IndexNo=101921-2003 and discussed in Committee on Legal Opinions, ABA Section of Business Law, *Annual Review of the Law on Legal Opinions,* 60 Bus Law 1057, 1062 (2005) (Annual Review). More common are claims brought by an opinion recipient or a third party alleging that the opinion giver or counsel for a party to a transaction intentionally or negligently misrepresented material facts to the opinion recipient/addressee. See, *e.g., Vega v Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 17 CR3d 26 (intentional misrepresentation); *Shafer v Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2003) 107 CA4th 54, 131 CR2d 777 (fraudulent misrepresentation); *Home Budget Loans, Inc. v Jacoby & Meyers Law Offices* (1989) 207 CA3d 1277, 255 CR 483 (intentional and negligence misrepresentation); *Roberts v Ball, Hunt, Hart, Brown & Baerwitz* (1976) 57 CA3d 104, 128 CR 901, discussed in 2007 Opinions Report n45 (negligent misrepresentation). See also the celebrated decision in *Dean Foods Co. v Pappathanasi* (Mass Super 2004) 18 Mass L Rptr 598, 2004 Mass Super Lexis 571, discussed in Annual Review p 1061 (negligent misrepresentation in connection with a "no litigation" opinion).

Because the damages for rendering a negligent or misleading opinion can be substantial, it is prudent for the attorneys preparing a closing opinion (referred to as the "opinion preparers") to conduct both the customary factual and legal due diligence necessary to enable the opinion giver to render the opinion called for by the Agreement. Opinion preparers often prepare and maintain a documentary record of the investigations they performed. To limit the opinion giver's exposure, opinion givers limit the persons who may rely on the opinion and the purpose for which it may be used. See form in §12.6.

It is generally understood that, regardless of compliance with other standards, and even if an opinion is technically correct, a lawyer should not render an opinion that the lawyer recognizes would be misleading to the opinion recipient. This principle is illustrated by the *Ball Hunt* decision, cited above. See 2007 Opinions Report p 10; Third-Party "Closing" Opinions, Report of the TriBar Opinion Committee §1.4(d) (1998) (TriBar Report) 53 Bus Law 592 (1998).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/12 Legal Opinions/§12.6 D. Form: Limitation on Use of Opinion

§12.6 D. Form: Limitation on Use of Opinion

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

12.6-1 Limitation on use of opinion

This opinion may be relied on solely by the named addressee(s) and is only for use in connection with the transactions described in the Agreement identified in this letter and may not be relied on by the addressee(s) for any other use. No other person may rely on this opinion. It may not be quoted or otherwise referred to in any financial statement or any other document, in whole or in part, nor may it be furnished to any other person or agency, without our prior written consent.

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§12.7 E. Form and Content of Opinion

The form and content of legal opinions are subjects for negotiation, taking into account such matters as the scope and difficulty of any necessary legal research and factual investigation, the extent to which a requested opinion may involve questions of fact as well as law, the value of the opinion to the client in relation to its cost, and the availability of other ways to protect the client. When negotiating the contents of the legal opinion to be provided, counsel for the opinion recipient, following the "Golden Rule" of opinion practice, should not ask for opinions or assurances it would be unwilling to give if it were the opinion giver.

The requirement for a legal opinion should appear as a condition to closing and not as a covenant in the Agreement. The client should not fear breach of the Agreement if counsel cannot responsibly deliver the requested opinion. See form in §12.9 for a provision stating the condition of delivery of an opinion of counsel.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/12 Legal Opinions/§12.8 F. Reasoned Opinions

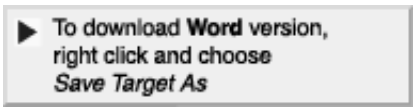
§12.8 F. Reasoned Opinions

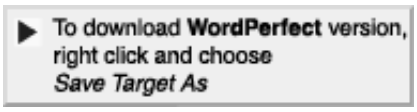
A reasoned opinion, sometimes referred to as an "explained opinion," summarizes the legal analysis supporting the opinion. It may be qualified or unqualified, but even if unqualified, the opinions cannot be separated from the discussion of the legal issues. Lawyers often argue over whether a "reasoned opinion" should conclude with the words "a court *would* hold" or "a court *should* hold." Many believe that the use of the word "would" expresses a stronger opinion. However, the use of either term conveys no more than the opinion giver's informed professional judgment concerning the legal issues addressed based on existing legal precedents. See 2007 Opinions Report p 18.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/12 Legal Opinions/§12.9 G. Form: Opinion Condition in Transaction Documents

§12.9 G. Form: Opinion Condition in Transaction Documents





12.9-1 Opinion requirement in transaction documents

At the Closing, _ _[*name of party requesting opinion*]_ _ shall have received from counsel for the Company an opinion, dated the Closing Date, in the form attached to this Agreement as Exhibit _ _[*specify*]_ _.

Comment: Often the Agreement will state the condition for an opinion letter and describe the desired contents of the letter rather than providing an agreed form, or it may state that the opinion shall be delivered in a form satisfactory to the opinion recipient. These approaches create opportunities for ambiguity and inefficiencies. The preferable approach, as stated in this sample clause, is to refer to an opinion in the form attached to the Agreement. It is also acceptable to identify and agree on the specific issues to be covered in the opinion letter.

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IV. SPECIFIC PROVISIONS

A. Preliminary Issues

§12.10 1. Factual Basis of Opinion

Closing opinions are based in large measure on facts not known personally to the opinion preparers but represented to them by persons or entities they have identified as being reliable sources. Unlike auditors, the opinion preparers have no obligation to conduct an investigation for the purpose of independently verifying facts represented to them by what they believe to be a reliable source. A person or entity that maintains factual information as a business record or public record is a reliable source for that information.

Opinion preparers typically rely on one or more officers' certificates to establish facts necessary to render the opinion. In this regard, Corp C §314 serves as an important aid. It states that bylaws or minutes of meetings of the board of directors or any committee of the board or resolutions adopted by the board or any committee, or by the shareholders, certified by the secretary or an assistant secretary of the corporation, is "prima facie evidence of the adoption of such bylaws or resolution or of the due holding of such meeting and of the matters stated therein." For a discussion of officers' certificates, see 2007 Opinions Report p 28.

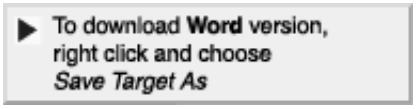
Opinion preparers do not establish all the facts required to support the opinions expressed in an opinion letter; opinions are based on factual assumptions. Opinion letters do not recite every factual assumption. Many such assumptions are understood to be implicit and are not required to be stated expressly, such as assumptions that apply to virtually all opinion letters (*e.g.,* that conformed copies furnished to the opinion preparer are identical to the originals and that signatures on documents are genuine) and assumptions concerning the opinion recipient (*e.g.,* its existence, its power to enter into the transaction, and the execution of the Agreement by a duly authorized officer of the recipient).

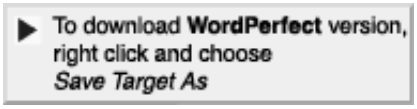
Opinion preparers are not entitled to rely on factual information or assumptions they recognize to be untrue or to have been furnished under circumstances that have led them to conclude that reliance is unwarranted. They also are not entitled to rely on a factual representation that in essence constitutes a legal conclusion (*e.g.,* that the company is not "doing business" in a specified state). Opinion preparers may, however, rely on legal conclusions contained in a certificate of a state official or in an opinion letter of other counsel they believe to be competent with regard to the subject matter of that letter.

Practice varies on the specificity with which opinion givers identify the documents on which they have relied in performing their factual due diligence. Some opinion givers preface their opinion letters with a detailed list of the documents and certificates examined, together with either a statement that they have examined such other documents and have made such further legal and factual investigation as they consider necessary for purposes of rendering the opinions expressed or, alternatively, specifically disclaim the making of any other examination or factual investigation. See the form in §12.11. Other opinion givers prefer to deliver opinion letters that merely set forth a general description of the factual inquiry they have conducted. See 2007 Opinions Report p 25. Opinion recipients are entitled to assume that the opinion giver has followed customary practice in determining the facts required to support the opinions expressed and in establishing those facts, unless the opinion giver expressly states limitations on the scope of its factual investigation.

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§12.11 2. Form: Materials on Which Opinion Preparer Relied





12.11-1 Materials on which opinion preparer relied

In the preparation of our opinion, we have examined certificates, agreements, and other documents as we have deemed appropriate for the opinions set forth in this letter. Regarding certain matters of fact material to the opinions expressed in this letter, we have relied on certificates of officers of the Company. In addition, we have relied on _ _[*describe other documents and materials on which attorney relied*]**_ _. We have assumed the accuracy of the factual information contained in all such agreements, documents, and certificates, and the accuracy of all representations of fact made by the Company in the Agreement.**

Comment: If an opinion giver refers to an officer's certificate on which it relies, the opinion giver may attach a copy of the certificate to the opinion or provide a copy to the opinion recipient.

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§12.12 3. Qualifications; Knowledge Limitations

Opinion givers use qualifications to limit an opinion's scope. Qualifications include assumptions and exceptions. Typical qualifications include a limitation on the law considered by the opinion giver (*e.g.,* limited to California and federal law; see §§12.14-12.15), laws not considered (such as tax, securities, antitrust, and local law), and assumptions about the recipient, such as that a lender qualifies as an exempt lender under California's usury law. See 2007 Opinions Report p 33.

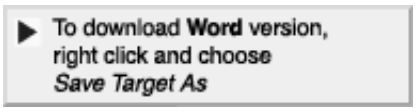
Qualifications may be expressed by the opinion giver or implied by customary practice. For example, an opinion delivered by a California lawyer should not be read to cover the substance or effect of the law of any other jurisdiction unless specifically stated otherwise in the opinion. Similarly, laws such as securities, tax, and insolvency laws are understood as a matter of customary practice to be covered only when an opinion refers to them expressly. See 2007 Opinions Report pp 56, 86.

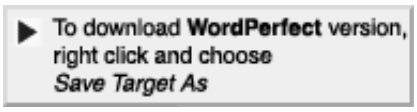
Factual confirmations, such as an opinion giver's litigation confirmation or negative assurance on the contents of a securities prospectus, are often limited by reference to the opinion giver's knowledge. Some common alternatives are to state that the factual confirmation is based only on the opinion giver's "current knowledge," "actual knowledge," or "best knowledge." Some attorneys qualify opinions by introducing them with language such as "after a review of limited scope, we do not know of" or "after a review of limited scope, nothing came to our attention which would. …" These phrases all have the same practical effect: The opinion preparers' knowledge is limited to the actual knowledge of those persons working on the transaction. It sometimes is defined also to include those persons having primary responsibility for the legal representation of the client. Opinion givers frequently define the scope of their knowledge qualifier in the opinion itself. For an example, see 2007 Opinions Report p 35.

The relationship between the opinion giver and its client can be a factor with regard to the question of what level of knowledge should reasonably be expected of the opinion giver. If the opinion giver has represented the client for many years, then the firm (limited to those persons mentioned above) can reasonably be expected to have more knowledge of the client's affairs than a law firm employed for the specific transaction. If the firm has been employed for the specific transaction, the opinion letter should say so. See the form in §12.13. It should be noted, however, that identifying the opinion giver as "special counsel" does not limit the opinion giver's responsibility for the opinions rendered by it, nor the scope of the factual or legal due diligence it should conduct to render the opinion in accordance with customary practice. Any such limitation should be expressly stated.

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§12.13 4. Form: Role of Opinion Preparer as Special Counsel





12.13-1 Opinion preparer as special counsel

We have acted as special counsel for the Company in this transaction. We have not previously represented the Company and have been retained solely to represent it in this transaction.

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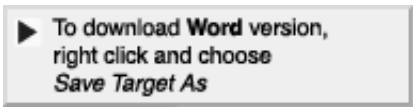
§12.14 5. Law Covered

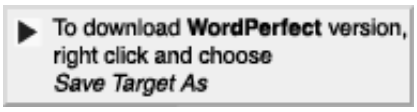
An opinion letter rendered by a California lawyer is understood to cover only the law of California and federal law and no other law. The laws covered are limited to those that a lawyer in California exercising customary professional diligence would recognize as being applicable to the entity, the transaction, or both. An opinion letter by customary practice is understood not to cover specialized areas of the law, such as securities, tax, and insolvency laws. An opinion giver can expand or limit the scope of customary usage by an express statement to that effect. Because of ambiguities (in particular, concerning the laws not addressed), opinion givers often specify the laws that their opinion does not address. See the form in §12.15.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/12 Legal Opinions/§12.15 6. Form: California Law

§12.15 6. Form: California Law





12.15-1 California law

We are not admitted to practice in any state other than the state of California, and this opinion does not address the effect or application of any law other than California and federal law.

12.15-2 Excluded laws

Furthermore, we express no opinion with respect to compliance with any law, rule, or regulation that as a matter of customary practice is understood to be covered only when an opinion refers to it expressly. Without limiting the generality of the foregoing _ _[*and except as stated herein*]_ _, we express no opinion on local or municipal law, antitrust, environmental, land use, securities, tax, pension, employee benefit, margin, insolvency, fraudulent transfer, anti-terrorism, money laundering, or investment company laws or regulations.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/12 Legal Opinions/§12.16 7. Date of Opinion

§12.16 7. Date of Opinion

Closing opinions are typically dated and delivered at the closing of the transaction. The opinion giver has no duty to update the opinion for facts or law that changes after the date of the opinion.

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B. Corporate Issues

§12.17 1. Corporate Status

A closing opinion typically includes an opinion on corporate status. The corporate status opinion covers the following points:

Due incorporation. An opinion that a corporation is "duly incorporated" means the corporation complied with the statutory requirements under the California Corporations Code at the time of its formation to become a California corporation. In California, a copy of the articles of incorporation, certified by the Secretary of State, provides conclusive evidence of the formation of the corporation and is prima facie evidence of its corporate existence. Corp C §209.

NOTE: A "duly incorporated" opinion does not cover any corporate action after the initial articles are filed and certified. Because this opinion only covers corporate status at the time of incorporation, it is routinely paired with an opinion about the company's current status, discussed below. See 2007 Opinions Report p 40. Often only the validly existing opinion is given. See form in §12.18.

Due organization. The opinion giver may address the Company's "due organization." To be duly organized:

- The corporation must have been duly incorporated;
- Bylaws must have been adopted;
- Officers and directors must have been duly elected or appointed in accordance with the bylaws and applicable corporate law; and
- Shares of capital stock of the Company must have been properly authorized and issued.

The law at the time of organization is the relevant law, not the current law.

Because of the intricacies of a "due organization" opinion, it is often not given, especially if the opinion giver who is asked to issue the opinion was not involved in the organization of the corporation. See Corp C §§200, 202, 210-212, 301, 312, and 400, among others, for a reminder of the necessary ingredients of due organization.

Validly existing. The subject company must be a de jure, not merely a de facto, corporation. To be validly existing, a corporation must have been duly incorporated and neither of the following may have occurred or commenced: (1) dissolution or liquidation proceedings or (2) expiration of the period for the corporation's existence as set forth in the articles of incorporation.

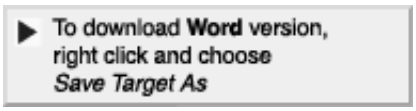
Good standing. A California corporation will lose its good standing if its charter has been suspended or forfeited (which can result if annual statements are not filed with the Secretary of State); if it has not filed its tax returns; or if it has not paid its taxes, penalties, or interest to the Franchise Tax Board. Corp C §§2204, 2205; Rev & Tax C §§19141, 23301, 23301.5, and 23775.

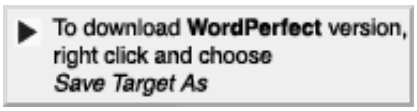
For language on corporate status, see form in §12.18. For language on qualification and good standing by the corporation in another state, see form in §12.20.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/12 Legal Opinions/§12.18 2. Form: Corporate Status--California Corporations

§12.18 2. Form: Corporate Status—California Corporations





12.18-1 Corporate status—California corporations

The Company has been duly incorporated and is validly existing and in good standing under the laws of the State of California.

Comment: The Corporations Committee of the Business Law Section believes that the trend in opinion practice is evolving away from providing "duly incorporated" opinions, particularly regarding older corporations, to providing solely a "validly existing" opinion and "good standing" opinion. See 2007 Opinions Report p 40.

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§12.19 3. Good Standing in Other Jurisdictions

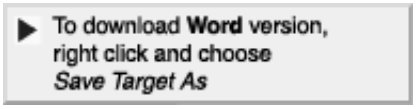
Opinion givers are often asked to give an opinion on whether the corporation is qualified to do business in a foreign jurisdiction. If given, the opinion is usually based solely on a certificate from the Secretary of State or other chartering agency of the foreign jurisdiction. See 2007 Opinions Report p 42. Because this is the sole basis of the opinion, providing the certificate without an opinion should suffice.

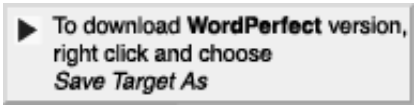
Opinion recipients may also request an opinion that the corporation is qualified to do business as a foreign corporation in all jurisdictions in which its properties or activities require qualification or in which the failure to qualify would have a material adverse effect on the corporation. These opinions are now widely disfavored and an opinion giver should resist rendering such an opinion See 2007 Opinions Report p 43.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/12 Legal Opinions/§12.20 4. Form: Corporate Status--Qualification in Other States

§12.20 4. Form: Corporate Status—Qualification in Other States





12.20-1 Corporate status—qualification to do business in other states

The Company has qualified to do business and is in good standing in the state(s) of _ _[*list*]_ _.

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§12.21 5. Corporate Power and Corporate Authority

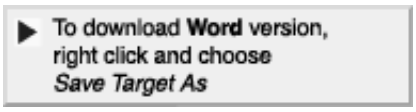
When opining on "corporate power," the opinion giver is asked to address two issues. First, the opinion often states that a party has the corporate power to enter into the transaction. This language means that neither the execution of the agreement nor the performance of the acts contemplated by it will be ultra vires. (On ultra vires acts, see Corp C §208; Organizing Corporations in California §2.18 (3d ed Cal CEB 2001)).

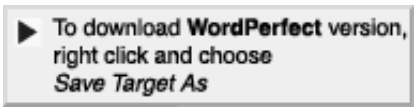
Second, the opinion may also state that a party has the corporate power to conduct its business. As a general rule, corporations not subject to banking laws and corporations that are not professional corporations may engage in any business activity, unless they are limited by their articles, as long as they have complied with the laws to which they may be subject. Corp C §§206-207. Counsel should qualify its knowledge concerning the conduct of the business by reference to a certificate or a document, such as a prospectus or annual report, that describes the business.

Opinion givers often use the word "corporate" to modify "power" to eliminate any reference to other legal requirements, such as regulatory concerns.

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§12.22 6. Form: Corporate Power and Corporate Authority





12.22-1 Corporate power and corporate authority

The Company has the corporate power and corporate authority to enter into and perform the Agreement and to carry on its business as to our knowledge it is currently being conducted.

Comment: Opinion language often reads "corporate power and authority." Some attorneys prefer to include the adjective "corporate" before "authority" to make it clear that the language does not intend to extend to all California, federal, and other approvals necessary to conduct the business. Other commentators believe that the structure of the sentence makes such use of "corporate" unnecessary. The Corporations Committee of the Business Law Section believes that current practice is evolving away from including an express reference to "corporate authority" in this opinion, but that the "corporate power" opinion is generally understood to have the same meaning whether or not "authority" is included, and if it is included it is generally understood to be limited to "corporate authority," even if the modifier "corporate" is not used. 2007 Opinions Report p 44.

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§12.23 7. Due Authorization

Authorization. The board of directors (or a committee of the board) and, when required, the shareholders must authorize a transaction by duly adopting appropriate resolutions to that effect. Typical transactions requiring shareholder approval are a recapitalization involving amendments to the articles of incorporation (see Corp C §§902-903) and the sale of all or substantially all of a corporation's assets (see Corp C §1001). In large corporations, the board of directors might issue a general signing authority from time to time, authorizing certain officers to enter into transactions within specified dollar limits, time constraints, or business activities.

Execution. The officers executing the documents were officers of the corporation at the time of execution and were authorized to execute the documents for and on behalf of the corporation. The signatures on the documents must be valid.

Delivery. "Due delivery" means that the company has delivered the document, with the intent to create a binding agreement.

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§12.24 8. Form: Due Authorization

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12.24-1 Due authorization

The Agreement has been duly authorized by all necessary corporate action on the part of the Company and has been duly executed and delivered by the Company.

Comment: The phrase "duly authorized by all necessary corporate action on the part of the Company" may be preferable to "duly authorized" alone, because the latter might imply authorization by a governmental regulatory body or by another third party whose consent may be required. See 2007 Opinions Report p 45.

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§12.25 9. Capital Shares

Authorized number of shares; **number outstanding.** If a California corporation acquires its own shares, they revert to the status of unissued stock and remain authorized unless the articles of incorporation prohibit their reissuance. Corp C §510. Thus, for corporations formed after 1976, any reference to "outstanding" in an opinion relating to the status of capital shares may be surplusage. There are no "treasury shares" under California corporation law.

Due authorization. Shares are "duly authorized" or "validly authorized" if, when the corporation issued the subject shares, the corporation had the power under its articles of incorporation and bylaws to issue that type and number of shares. The steps required to approve a particular share issuance are covered by the "validly issued" part of this opinion. As of the date of the opinion, the number of outstanding shares must not exceed the number of authorized shares of that type of stock. The due authorization opinion also covers whether the shares carry characteristics prohibited by the General Corporation Law (Corp C §§100-2319). See, *e.g.*, Corp C §402(c) (prohibiting the issuance of redeemable common shares other than as permitted by that subdivision).

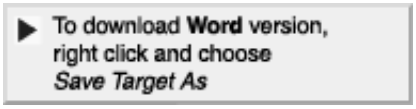
Valid issuance. To be validly issued, the shares must have been "duly authorized" and approved by the directors (and in some cases the shareholders). Additionally, they must have been issued for adequate and acceptable consideration. See Corp C §409(a), (e) for acceptable types of consideration and required resolutions when the corporation does not receive cash for the shares. Failure to comply with California or federal securities laws does not affect the validity of the issuance, because these statutes do not render the issuance void.

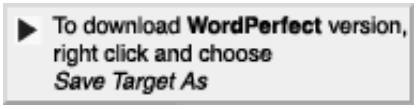
Full payment and assessability. A corporation may issue its shares as partially paid. In this circumstance, they remain subject to call for the remainder of the consideration. The share certificate must set out certain information in this event. See Corp C §409(d). Shares that are "fully paid" are "nonassessable."

PRACTICE TIP: Sometimes a closely held corporation has a history of share transactions that have not been formally documented or concerning which records of compliance with corporate and securities laws are incomplete. In some situations, these deficiencies can be cured, such as by the adoption of board resolutions ratifying prior acts. It is also prudent to fully disclose the problems and the steps taken to bring prior issuances of shares into compliance.

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§12.26 10. Form: Capital Shares





12.26-1 Capital Shares

The Company's authorized capitalization consists of _ _[*specify number*]**_ _ common shares, of which _ _**[*specify number*]**_ _ shares are issued and outstanding. The shares _ _**[*whose issuance is the subject of the opinion*]**_ _ have been duly authorized and validly issued and are fully paid and nonassessible.**

Comment: Opinion givers may be asked by an opinion recipient to render an opinion that the issued and outstanding common shares (and preferred shares) of the corporation have been duly authorized and validly issued and are fully paid and nonassessable. In most situations, the giving of such an opinion is not cost-effective. For older companies, the amount of factual and legal due diligence required to render this opinion can be substantial. Any opinion concerning the number of shares issued would customarily be based solely on an examination of the issuer's stock records.

The opinion giver may also be asked to render a factual confirmation that the opinion giver has "no knowledge of any outstanding options, rights, warrants, or other agreements or commitments obligating the corporation to issue any additional shares of its capital stock." Such factual confirmations are more appropriately given by the corporation. If given at all by an opinion giver, the confirmation should be limited to the opinion giver's "knowledge." See §12.12. See also 2007 Opinions Report p 75.

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C. General Transaction Issues

§12.27 1. Remedies Opinion

The "remedies opinion" (also referred to as an "enforceability opinion") addresses the issue of whether, and subject to what limitations, an agreement is valid, binding, and enforceable. Historically this opinion (and its limitations and exceptions) has been the subject of intense negotiation between opinion givers and counsel to opinion recipients because it concerns whether the recipient's contractual rights will be upheld if litigated. See 2007 Remedies Report p 5.

An opinion that a contract is "legal, valid, binding and enforceable" has the same meaning as an opinion that uses one or more but not all of those terms, although, at a minimum, the opinion should contain the word "binding" or "enforceable."

By customary usage, a remedies opinion expresses the opinion giver's professional judgment that:

- A contract has been formed;
- In the event of a material breach by the party identified in the opinion letter, a court would give effect to the obligations of that party (even if only through money damages); and
- Provisions calling for a particular remedy will be given effect unless expressly or implicitly excluded from the scope of the opinion.

See 2007 Remedies Report p 3; Third-Party "Closing" Opinions, Report of the TriBar Opinion Committee §3.1 (1998) (TriBar Report) 53 Bus Law 592 (1998).

In rendering the remedies opinion, the opinion giver needs to satisfy itself that the contract has been duly authorized, executed, and delivered by the party identified in the opinion; that adequate consideration has been furnished to that party as a matter of contract law; and that other requirements relating to the formation of a contract have been met. On contract formation requirements, see California Law of Contracts chaps 2-4 (Cal CEB 2007).

A remedies opinion is subject to commonly recognized exceptions relating to bankruptcy, insolvency, and equitable principles that limit the enforcement of rights and remedies and that may lead a court not to give effect to the agreement as a whole or to a specific contractual provision in certain circumstances. Examples of such matters include inequitable conduct of the party seeking enforcement, the discretion that courts exercise in granting equitable remedies, the duty of good faith and fair dealing, limitations on the rights of creditors in acting on their collateral, rules limiting waivers of a contracting party's rights, and limitations on the enforceability of provisions exculpating or indemnifying a party for reckless or willful misconduct. See 2007 Remedies Report p 9, Apps 10-11. See generally California Law of Contracts (Cal CEB 2007).

With the increasing standardization of loan agreements, particularly for smaller loans (less than $10 million), and the preference by lenders to select New York law as the law governing the loan agreement, opinion givers should raise with counsel to opinion recipients the possibility of allocating responsibility for advising the lender concerning the enforceability of the agreement to lender's counsel rather than to counsel for the borrower. Lender's counsel will have prepared the form of loan agreement and be thoroughly familiar with its terms under New York law. If this allocation of responsibility is acceptable to the opinion recipient, then the opinion giver for the borrower would render an "as-if" remedies opinion (as if the loan agreement were governed by California law) or an opinion only on the loan agreement's choice of law clause. For further discussion, see 2007 Opinions Report p 88. On the enforceability of choice of law clauses, see California Law of Contracts chap 5 (Cal CEB 2007).

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§12.28 2. Form: Remedies Opinion

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12.28-1 Remedies opinion

The Agreement constitutes the valid and binding obligation of the Company, enforceable against the Company in accordance with its terms, except as such enforcement may be limited by (i) bankruptcy, insolvency, reorganization, arrangement, moratorium, or similar laws relating to or affecting the rights of creditors generally, and (ii) general principles of equity (including the possible unavailability of specific performance or injunctive relief), whether enforceability is considered in a proceeding at equity or at law.

Comment: This form of the opinion conforms to the current trend in referring to the Agreement as "valid and binding" rather than "legal, valid and binding," even though the selection of terms should not limit (or expand) the scope of the opinion. A remedies opinion that does not expressly state the bankruptcy and equitable principles exceptions noted above is nevertheless subject to these commonly recognized exceptions. See §12.27.

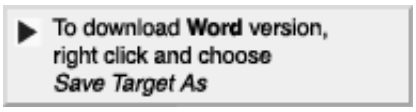
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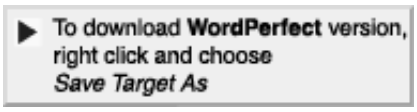
§12.29 3. No-Violation Opinion

Opinion recipients often ask Company counsel to opine that the contemplated transaction will not violate any of the Company's governing documents or existing agreements. Counsel should limit this opinion to specific agreements identified in a client certificate or by reference to a schedule to the Agreement or to a SEC filing. See form in §12.30.

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§12.30 4. Form: No-Violation Opinion





12.30-1 No-violation opinion

The execution and delivery of the Agreement and the performance by the Company of its obligations under the Agreement do not (a) violate the Company's articles of incorporation or bylaws; (b) constitute a default under or a _ _[*material*]_ _ breach of any agreement _ _[*identified in the Client Certificate*]_ _ _ _[*, but excluding in any such case financial covenants requiring the analysis of financial information*]_ _; (c) violate any judgment, order, or decree of any court or arbitrator _ _[*identified in the Client Certificate*]_ _; or (d) violate any federal or California law, rule, or regulation that in our experience is typically applicable to transactions of the nature contemplated by the Agreement or generally applicable to companies engaged in the same line of business as the Company.

Comment: Historically, this opinion was referred to as a "no conflict" opinion. Customary practice now uses the term "no violation" opinion to avoid the imprecise nature of "conflict with," and uses the terms "breach" and "default" for clarity. The language limiting the opinion to specifically listed agreements also reflects customary practice.

There is a difference of opinion concerning whether, under customary practice, this opinion, when addressing agreements, includes financial covenants. For example, the Company may currently be a party to a loan agreement containing financial covenants, *e.g.,* that the Company shall, at all times, maintain a funded debt-to-equity ratio not greater than a specified ratio. Is an opinion giver rendering the no-violation opinion opining that, by entering into the Agreement, the Company is not violating this financial covenant? The bracketed information in the opinion above excludes from the scope of the opinion any such coverage. Alternatively, if an exclusion is not taken, then the opinion giver should secure an officer's certificate confirming compliance with all relevant financial covenants in the listed agreements or state an explicit assumption to the effect that the opinion giver assumes that the Company is not in violation of any financial covenant contained in the list of agreements. Some opinion givers do neither and rely on the implicit exclusion of financial covenants from the scope of the opinion. See 2007 Opinions Report p 51 and n161.

A variant of this form is a request for an opinion that the party "is not in material violation of any federal, state, or local law, regulation, or administrative ruling." This opinion requests too much and should not be given. See Committee on Legal Opinions, ABA, Guidelines for the Preparation of Closing Opinions ¶4.3, 57 Bus Law 875 (2002); the report is available at the ABA website (http://www.abanet.org/buslaw/tribar/materials/20050120000001.pdf), and is reprinted in The Collected ABA and TriBar Opinion Reports (2005) (Collected Opinion Reports).

Opinion givers often explicitly describe the laws not reviewed by the opinion giver. See §§12.14-12.15.

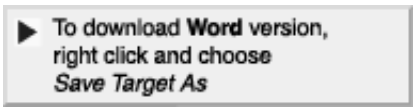
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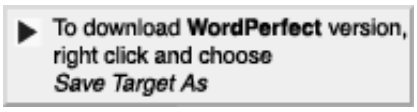
§12.31 5. Absence of Litigation Assurance

Opinion recipients commonly request a statement from the opinion giver concerning the absence of proceedings, pending or threatened, against the Company. Historically referred to as the "no litigation opinion," current practice is to treat it as a factual statement as to the state of knowledge of the opinion giver and not as an opinion at all. Typically the assurance is given based on the opinion giver's knowledge, see §12.12, and is included as a separate, unnumbered paragraph of the opinion letter or in a separate letter. See 2007 Opinions Report pp 15, 62. See also form in §12.32.

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§12.32 6. Form: Absence of Litigation Assurance





12.32-1 Absence of litigation assurance

To our knowledge, except as listed on Schedule _ _[*specify*]_ _ to _ _[*the Agreement/this Opinion*]_ _, there is no action or proceeding pending or threatened in writing against the Company that may adversely affect the transaction contemplated by the Agreement or that may have a material adverse effect on the Company.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/12 Legal Opinions/§12.33 7. Consent of Governmental Authority

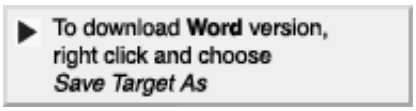
§12.33 7. Consent of Governmental Authority

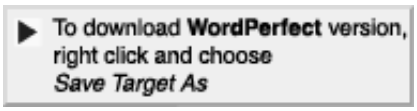
The opinion recipient will want assurance that the Company has complied with necessary governmental requirements in connection with the transaction. Typical governmental consents, declarations, and filings of interest include (a) those required under the Agreement; (b) real estate recordations; (c) UCC filings (Secretary of State); (d) securities filings (SEC, Blue Sky); (e) Secretary of State filings relating to changes in capitalization, mergers, and amendment of articles; and (f) consents relating to transfers of ownership such as liquor license and public utility ownership, and to transactions triggering notice requirements under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (15 USC §18a).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/12 Legal Opinions/§12.34 8. Form: Consent of Governmental Authority

§12.34 8. Form: Consent of Governmental Authority





12.34-1 Consent of governmental authority

All consents, approvals, authorizations, or orders of, and filings, registrations, and qualifications on the part of, the Company with any federal or California regulatory authority or governmental body required for the execution, delivery, and performance of the Agreement have been made or obtained.

Comment: This opinion complements the "no violation" opinion as it relates to applicable laws, and the remedies opinion.

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§12.35 9. Title to Assets

Sometimes a party requests an opinion that the other party has good and marketable title to all its assets and property. Such a provision puts the attorney in the position of virtually insuring the ownership of the client's assets. It should not be requested or given except in unusual circumstances, such as those involving negotiable securities (and even then, such opinions should be based on extensive assumptions). In place of this opinion, the property owner may give a warranty of title or obtain title insurance for any real property. When given, the opinion is phrased in terms of what the opinion recipient receives under applicable UCC provisions.

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§12.36 10. Enforceability of Security Agreement

The concepts of attachment, perfection, and priority are critical to ascertaining what rights a secured party has in personal property collateral. See Com C §§9103, 9203, 9301-9305. An opinion that a security agreement is enforceable, however, does not give assurance to the opinion recipient that *attachment* of the security interest to particular collateral has occurred, that the security interest has been *perfected,* or that the secured party has *priority* over third parties with respect to the collateral. As a rule, these matters, if desired to be addressed in the opinion, should be separately addressed in the opinion. See State Bar of California, Business Law Section, Uniform Commercial Code Committee, UCC Opinions Report: Legal Opinions in Personal Property Secured Transactions (2005).

Counsel may be asked to give a "priority opinion." Counsel should rarely give a "priority" opinion outside of a securitization transaction. Opinions on secured transactions are very complex and require expertise in the UCC. They are beyond the scope of this chapter.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/12 Legal Opinions/§12.37 V. BIBLIOGRAPHY

§12.37 V. BIBLIOGRAPHY

The following publications discuss legal opinions in more detail:

- 2005 Report, Corporations Committee, State Bar of California, Business Law Section, Legal Opinions in Business Transactions (Excluding the Remedies Opinion) (May 2005, rev'd Oct. 2007), available on the State Bar's website at http://www.calbar.ca.gov.
- State Bar of California, Business Law Section, Uniform Commercial Code Committee, UCC Opinions Report: Legal Opinions in Personal Property Secured Transactions (2005), available on the State Bar website at http://www.calbar.ca.gov/calbar/pdfs/sections/buslaw/opinion-resources_2005_ucc-opinion-report.pdf.
- State Bar of California, Business Law Section, Report on Third-Party Remedies Opinions (Sept. 2004, rev'd Sept. 2007), available on the State Bar website at http://www.calbar.ca.gov/calbar/pdfs/sections/buslaw/opinions/2007-10_remedies-opinions-update.pdf.
- ABA Committee on Legal Opinions, *Guidelines for the Preparation of Closing Opinions,* 57 Bus Law 875 (2002), available on the ABA website at http://www.abanet.org/buslaw/tribar/materials/20050120000001.pdf.
- ABA Committee on Legal Opinions, *Legal Opinion Principles*, 53 Bus Law 831 (1998), available on the ABA website at http://www.abanet.org/buslaw/tribar/materials/20050120000000.pdf.
- TriBar Opinion Committee, *Third-Party "Closing" Opinions*, 53 Bus Law 591 (1998), available on the ABA website at http://www.abanet.org/buslaw/tribar/materials/20050303000003.pdf.
- Restatement (Third) of the Law Governing Lawyers §95 (2000).
- Statement of the Joint Committee of the Real Property Law Section of the State Bar of California and the Real Property Law Section of the Los Angeles County Bar Association (May 2001).
- *Real Estate Opinion Letter Guidelines*, 38 Real Prop Prob & Tr J 251 (2003).
- Erickson, T. *Legal Opinions in Sale-Leaseback Transactions*, 4 CEB Cal Bus L Prac 112 (Summer 1989).
- Freeman, P. *Legal Opinions in Business Transactions*, 3 CEB Cal Bus L Prac 1 (Winter 1988).
- Glazer & Fitzgibbon. Glazer and Fitzgibbon on Legal Opinions (3d ed 2008).
- Groh, M. *A Checklist for Preparing Opinion Letters in Standard Corporate Transactions*, 4 CEB Cal Bus L Prac 137 (Fall 1989).

The following are available to State Bar Business Law Section members at http://www.calbar.ca.gov/state/calbar/calbar_sections_generic.jsp?cid=13901&id=30283. They are also included in State Bar of California, Business Law Section, 2002 California Opinion Reports, which may be ordered at http://www.calbar.ca.gov.

- Report on Legal Opinions Concerning California Partnerships (Feb. 1998);
- Report on Legal Opinions Concerning California Limited Liability Companies (Feb. 2000);
- Legal Opinions in California Real Estate Transactions;
- Legal Opinions in California Real Estate Transactions: An Addendum (Mar. 14, 1990);
- 1995 California Real Property Legal Opinions Report;
- First Supplement to 1995 California Real Property Legal Opinions Report (1998); and
- Inclusive Real Estate Secured Transaction Opinion, incorporating the Principal Concepts of the ABA Section of Real Property, Probate and Trust Law and the Amercian College of Real Estate Lawyers Report on Adaptation of the Legal Opinion Accord.

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13

Rights of Nonparties: Assignment, Delegation, and Third Party Beneficiaries

Michael A. Grayson
Alexander Fried
Jonathan Golden

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  4. Form: Obligations of Assignee §13.31
  5. Form: Purpose of Assignment §13.32
  6. Form: Further Assurances §13.33

7. Form: Representations and Warranties §13.34
8. Form: Assignor's Covenants §13.35
9. Form: Appointment of Attorney-in-Fact §13.36
10. Form: Indemnification §13.37
11. General Provisions §13.38
12. Ancillary Matters §13.39
C. Form: Consent to Assignment §13.40
D. Form: Notice of Assignment §13.41

V. THIRD PARTY BENEFICIARIES
A. Rights of Third Party Beneficiary §13.42
B. Requirements for Third Party Beneficiary Status §13.43
C. Form: No Third Party Beneficiary Intended §13.44

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§13.1 I. CHECKLIST: RIGHTS OF NONPARTIES

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- Assignment (see §§13.2-13.41)
- Limitations (see §§13.3-13.6, 13.8-13.9)
- Permitted
- Prohibited
- Partially prohibited
- Consent required
- Notice required
- Delegation (see §§13.2-13.23)
- Limitations (see §§13.7-13.9)
- Permitted
- Prohibited
- Partially prohibited
- Assumption required
- Consent required
- Notice required
- Third party beneficiaries (see §§13.42-13.44)
- None intended
- Specific third party beneficiaries intended

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II. GENERAL PRINCIPLES OF ASSIGNMENT AND DELEGATION

§13.2 A. Definitions

An assignment is the transfer by one party, the assignor, to another, the assignee, of title or ownership of property or rights. The transfer of title or ownership may be separate from the transfer of possession. See *Hudson Prop. v Governing Bd.* (1985) 168 CA3d 63, 72, 213 CR 909. The assigned rights may arise from a contract with a third party or by operation of law. See Corbin, *Assignment of Contract Rights*, 74 U Pa L Rev 207 (1926).

WARNING: The assignor may make a partial assignment. An assignee of a partial interest in an agreement generally cannot individually enforce performance of the agreement by the nonassigning party without the nonassigning party's consent, however, unless all parties entitled to the performance are joined in the action. *Stein v Cobb* (1940) 38 CA2d 8, 100 P2d 358; Restatement (Second) of Contracts §326(2) (1981). This rule protects the nonassigning party from the expense and inconvenience of multiple lawsuits.

A delegation is a transfer of the obligations of one party to another, without releasing the delegating party from liability. See Restatement (Second) of Contracts §316, comment c (1981).

Assignment and delegation differ from novation, in which the parties substitute a new obligation for an existing one; *e.g.,* the nonassigning party accepts the assignee as a substitute for the assignor, relieving the assignor from liability. CC §1530. See *Davies Mach. Co. v Pine Mountain Club, Inc.* (1974) 39 CA3d 18, 24, 113 CR 784.

An assignment and delegation provision in an agreement permits, prohibits, or restricts assignment of the benefits of, or delegation of the duties under, the agreement. The provision can protect a party from having to deal with a third party who was not a party to the original agreement and whose ability to perform under the contract may be in doubt. Alternatively, it can preserve a party's ability to transfer benefits or duties if that party needs or desires to do so.

WARNING: In the absence of specific language prohibiting assignment by operation of law, the parties run the risk that an assignment or a delegation resulting solely from a change in the legal form of ownership of a business may be enforced. The validity of such assignment or delegation depends, in California, on its effect on the interest of the party benefiting from nonassignability of the contract. *Trubowitch v Riverbank Canning Co.* (1947) 30 C2d 335, 344, 182 P2d 182 (corporation dissolved, assets assigned to shareholders who formed corporation; defendant not adversely affected by assignment). This uncertainty can be eliminated in the assignment provision by prohibiting assignment or delegation, "whether by operation of law or otherwise." Note that in other jurisdictions, an assignment by operation of law may be treated like other assignments unless specific language distinguishes such assignments. See, *e.g., Nicholas M. Salgo Assocs. v Continental Ill. Prop.* (D DC 1981) 532 F Supp 279, 283.

Assignments are often classified as (1) total or partial absolute assignments, (2) assignments as security, (3) assignments for collection, (4) assignments for the benefit of creditors, or (5) assignments as gifts. See Secured Transactions in California Commercial Law Practice §2.37 (2d ed Cal CEB 2001); Debt Collection Practice in California §§1.25-1.26, 4.100-4.103 (2d ed Cal CEB 1999).

NOTE: The right to sublicense in a license agreement not only raises the same considerations as the right to assign, it raises some additional issues. In an assignment, the assignee assumes all the obligations of the assignor. In a sublicense, the sublicensee may gain rights *without* obligations unless specifically required otherwise in the primary agreement.

On assignments, see generally California Law of Contracts §§7.2-7.60 (Cal CEB 2007).

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§13.3 B. Limits on Assignments

The first major issue counsel must consider is whether a certain right is assignable. Assignability is the rule; nonassignability is the exception. *Rokos v Peck* (1986) 182 CA3d 604, 617, 227 CR 480; *Goodley v Wank & Wank, Inc.* (1976) 62 CA3d 389, 133 CR 83. See CC §1458.

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§13.4 1. Assignable Rights

Certain assignments are expressly validated by the California Commercial Code, as in effect through June 30, 2001. For example:

- Com C §9318(4): The right to receive money under a contract, if no further performance is required of the assignor (*Butler v San Francisco Gas & Elec. Co.* (1914) 168 C 32, 41, 141 P 818; but see *Benton v Hofmann Plastering Co.* (1962) 207 CA2d 61, 67, 24 CR 268 (contract provision specifically prohibiting assignment of money due or to become due under contract is enforceable).
- Com C §2210(2): The right to money damages for breach of contract (*Trubowitch v Riverbank Canning Co.* (1947) 30 C2d 335, 182 P2d 182).
- CC §954: The right to recover personal property, arising from violation of a property right or obligation.
- CC §1458: A right arising from an obligation.
- CC §1459: A nonnegotiable written contract for money or personal property.

Effective July 1, 2001, existing Division 9 of the California Commercial Code was repealed and a new Division 9 has been enacted. New Division 9 does not include a provision similar to §9818(4). Counsel should carefully review the new law to determine its impact on assignments. See CC §§9401-9409 regarding the rights of third parties.

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§13.5 2. Nonassignable Rights

Without language to the contrary, an agreement is not assignable if (see *LaRue v Groezinger* (1890) 84 C 281, 283, 24 P 42; *Thomas v Thomas* (1961) 192 CA2d 771, 779, 13 CR 872):

- Performance under the contract requires some personal quality of the promisor.
- The contract expressly or impliedly prohibits assignment.
- Statutory law limits assignment. For example:
- CCP §377.34: Damages for pain, suffering, and disfigurement are not recoverable by personal representatives.
- 41 USC §15: Assignment of rights under contracts with the federal government is limited.
- 11 USC §§365, 541: Contract provisions restricting or prohibiting assignment or delegation that would be applied against bankruptcy debtors are prohibited. See §13.9.

Contracts for the sale of goods are not assignable if (Com C §2210(2)):

- The assignment would materially change the duty of the nonassigning party (*e.g.,* personal confidence or extension of credit);
- The assignment would increase the nonassigning party's risks or burdens; or
- The assignment would make it less likely that the promisor will receive the agreed exchange for his or her own performance (*e.g.,* exclusive dealing, requirements, and output contracts).

Because the Commercial Code imposes a "good faith" requirement (Com C §2306(1)) and a "best efforts" requirement (Com C §2306(2)) on the parties, and because the nonassigning party has the right to demand assurances from the assignee (Com C §2210(6)), it may be difficult to establish the nonassignability of exclusive dealing, requirements, or output contracts.

Causes of action arising out of tort law and contracts of a purely personal nature are also not assignable. *Rokos v Peck* (1986) 182 CA3d 604, 617, 227 CR 480 (contract between author and agent, producer or director is personal in nature and therefore not assignable); *Hudson Prop. v Governing Bd.* (1985) 168 CA3d 63, 71, 213 CR 909 (right of first refusal granted under former Ed C §39369.5 is personal and therefore not assignable); *Goodley v Wank & Wank, Inc.* (1976) 62 CA3d 389, 395, 133 CR 83 (legal malpractice claim not assignable).

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§13.6 3. Special Consideration: Garn-St. Germain Depository Institutions Act of 1982

A due-on-sale provision requires that a borrower pay in full an obligation secured by a mortgage or trust deed if the property securing the obligation is sold. Its effect is similar to a prohibition on assignment and delegation. The Garn-St. Germain Depository Institutions Act of 1982 provides that due-on-sale provisions are generally enforceable. 12 USC §1701j-3(b). Enforcement of these provisions for certain transactions pertaining to residential real property of fewer than five dwelling units, however, is prohibited. 12 USC §1701j-3(d).

For form of due-on-sale provision, see §13.14.

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§13.7 C. Limits on Delegation

The burden of an obligation may be transferred and the transferor released from liability only with the consent of the party entitled to its benefit. CC §1457. This statute prevents a party from avoiding liability for performance merely by delegating the duty to perform.

Unless the contract expressly prohibits the delegation, a party may generally delegate or subcontract the duty to perform without the other party's consent, but it will remain liable for performance of the obligation delegated. *Anderson v De Urioste* (1892) 96 C 404, 31 P 266. See *Scott v Mullins* (1962) 211 CA2d 51, 55, 27 CR 269. A contract that requires the skill, credit, or other personal quality of a promisor, however, cannot be delegated without the consent of the nondelegating party, absent contractual language to the contrary, because the performance received from the assignee would be fundamentally different from that anticipated in the original contract. See *Davis v Basalt Rock Co.* (1951) 107 CA2d 436, 444, 237 P2d 338 (parties intended obligation to be purely personal). If only a portion of performance is personal and the personal obligations are discharged, the rest of the agreement may be delegated. *Fenn v Pickwick Corp.* (1931) 117 CA 236, 241, 4 P2d 215.

Contracts that have been held to be personal in nature, and therefore not delegable, include:

- A contract for the sale of land requiring the purchaser to deliver unsecured notes for deferred payments of the purchase price. *Montgomery v De Picot* (1908) 153 C 509, 96 P 305.
- A contract to act as an exclusive sales agent in the sale of real estate. *Sumner v Nevin* (1906) 4 CA 347, 87 P 1105.
- A contract giving an exclusive right to promote, distribute, and sell a manufacturer's product. *Coykendall v Jackson* (1936) 17 CA2d 729, 62 P2d 746.

NOTE: A contract made with a corporation, by definition, is not a personal service contract, because a corporation cannot perform personal functions. *Haldor, Inc. v Beebe* (1945) 72 CA2d 357, 366, 164 P2d 568.

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D. Special Considerations: Rules for Specific Transactions

§13.8 1. Commercial Sales Agreements

The Commercial Code governs agreements for the sale of goods. Com C §2102. The section relating to assignments and delegation, Com C §2210, does not address all issues concerning these topics, but it does establish certain principles:

- Generally, contracts are freely assignable. Com C §2210(2).
- An assignment transfers rights to the assignee and away from the assignor. A delegation transfers duties to the assignee, but the assignee and assignor both remain liable. Com C §2210(1).
- All delegations, but not all assignments, can be prohibited by agreement. See Com C §2210(1).
- An assignment of "the contract" or "all my rights under the contract" generally constitutes a delegation of performance, and the assignee's acceptance constitutes his or her agreement to perform the delegated duties. Com C §2210(5).
- A prohibition on "assignment" of a contract is a prohibition of delegation only, unless the context indicates otherwise. Com C §2210(4).
- A delegation, but not an assignment, specifically gives the nondelegating party the right to require assurances. Com C §2210(6).

For further discussion of assignment and delegation of contracts for the sale of goods, see California UCC Sales and Leases, chap 11 (Cal CEB 2002).

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§13.9 2. Bankruptcy Code §§365, 541

Despite any provision to the contrary in a contract or lease, a trustee or debtor-in-possession may assign certain executory contracts or unexpired leases only if (11 USC §365(f)(2)):

- The trustee first assumes the contract or lease, and
- The trustee receives adequate assurance of future performance of the contract or lease by the assignee.

The right to assign does not apply to (a) contracts that are nonassignable under applicable state law (*e.g.,* personal service contracts), (b) contracts to make a loan or to extend other debt financing or financial accommodations, or (c) a lease of nonresidential real property that was terminated under applicable nonbankruptcy law before the bankruptcy court's order for relief. 11 USC §365(c). The assignment of a contract or a lease that the trustee or debtor-in-possession has assumed relieves the trustee and debtor-in-possession from any liability for breach of the contract occurring after the assignment. 11 USC §365(k).

Interests and property of the debtor generally become property of the bankruptcy estate, even if transfer of the interest or property is restricted by agreement. 11 USC §541(c)(1)(A). Restrictions in trusts (such as spendthrift trusts) that are enforceable under state law, however, are enforceable in bankruptcy cases. 11 USC §541(c)(2). See *In re Neuton* (9th Cir 1990) 922 F2d 1379, 1383, in which the court held that, because California law (Prob C §15306.5) enforces spendthrift restrictions only on 75 percent of the interest in the trust, the remaining 25 percent becomes part of the bankruptcy estate.

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E. Effect of Assignment or Delegation

§13.10 1. Status of Parties

After an effective assignment, the assignee stands in the shoes of the assignor, taking the assignor's rights and remedies subject to any right of setoff or other defenses against the assignor existing before the promisor has actual notice of assignment. CC §1459; CCP §368; *Christian v County of Los Angeles* (1986) 176 CA3d 466, 222 CR 76; *Salaman v Bolt* (1977) 74 CA3d 907, 141 CR 841.

Generally, the assignee is not automatically bound by all contract obligations unless he or she expressly makes an assumption or promises to perform. *Griffin v Williamson* (1955) 137 CA2d 308, 314, 290 P2d 361. A voluntary acceptance of the benefit of a transaction (*i.e.,* assignment of right), however, is equivalent to a consent to its obligations when the facts are known to the person accepting. CC §1589.

NOTE: When a bilateral contract provides that its terms are binding on successors and assigns of the parties, assignment of a party's contractual rights also transfers that party's contractual burdens, regardless of whether it is expressly assumed by the assignee. *Weidner v Zieglar* (1933) 218 C 345, 350, 23 P2d 515; *Citizens Suburban Co. v Rosemont Dev. Co.* (1966) 244 CA2d 666, 676, 53 CR 551; *Brady v Fowler* (1920) 45 CA 592, 188 P 320. See form in §13.31 for language addressing the assignee's obligations after assignment or delegation.

The assignee's acceptance of the delegation of duties is the assignee's promise to perform, enforceable by the assignor and the nondelegating party. The assignor, however, remains liable to the nondelegating party. CC §1457; *Baer v Associated Life Ins. Co.* (1988) 202 CA3d 117, 248 CR 236. If sued by the nondelegating party for breach of contract, the assignor can cross-complain against the assignee and, if necessary, bring the assignee into the action as an additional party. The assignor's relation to the assignee becomes that of a surety to a principal debtor. *Cutting Packing Co. v The Packers' Exch.* (1890) 86 C 574, 577, 25 P 52. As surety, the assignor can compel the assignee to perform (CC §2846) and can recover from the assignee any amounts the assignor has paid to the nondelegating party on account of the assignee's failure to perform, together with costs and expenses (CC §2847).

Nonassignment and nondelegation provisions are for the benefit of the nonassigning, nondelegating party, which can waive objection to a prohibited assignment or delegation expressly or by performing to the assignee. An assignment or a delegation is enforceable as between the assignor and the assignee, however, even if prohibited by contract provisions or statute. *Johnston v Landucci* (1942) 21 C2d 63, 67, 130 P2d 405. In *Johnston*, the original contract prohibited the buyer's assignment without the seller's consent. The buyer assigned its interest by an agreement stating that the assignment was "subject to the approval" of the seller. The court held that in this case, rather than being a condition precedent to the effectiveness of the assignment, the quoted language was instead a reference to the original contract, putting the assignee on notice that the nonassigning party need not recognize the assignment.

PRACTICE ADVICE: If the parties to the assignment do not want the assignment to be effective without the nonassigning party's consent, the assignment should expressly state this condition.

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§13.11 2. Remedies for Breach of Nonassignment or Nondelegation Provision

The typical remedy for breach of a nonassignment provision is damages, which are often either nonexistent or impossible to ascertain until it is too late for the remedy to be effective. Some courts award injunctive or declaratory relief if the provision includes language declaring that any prohibited assignment (a) is void or (b) is voidable and a basis for terminating the contract.

PRACTICE ADVICE: A provision stating that the client has the *option* to terminate a voidable assignment or delegation could jeopardize the client's rights. If the client fails to act promptly, the other parties could possibly establish an estoppel claim. Therefore, the stronger provision declares unauthorized assignments void.

See *McClaran v Plastics Indus.* (9th Cir 1996) 97 F3d 347 for discussion of the liability for assigning a contract as part of the sale of a business, in violation of an express prohibition against assignment without consent. In this case, the court refused to hear the affirmative defenses of the assignee because the assignment was invalid; the defendants (assignor and assignees) were each held liable.

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III. PROVISIONS IN ORIGINAL AGREEMENT PERMITTING OR PROHIBITING ASSIGNMENT AND DELEGATION

§13.12 A. Preliminary Issues for Drafting Original Agreement

Counsel must draft the original agreement carefully and specifically to give effect to the parties' intent regarding assignability or nonassignability (*Trubowitch v Riverbank Canning Co.* (1947) 30 C2d 335, 344, 182 P2d 182):

> Where a bilateral contract in terms forbids assignment, it becomes a matter of interpretation as to what is meant. Is it intended that a duty under the contract shall not be delegated, or is it intended that a right shall not be assigned, or are both prohibitions intended?

Assignment and delegation provisions involve more issues than many "boilerplate" provisions. Before drafting the provision, counsel should answer the following questions:

- Should the provisions be symmetrical, treating all parties identically, or should fewer than all parties be free to assign or delegate?
- What can be transferred: rights only? duties only? or rights and duties together?
- If assignment and delegation are prohibited, should an exception be made to allow assignment or delegation to certain types of persons or entities; *e.g.,* affiliates, successors to all or substantially all the assignor's business, parties having a specified minimum net worth, or parties having certain specified characteristics?
- Should permitted assignees be required to execute and deliver an assumption agreement satisfactory to the nonassigning party before an assignment is effective?
- Is consent from any other party required or desirable, and, if so, what standards should the consenting party comply with in deciding to grant or deny consent?
- What procedures must the parties follow if the assignment or delegation is to be effective?

PRACTICE ADVICE: Most courts interpret nonassignment provisions narrowly. A provision that prohibits "assignment of this Agreement" addresses little more than a basic sale of contract rights. If the attorney intends to prohibit other types of assignments, such as those triggered by mergers, the agreement must prohibit "assignment of this Agreement, whether by operation of law or otherwise," in order to protect against effective control changing hands or rights, and perhaps duties, moving to another party. See *Trubowitch v Riverbank Canning Co., supra*.

See forms in §§13.13-13.23 permitting or restricting assignment and delegation.

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B. General Assignment and Delegation Provisions

§13.13 1. Form: Prohibition of Assignment and Delegation (Both Parties Prohibited From Assigning Rights or Delegating Duties)

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13.13-1 Prohibition of assignment and delegation (both parties prohibited from assignment or delegation)

___*. Prohibition of Assignment and Delegation.* Neither party to this Agreement may assign any of its rights or delegate any of its duties under this Agreement

[A*dd the following if prohibition is not to be absolute*]

without the prior written consent of the other party to this Agreement, which consent _ _[*e.g., may not be unreasonably withheld or delayed/may be withheld in that party's sole and absolute discretion*]**_ _. Despite such consent, no assignment will release the assignor from any of its obligations or alter any of its primary obligations to be performed under the Agreement.**

[*If applicable, add the following option*]

Any attempted assignment or delegation in violation of this provision is _ _[*void/voidable at the option of the nonassigning and nondelegating party*]**_ _ and will entitle that party to terminate this Agreement.**

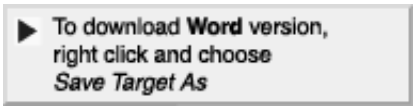
[*Continue*]

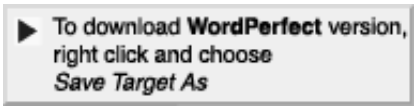
As used in this provision, "assignment" and "delegation" means any sale, gift, pledge, hypothecation, encumbrance, or other transfer of all or any portion of the rights, obligations, or liabilities in or arising from this Agreement to any person or entity, whether by operation of law or otherwise, and regardless of the legal form of the transaction in which the attempted transfer occurs.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/13 Rights of Nonparties: Assignment, Delegation, and Third Party Beneficiaries/§13.13A 2. Form: Prohibition of Assignment and Delegation (One Party Prohibited From Assigning Rights or Delegating Duties)

§13.13A 2. Form: Prohibition of Assignment and Delegation (One Party Prohibited From Assigning Rights or Delegating Duties)





13.13A-1 Prohibition of assignment and delegation (one party prohibited from assigning rights or delegating duties)

___. *Prohibition of Assignment and Delegation.* _ _[*First party*]_ _ **may not assign any of its rights or delegate any of its duties under this Agreement.**

[*Add the following if prohibition is not to be absolute*]

without the prior written consent of _ _[*second party*]_ _**, which consent** _ _[*e.g., may not be unreasonably withheld or delayed/may be withheld in* _ _[*second party*]_ _*'s sole and absolute discretion*]_ _**. Despite** _ _[*second party's*]_ _ **consent, no assignment will release the** _ _[*first party*]_ _ **from any of its obligations or alter any of its primary obligations to be performed under the Agreement.**

[*If applicable, add the following option*]

_ _[*Second party*]_ _ **may assign any of its rights to or delegate any of its duties under this Agreement at any time. Any attempted assignment or delegation in violation of this provision is** _ _[*void/voidable at the option of* _ _[*second party*]_ _]_ _ **and will entitle** _ _[*second party*]_ _ **to terminate this Agreement.**

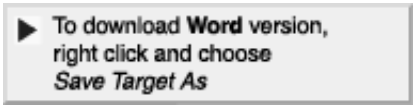
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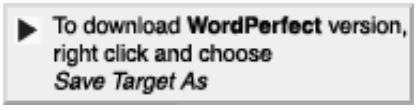
As used in this provision, "assignment" and "delegation" means any sale, gift, pledge, hypothecation, encumbrance, or other transfer of all or any portion of the rights, obligations, or liabilities in or arising from this Agreement to any person or entity, whether by operation of law or otherwise, and regardless of the legal form of the transaction in which the attempted transfer occurs.

Comment: The sentence declaring that one party can freely assign may be omitted because this is often the residual rule and counsel may not want to flag the issue.

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§13.14 3. Form: Due-on-Sale Provision





13.14-1 Due-on-sale provision

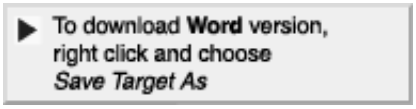
___. *Due-On-Sale Provision.* If, without Lender's prior written consent, (a) all or any part of the Property or any interest in it is sold or transferred, or (b) a beneficial interest in Borrower is sold or transferred (if Borrower is not a natural person), then all sums secured by this _ _[*e.g., Deed of Trust/Mortgage*]_ _, _ _[*as well as any prepayment penalty required by this* _ _[*e.g., Deed of Trust/Mortgage*]_ _]_ _ **will be immediately due and payable.**

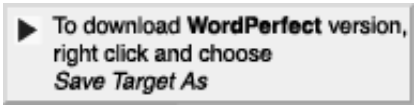
Comment: See 12 USC §1701j-3(d) (list of exceptions to enforceability of due-on-sale provisions).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/13 Rights of Nonparties: Assignment, Delegation, and Third Party Beneficiaries/§13.15 4. Form: Assignment and Delegation Expressly Permitted

§13.15 4. Form: Assignment and Delegation Expressly Permitted





13.15-1 Assignment and delegation expressly permitted

___. *Assignment and Delegation.* **Each party to this Agreement may assign** _ _[*all or part of its rights under this Agreement/*_ _[*describe assignable rights*]_ _]_ _ **and may delegate** _ _[*all or part of its duties under this Agreement/*_ _[*describe delegable duties*]_ _]_ _

[*Add the following if there are conditions to or requirements for effective assignment or delegation*]

provided that _ _[*specify conditions or requirements, e.g., consent from or notice to another party; payment of fees and expenses; requirement that assignee meet specific financial criteria*]_ _**.**

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§13.16 C. Assignment Provisions in Partnership Agreements

A transfer of a partnership interest does not, by itself, dissolve the partnership. Corp C §§15027(1), 15672(a). No one can become a member of a general or limited partnership, however, unless all parties consent or, in a limited partnership, the partnership agreement provides otherwise. Corp C §§15018(g), 15674. The assignment of a partnership interest does not entitle the assignee (1) to interfere in the management or administration of the partnership business, (2) to require any information on account of partnership transactions, or (3) to inspect the partnership books. Corp C §15027(1). The assignee is entitled to receive, to the extent assigned, only the partnership profits to which the assigning partner would otherwise be entitled. If the partnership is dissolved, the assignee is entitled to receive the assignor's interest and may receive an account from the date only of the last account agreed to by all the partners. Corp C §15027(2).

A partner's interest in the partnership is defined as the partner's "share of the profits and surplus" (Corp C §15026) and does not necessarily include the right to receive distributions. Even if it does, a provision prohibiting transfer of a partner's interest may not prevent the partner from assigning distributions as money due or as future income rather than as a component of the partner's partnership interest. See Com C §9318(4).

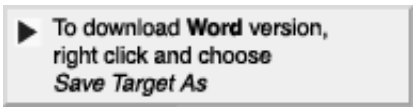
NOTE: An assignment of a partner's interest may be enforceable by the assignee against the assignor even though it may not bind the partnership or allow direct collection by the assignee from the partnership. *Johnston v Landucci* (1942) 21 C2d 63, 130 P2d 405.

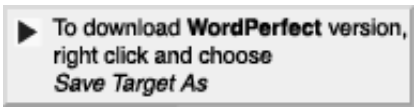
The agreement should clearly and specifically restrict assignment of limited partnership interests and shareholder ownership. Certain exemptions from reporting requirements and SEC regulations depend on the accredited or nonaccredited status of the investor or partner. For example, an unlimited number of accredited investors may participate in the partnership, but exemptions limit the offering to 35 nonaccredited investors. Exceeding the statutory number can subject the organization to significant reporting requirements as well as penalties. This can occur when an accredited investor assigns his or her rights to one or more investors or a nonaccredited investor assigns some or all of his or her rights to others who have not been qualified by the entity or who may not be accredited. Further, even assigning the right to receive income distributed to the investor may cause the assignee to be considered an investor instead of a named party.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/13 Rights of Nonparties: Assignment, Delegation, and Third Party Beneficiaries/§13.17 1. Form: Assignment Permitted

§13.17 1. Form: Assignment Permitted



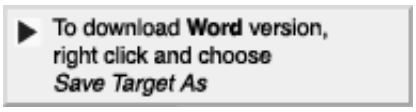


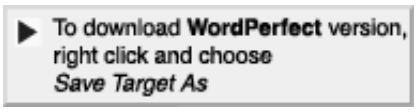
13.17-1 Assignment permitted

___. *Assignment of Interest.* Each partner may transfer his, her, or its interest in the partnership without dissolving the partnership by the transfer, but such a transfer will not make the transferee a partner or entitle the transferee to any of the rights of a partner, other than the right to receive as much of the transferor's share of the partnership distributions as is transferred to the transferee. Until the transferee is admitted to the partnership in substitution for the transferor under the provisions of the partnership agreement for admitting new partners, such a transfer will not terminate any of the transferor's obligations.

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§13.18 2. Form: Assignment Prohibited





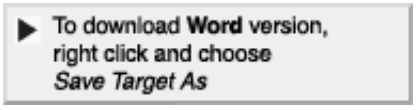
13.18-1 Assignment prohibited

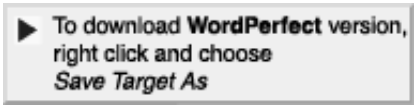
___*. No Assignment of Interest.* A partner shall not transfer his, her, or its interest in the partnership, in whole or in part, except by intestate succession, testamentary disposition, or through a decree or judgment from a court of competent jurisdiction. Any other purported transfer of all or part of a partner's interest is void and of no effect against the partnership, any other partner, any creditor of the partnership, or any claimant against the partnership.

No such transfer constitutes the transferee a partner or entitle the transferee to any of the rights of a partner, other than the right to receive as much of the transferor's share of the partnership distributions as is transferred to the transferee.

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§13.19 3. Form: Assignment Permitted on Compliance With Conditions





13.19-1 Assignment permitted on compliance with conditions

___. *Assignment of Interest.* A partner may transfer all or part of his, her, or its interest in the partnership only as follows:

(a) To the partnership or to any other partner;

(b) By intestate succession or testamentary disposition on the partner's death;

(c) By a gift to the partner's spouse or children, to a trustee for the partner's spouse or children, or both;

(d) To a corporation if, immediately after the transfer, the partner making the transfer continues to own at least 50 percent of that corporation's voting shares; or

(e) To any person after the partner making the transfer has first offered the other partners their rights of first refusal in accordance with the provisions of this Agreement dealing with such rights.

No such transfer constitutes the transferee a partner or entitle the transferee to any of the rights of a partner, other than the right to receive as much of the transferor's share of partnership distributions as is transferred. Until the transferee is admitted to the partnership in substitution for the transferor under the provisions of this Agreement for admitting new partners, such a transfer does not terminate any of the transferor's obligations.

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§13.20 D. Assignments in Lease Agreements

A commercial lease may contain provisions restricting assignment, CC §1995.210(a), but in the absence of any restrictions, the lease is assignable, CC §1995.210(b). The landlord may absolutely prohibit assignment (CC §1995.230) or may condition assignment on the landlord's consent (CC §1995.240). The provision may state that consent cannot be unreasonably withheld or may be subject to other standards (CC §1995.250) but, if no standard for giving consent is provided, it may not be unreasonably withheld (CC §1995.260). *Kendall v Ernest Pestana, Inc.* (1985) 40 C3d 488, 506, 220 CR 818 ("where a commercial lease provides for assignment only with the prior consent of the lessor, such consent may be withheld only where the lessor has a commercially reasonable objection to the assignee or the proposed use"). See *Harara v Conocophillips Co.* (ND Cal 2005) 377 F Supp 2d 779, 787 (*Kendall* holding expressly limited by 1989 revision of CC §1995.230). The landlord also has the right to condition consent on the landlord's receipt of some or all of the consideration paid by the assignee in excess of rent. CC §1995.240. See *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 6 CR2d 467.

A landlord's failure to state in writing its reasons for withholding consent within a reasonable time after the tenant requests such a writing is deemed proof that consent was unreasonably withheld. CC §1995.260.

NOTE: Civil Code §1995.260 applies only to restrictions on transfers in leases executed after September 22, 1983. CC §1995.270(4)(b).

It is commercially reasonable for a landlord to withhold consent to the assignment of a lease to a tenant who would not pay as much rent as the original tenant. *John Hogan Enters. v Kellogg* (1986) 187 CA3d 589, 231 CR 711. Thus, a landlord may block the assignment or sublease of a percentage lease or other agreement that establishes rent as a function of the tenant's gross sales if the proposed assignee's gross sales would not be as high as the gross sales of the original tenant.

For form of assignment of lease, see §§13.21-13.23. For further discussion of assignment of commercial leases, together with forms, see Office Leasing: Drafting and Negotiating the Lease, chap 24 (Cal CEB 1996).

A lessor may be willing to allow an assignment or a sublease if the lessor is entitled to receive all or part of the benefits of the assignment or the sublease, particularly if the original rent is below the fair market rental value of the property. See CC §1995.240. See form in §13.22 for provision granting lessor the right to receive benefits of the assignment or the sublease. In such a provision, the amount to be paid to the lessor can be based on the difference between the rent payable by the lessee and the rent payable by the assignee or sublessee, or on the net excess consideration received after taking into account appropriate adjustments paid by the assignor, such as commissions and tenant improvements. However, any additional consideration must be limited to the value of the lease; an attempt to capture a portion of the value of good will or of a noncompete provision on transfer of a business is unconscionable. *Ilkhchooyi v Best* (1995) 37 CA4th 395, 45 CR2d 766. The Law Revision Commission Comment on the final version of CC §1995.240 stated:

> As used in this section, "consideration" includes "appreciated rentals" or any other term or description used by the parties to define any bonus value of the leasehold interest or any consideration attributable to the value of the leased premises that may be subject to sharing or shifting between the parties pursuant to contract in case of transfer by the tenant. (20 L Rev Comm'n Rep 275 (1990).)

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§13.21 1. Form: General Prohibition of Assignment

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13.21-1 General prohibition of assignment

___. *Assignment or Sublease.* Lessee shall not, without Lessor's prior written consent: (a) permit assignment of all or any interest in this Lease, by operation of law or otherwise, (b) sublet all or any part of the Premises or any right or privilege appurtenant to the Premises, or (c) suffer any other person (other than Lessee's agents and servants) to occupy or use all or any part of the Premises.

[*Add one of the following alternatives*]

[*Alternative 1: Lessor may withhold consent in its sole discretion*]

In Lessor's sole and absolute discretion, Lessor may withhold its consent to any assignment, sublease, occupation, or use. Lessor shall not be bound by any standard of reasonableness in exercising this discretion.

[*Alternative 2: Lessor may not unreasonably withhold or delay consent*]

Lessor may not unreasonably withhold or delay its consent to any assignment, sublease, occupation, or use by another party.

[*Continue*]

Any assignment, subletting, occupation, or use by another person without Lessor's prior written consent is void and will, at Lessor's option, terminate this Lease.

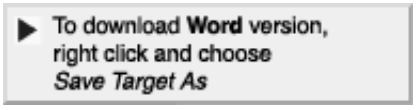
If Lessee requests Lessor to consent to a proposed assignment, subletting, occupation, or use by any other person, Lessee shall pay to Lessor, whether or not consent is ultimately given, Lessor's reasonable attorney fees and costs incurred in connection with each such request.

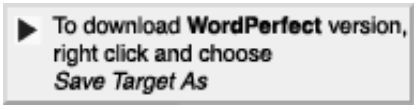
Lessor's consent to one assignment, subletting, occupation, or use by any other person is not deemed to be a consent to any subsequent assignment, subletting, occupation, or use by the same or any other person.

Comment: Use of explicit language in identifying Lessor's sole and absolute right to withhold consent, without regard to any standard of reasonableness, brings the significance of this provision to the parties' attention. See CC §1995.250.

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§13.22 2. Form: Lessor to Receive Benefits of Assignment or Sublease





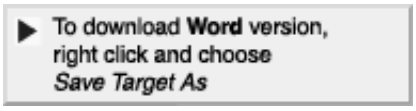
13.22-1 Lessor to receive benefits of assignment or sublease

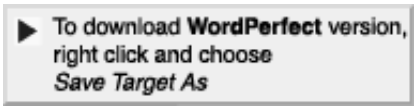
___. *Benefits of Assignment or Sublease.* If, on or after (a) any assignment of this Lease or any interest in this Lease, or (b) any sublease of all or any part of the Premises, Lessee receives or is entitled to receive from the assignee or the sublessee any payment, premium, consideration, or rent in excess of the amount of rent required under this Lease, Lessee shall pay to Lessor _ _[*e.g., the entire amount/half the amount*]**_ _ of that payment, premium, consideration, or rent in excess of the rent required under this Lease, as and when received by Lessee from the assignee or sublessee.**

Lessee immediately and irrevocably assigns to Lessor, as security for Lessee's obligations under this Lease, all rent from any subletting of all or part of the Premises as permitted by this Lease; and Lessor, as assignee and as attorney-in-fact for Lessee, or a receiver for Lessee appointed on Lessor's application, may collect such rent and apply it to Lessee's obligations under this Lease; except that, until the occurrence of an event of default by Lessee, Lessee has the right to collect such rent.

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§13.23 3. Form: Dissolution, Merger, or Similar Transfer Deemed Assignment When Lessee Is Corporation





13.23-1 Dissolution, merger, or similar transfer deemed assignment

___. *Assignment on Dissolution, Merger, or Similar Transfer.* Any dissolution, merger, consolidation, or other reorganization of Lessee, or the sale or other transfer of a controlling percentage of the capital stock of Lessee, or the sale of at least _ _[*e.g., 51*]_ _ percent of the value of Lessee's assets, will be deemed a voluntary assignment. "Controlling percentage" means the ownership of, and the right to vote, stock possessing at least _ _[*e.g., 51*]_ _ percent of the total combined voting power of all classes of Lessee's capital stock issued, outstanding, and entitled to vote for the election of directors. This paragraph does not apply to corporations whose stock is traded through an exchange or over the counter.

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IV. PROVISIONS TO EFFECT ASSIGNMENT AND DELEGATION

§13.24 A. Preliminary Issues for Drafting Assignment or Delegation Agreement

The form of each assignment may vary widely and depends on the facts and circumstances of the transaction. Before counsel can draft the assignment or delegation agreement, the following issues must be resolved:

- Should the agreement assign rights only, delegate duties only, or both?
- Should the assignee assume obligations or clearly state that obligations are not assumed?
- Is any other party's consent required or desirable and, if so, what standards must the consenting party meet in deciding to grant or deny consent?
- Is notice to any other party required or desirable?
- What related provisions should be included, *e.g.,* do any provisions of the assigned contract need to be changed?
- What procedures must the parties follow if the assignment or delegation is to be effective?

The legal context of the assignment should be clearly stated and understood in the assignment agreement. Introductory provisions and recitals may be appropriate. See §13.30. If contract rights or things in action are assigned, the recitals should (a) identify the parties to the original contract, (b) describe what is being assigned, and (c) state the parties' intent to make an absolute assignment, as distinguished from an assignment for security purposes, which terminates once the secured obligation is satisfied.

As in other business agreements, the assignee may demand that the assignor make representations and warranties on the subject matter of the transaction. Typically, they include representations about the power and authority of the contracting entity, authority to enter into the transaction, an absence of conflicting rights and obligations, and the status of the contract being assigned. See §13.34. The assignor may demand similar representations and warranties from the assignee. The parties may also add covenants if appropriate to the specific transaction. See §13.35.

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§13.25 1. Requirements for Validity

There are no prescribed formalities for making an effective assignment or delegation. All that is necessary is clear and positive proof of the intent to transfer title without further action, which requires only that the rights assigned be described with sufficient particularity. *Mission Valley East, Inc. v County of Kern* (1981) 120 CA3d 89, 174 CR 300. See *McCown v Spencer* (1970) 8 CA3d 216, 87 CR 213.

Counsel cannot always ascertain all steps that may be required to give effect to the assignment when the assignment documents are prepared and executed. Therefore, the assignment should contain a provision (commonly referred to as a "further assurances" provision) obligating the assignor to cooperate to complete any additional documentation that may be required later, protecting the assignee if a third party demands that the assignor execute additional documents. For example, if rights to an insurance policy are assigned, the insurance company frequently requires the completion of its own form before it will honor the assignment. See form in §13.33 for further assurances provision.

Depending on the nature of the rights being assigned, it might also be necessary for the assignee to be granted a power of attorney for purposes of enforcing its rights under the assignment. If further steps need to be taken on the part of the assignor, the assignee then has the right and authority to comply without having to seek out the assignor and demand further action. The power of attorney also allows the assignee to act on behalf of the assignor with respect to the contract. See form in §13.36 for provision appointing attorney-in-fact.

An effective assignment may be conditional, revocable, or voidable by the assignor for lack of consideration, failure to comply with the statute of frauds, or other reasons. Restatement (Second) of Contracts §331 (1981). The assignment may be oral unless a writing is required by statute or by the agreement being assigned. CC §1052. See *Norton v Consolidated Fisheries* (1953) 120 CA2d 86, 260 P2d 617. The assignee's assent is not required for an assignment to be binding. Restatement §327, comment a. Completion of the assignment may or may not imply a promise by the assignee to perform the duties of the contract, but acceptance of benefits may imply consent to obligations. CC §1589. Note that for contracts for the sale of goods, the assignee's acceptance of a delegation constitutes a promise to perform that is enforceable by the nondelegating party. Com C §2210(5).

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§13.26 2. Implied Warranties in Assignments and Delegations

In any assignment or delegation, the parties are free to include express warranties that reflect their intent. The law implies the following warranties by the assignor, unless contradicted by express warranties or language in the agreement:

- The assignor will do nothing to defeat or impair the value of the assignment. Restatement (Second) of Contracts §333(1)(a) (1981).
- The right, as assigned, actually exists and is not subject to any limitations or defenses against the assignor other than those stated or apparent at the time of assignment. Restatement §333(1)(b).
- The interest assigned is genuine and valid, and the assignor has title to that interest. See *Mary Pickford Co. v Bayly Bros.* (1939) 12 C2d 501, 519, 86 P2d 102 (applicable existing laws at time of contract enter into and form part of contract as if expressly incorporated and referred to). See also Restatement §333(1)(c).

For discussion of implied warranties under the Commercial Code, applicable to contracts for the sale of goods, see Com C §§2312-2313, 2316-2317; California UCC Sales and Leases §§3.21-3.41 (Cal CEB 2002).

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§13.27 3. Notice and Consent

Notice to or consent from the nonassigning party is not necessary to complete an assignment of a right under a contract unless express language in the contract imposes such conditions. See *Smith v Harris* (1954) 127 CA2d 311, 317, 273 P2d 835. Notice to the nonassigning party is important, however, in establishing priority of the assignment over other assignees. See *First Nat'l Bank v Pomona Tile Mfg. Co.* (1947) 82 CA2d 592, 605, 186 P2d 693. See Notice to the nonassigning party can also perfect the assignee's rights under the assignment; without such notice, the nonassigning party's performance for the assignor's benefit is a defense to the assignee's action for performance. *Board of Admin. v Glover* (1983) 34 C3d 906, 911, 196 CR 330.

NOTE: Consent of the nondelegating party *is* required if the assignor intends to delegate a duty under the contract. CC §1457.

The nonassigning party may have the right to grant or withhold consent in its sole discretion. This discretionary power must be exercised in good faith and in accordance with fair dealing unless otherwise specified (*e.g.,* unless the contract provides that consent may be withheld in the sole and absolute discretion of the nonassigning party). See Com C §2210. Civil Code §§1995.101-1995.340 provide special rules and presumptions relating to a lessor's consent to assignment by the lessee. See §13.20.

PRACTICE ADVICE: Regardless of whether the assigned contract imposes notice and consent requirements, counsel should consider obtaining the nonassigning party's written consent to the assignment to deter that party's challenging the enforceability of the assignment.

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B. Assignment and Delegation Agreement

§13.28 1. Form: Introduction

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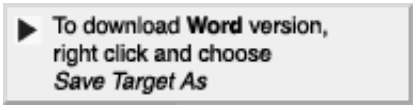
13.28-1 Introduction

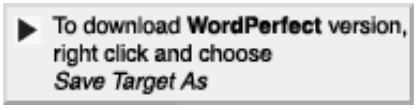
ASSIGNMENT OF _ _[*SPECIFY AGREEMENT BEING ASSIGNED*]_ _

This Assignment of _ _[*specify agreement being assigned*]_ _ **(this "Assignment") is made as of** _ _[*date*]_ _**, by** _ _[*name of assignor*]_ _ **("Assignor") to** _ _[*name of assignee*]_ _ **("Assignee").**

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§13.29 2. Form: Recitals





13.29-1 Recitals

[*Add one of the following alternatives*]

[*Alternative 1: Assignment of single agreement*]

A. On or about _ _[*date*]_ _, Assignor and _ _[*name of other party to agreement being assigned*]_ _ entered into a _ _[*specify agreement being assigned*]_ _ (the "Agreement"), _ _[*a memorandum of which is recorded in the _ _[name of recording office*]_ _ ***at* _ _[*location of recording office*]_ _]_ _.**

B. Assignor desires to sell and Assignee desires to purchase all of Assignor's right, title, and interest in and under the Agreement.

[*Alternative 2: Assignment of group of agreements*]

A. On or about _ _[*date*]_ _, Assignor and _ _[*name of other party to agreement being assigned*]_ _ entered into certain agreements _ _[*relating to _ _[describe agreements*]_ _]_ _.

B. Assignor desires to sell and Assignee desires to purchase all of Assignor's right, title, and interest in and under all contracts of any nature now or later executed by Assignor _ _[*relating to _ _[describe agreements*]_ _]_ _, _ _[*including without limitation the contracts identified on Exhibit _ _ attached to this Assignment*]_ _, together with any and all modifications of those contracts, and any and all deposits or other payments made in connection with those contracts (collectively, "Agreements").

[*Continue*]

C. Assignor desires to assign to Assignee its rights under the Agreement(s) on the following terms and conditions.

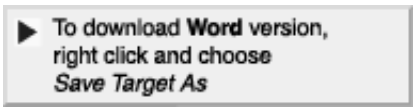
NOW THEREFORE, for valuable consideration, the receipt and sufficiency of which Assignor acknowledges, the parties agree as follows:

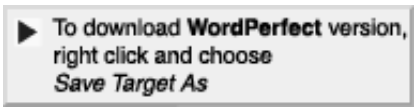
Comment: The assigned item or items should be described with great particularity. If a small number of short agreements are being assigned, copies may be attached as an exhibit to the assignment. If all agreements of a particular nature are assigned, the comprehensive nature of the description of the subject matter is of key importance. Any modifications, substitutions, extensions, and amendments of the assigned agreements, together with any filing information, should be included in the description. For further discussion of introductory information, see chap 5.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/13 Rights of Nonparties: Assignment, Delegation, and Third Party Beneficiaries/§13.30 3. Form: Granting Provision for Assignment

§13.30 3. Form: Granting Provision for Assignment



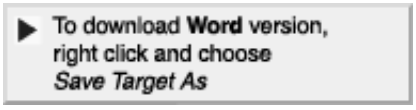


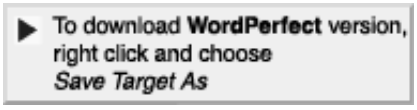
13.30-1 Granting provision for assignment

1. *Assignment.* Assignor assigns, transfers, and conveys to Assignee all of Assignor's right, title, and interest in and to _ _[*and delegates to Assignee all its duties and obligations under/but none of its duties or obligations under*]**_ _ the Agreement(s).**

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§13.31 4. Form: Obligations of Assignee





13.31-1 Obligations of assignee

___. Obligations of Assignee.

[*Add one of the following alternatives*]

[*Alternative 1: Assignee assumes obligations of assignor*]

Assignee accepts the assignment to it by Assignor of all of Assignor's right, title, and interest in and to, and the delegation to it by Assignor of all of Assignor's duties and obligations under, the Agreement(s). Assignee covenants that it (a) approves, ratifies, and confirms all terms, covenants, conditions, and provisions of the Agreement(s), (b) will perform at its own expense all duties and obligations imposed on Assignor by the Agreement(s), and (c) will be bound by all the terms, covenants, conditions, provisions, and obligations of Assignor under the Agreement(s) after the effective date of this Assignment.

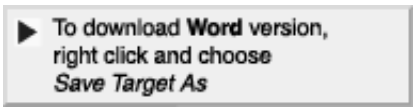
[*Alternative 2: Assignee does not assume obligations of assignor*]

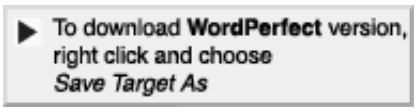
This Assignment does not create any liability or responsibility on the part of Assignee to any party under _ _[*the/any of the*]_ _ Agreement(s), unless and until Assignee expressly assumes such liability or responsibility by written notice to that party, and then only to the extent expressly stated in that notice. Assignor will continue to perform its duties at Assignor's expense under the provisions of this Agreement.

Comment: The second alternative prevents the assignment from being treated as a delegation or novation requiring the assignee to perform the assignor's obligations under the assigned agreement.

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§13.32 5. Form: Purpose of Assignment





13.32-1 Purpose of assignment

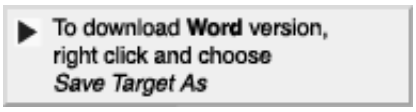
___. *Purpose of Assignment.* This Assignment is made _ _[*state purpose, e.g., to induce Lender to enter into the Loan Agreement dated _ _ _ _, in which Assignor is Borrower and Lender is Lender/in consideration of payment by Assignee to Assignor of the sum of $_ _*[*amount*]*_ _*]*_ _.**

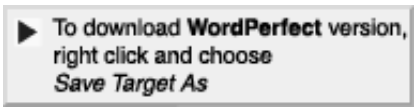
Comment: If an assignment is partial consideration for the performance of contract obligations, as in a loan transaction, the relationship between the assignment and the balance of the transaction should be stated. If the assignment is consideration for the payment of a sum of money, a description of purchase price and terms of payment may be substituted for the statement of purpose.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/13 Rights of Nonparties: Assignment, Delegation, and Third Party Beneficiaries/§13.33 6. Form: Further Assurances

§13.33 6. Form: Further Assurances



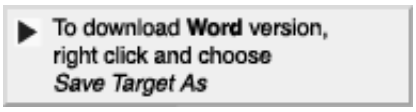


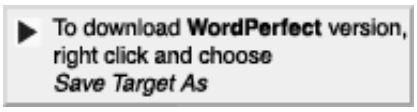
13.33-1 Further assurances

___*. Assignee to Deliver Further Assurances.* Assignor covenants that at any time and from time to time, on written request, Assignor will execute and deliver to Assignee any new or confirmatory instruments or documents that Assignee may reasonably request in order to fully give effect to this Assignment; and to protect Assignee's right, title, and interest in and to the Agreement(s) or to otherwise realize or enjoy such rights in and to the Agreement(s).

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§13.34 7. Form: Representations and Warranties





13.34-1 Representations and warranties

___. *Representations and Warranties of Assignor.* Assignor represents and warrants to Assignee that:

(a) Assignor has the power and authority to enter into and carry out this Assignment;

(b) Assignor has not previously assigned any of its rights under the Agreement(s);

(c) All covenants, agreements, and conditions required to be performed or to occur on Assignor's part as of the date of this Assignment have been performed or have occurred as required by the Agreement(s);

(d) There is no default (or event that, with the passage of time, giving of notice, or both, would constitute a default) under the Agreement(s) on the part of any party to the Agreement(s);

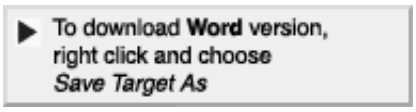
(e) Neither the execution nor the performance of this Assignment or any of the documents that may be executed under it violates _ _[*e.g., the partnership agreement of Assignor/the organizational documents of its partner, or*]**_ _ any agreement, instrument, indenture, judgment, or other legal obligation by which Assignor may be bound;**

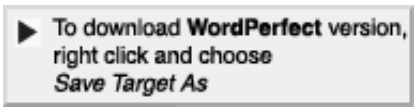
(f) Assignor has neither failed to comply with nor violated any laws relating to the Agreement(s); and

(g) The documents _ _[*delivered to Assignee/identified in Exhibit _ _*]**_ _ as constituting the Agreement(s) are the true and complete agreements of Assignor with respect to the Agreement(s).**

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§13.35 8. Form: Assignor's Covenants





13.35-1 Assignor's covenants

___. *Covenants by Assignee.* Assignor covenants that for as long as this Assignment is in effect:

(a) Assignor will not make or execute any other assignment of all or any part of the Agreement(s) without Assignee's prior written consent;

(b) Assignor will not amend, terminate, assign, sell, pledge, transfer, or otherwise encumber in any way any of Assignor's right, title, or interest in or under the Agreement(s), including without limitation Assignor's right to receive proceeds;

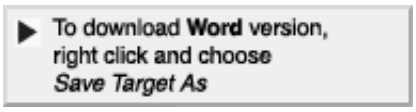
[*If applicable, add the following option*]

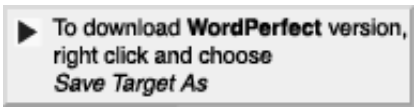
[*Option: Assignment made without delegation*]

(c) Assignor will _ _[*use its best efforts to*]_ _ perform and discharge all of Assignor's obligations, covenants, and agreements under the Agreement(s), at Assignor's sole cost and expense.

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§13.36 9. Form: Appointment of Attorney-in-Fact





13.36-1 Appointment of attorney-in-fact

___. *Attorney in Fact.* Assignor irrevocably appoints Assignee as Assignor's agent (attorney-in-fact), which appointment is coupled with an interest, to make, demand, exercise, enforce, and in all other ways take any action or make any decision that Assignor may or can make or take regarding Assignor's rights under the Agreement(s).

Comment: The assignment must state that the appointment is coupled with an interest if it is to be irrevocable. *Lombardo v Santa Monica Y.M.C.A.* (1985) 169 CA3d 529, 541, 215 CR 224.

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§13.37 10. Form: Indemnification

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

13.37-1 Indemnification

___. *Indemnification.* Assignor shall indemnify, defend, and hold Assignee harmless from and against any and all liability, demands, claims, losses, damages, recoveries, settlements, and expenses (including without limitation reasonable attorney fees) arising from or in connection with the Agreement(s) before the effective date of this Assignment. Assignee agrees to indemnify and hold Assignor harmless from and against any and all costs, liabilities, damages, expenses, or claims, including without limitation reasonable attorney fees, arising from or in connection with the Agreement(s) after the effective date of this Assignment.

Comment: For additional forms of indemnification provisions, see chap 11.

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§13.38 11. General Provisions

Additional miscellaneous provisions that may be appropriate should be included here, *e.g.,* provisions relating to successors and assigns, third party beneficiaries (see §§13.42-13.44), and notices (see §§17.3-17.4). Counsel should review chap 17 to identify any other necessary provisions.

For form of signature blocks, see chap 18.

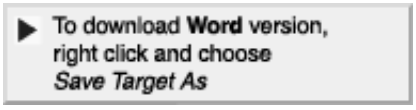
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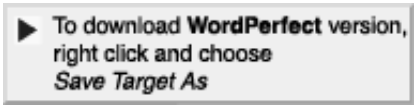
§13.39 12. Ancillary Matters

Ancillary rights and obligations that are overlooked can result in later disputes over whether they were intended to be transferred. Examples include whether the seller of real property transfers to the buyer claims against tenants in arrears for real property tax refunds or for injury to the property; whether the seller of corporate stock transfers to the buyer securities law claims against a prior seller; whether security deposits and prepaid rents are transferred as part of a leasehold assignment; or whether a partner intends to transfer all or some of his or her rights and obligations or to have the assignee become a substituted partner. All such matters should be explicitly addressed in the assignment documents.

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§13.40 C. Form: Consent to Assignment





13.40-1 Consent to assignment

___. *Consent to Assignment.* The undersigned consents to the assignment by _ _[*name of assignor*]_ _ **("Assignor") to** _ _[*name of assignee*]_ _ **("Assignee") of all of Assignor's right, title, and interest in and to the** _ _[*specify agreement being assigned*]_ _ **(the "Agreement"),** _ _[*a memorandum of which is recorded in the* _ _[*name of recording office*]_ _ *at* _ _[*location of recording office*]_ _]_ _**,** _ _[*as described in the Assignment to which this consent is attached*]_ _**. This consent is effective** _ _[*as of* _ _[*date*]_ _*/immediately/on Assignee's written assumption of all of Assignor's duties and obligations under the Agreement* _ _[*and the recording of such assumption in the Recorder's Office of* _ _ _ _ _ _ *County*]_ _]_ _**.**

[*If applicable, add the following option*]

[*Option: Assignee assumed duties and obligations*]

The undersigned agrees to and acknowledges the assumption and agreement by Assignee to perform and be bound by all terms, conditions, covenants, and provisions of the Agreement, and all duties and obligations of Assignor under the Agreement.

[*Continue*]

This consent relates to the assignment described above only. Assignee may not assign any interest in the Agreement without the undersigned's prior written consent, which consent _ _[*shall not be unreasonably withheld or delayed/may be withheld in the sole and absolute discretion of the undersigned*]_ _**.**

[*If applicable, add the following option*]

[*Option: Consenting party's representations and warranties*]

The undersigned acknowledges that:

(a) All of Assignor's obligations under the Agreement are current as of _ _[*date*]_ _**;**

(b) As of the date of this consent, the Agreement is in full force and effect unmodified _ _[*except* _ _[*specify modifications*]_ _]_ _**;**

(c) There are no present defaults (or events that, with the passage of time, giving of notice, or both, would constitute such a default) by either party under the Agreement.

[*If applicable, add the following option*]

[*Option: Release of guarantor*]

The undersigned releases _ _[*names of guarantors*]_ _ **from their joint and several obligations to guarantee the full performance by Assignor of all provisions, covenants, and conditions of the Agreement, under the** _ _[*name of guaranty agreement*]_ _ **of** _ _[*date*]_ _**.**

Comment: By attaching the consent to the assignment, the parties specifically identify the assignment for which the consent is given. If the assignee and assignor do not want the consenting party to see the details of the assignment and if the consenting party does not require their disclosure, the assignment transaction can be summarized in the consent.

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§13.41 D. Form: Notice of Assignment

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13.41-1 Notice of assignment

_ _[*Name of person receiving notice*]_ _

_ _[*Address of person receiving notice*]_ _

Dear _ _[*name of person receiving notices*]_ _

This notice is to inform you that on _ _[*date of assignment*]_ _**,** _ _[*name of assignor*]_ _ **assigned to** _ _[*name of assignee*]_ _ **all of its right, title, and interest in and to** _ _[*, and delegated to* _ _[*name of assignee*]_ _ *all its duties and obligations under*]_ _ **the** _ _[*specify agreement assigned*]_ _ **between** _ _[*name of parties to agreement assigned*]_ _ **dated** _ _[*date*]_ _ **(the "Agreement"). Please tender all future performance under the Agreement** _ _[*, including payment of all amounts due*]_ _ **directly to** _ _[*name of assignee*]_ _**, and send communications relating to or arising from the Agreement to** _ _[*specify where communications should be sent*]_ _**.**

Signed,

__[*Signature of assignor or assignee*]__

Dated: _ _ _ _ _ _ _ _[*Typed name*]_ _

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V. THIRD PARTY BENEFICIARIES

§13.42 A. Rights of Third Party Beneficiary

A third party may enforce in its own name a contract expressly made for its benefit, as if the agreement was made for the beneficiary, unless before enforcing it the parties to the agreement rescind it. CC §1559. See *Eastern Aviation Group, Inc. v Airborne Express, Inc.* (1992) 6 CA4th 1448, 8 CR2d 355; Restatement (Second) of Contracts §302 (1981). See also *Bass v John Hancock Mut. Life Ins. Co.* (1974) 10 C3d 792, 796, 112 CR 195 (union member is third party beneficiary of union collective bargaining agreement). The parties to the agreement retain the right to modify or rescind it, and each party retains the right to unilaterally rescind it on statutory grounds, unless, before the beneficiary receives notice of the modification or rescission, the beneficiary materially changes its position in justifiable reliance on the agreement. *Karo v San Diego Symphony Orchestra Ass'n* (9th Cir 1985) 762 F2d 819, 822; *R.J. Cardinal Co. v Ritchie* (1963) 218 CA2d 124, 135, 32 CR 545.

The third party beneficiary may sue the promisor, the promisee, or both, for failure to perform under the agreement. Satisfaction by either the promisee or the promisor satisfies the obligations of both. *Kraus v Willow Park Pub. Golf Course* (1977) 73 CA3d 354, 371, 140 CR 744.

The third party's rights against the promisor are no greater than the promisee's rights against the promisor. *Marina Tenants Ass'n v Deauville Marina Dev. Co.* (1986) 181 CA3d 122, 132, 226 CR 321; *Levy v Bellmar Enters.* (1966) 241 CA2d 686, 689, 50 CR 842. Any of the promisor's defenses effective against the promisee are also effective against the beneficiary; *e.g.,* unenforceability of the contract, impossibility or failure of performance, breach by promisee, and the statute of limitations. Restatement §304. See *Votaw Precision Tool Co. v Air Canada* (1976) 60 CA3d 52, 131 CR 335.

WARNING: Civil Code §1559 does not apply to a trust created for the benefit of a third party; the trust is governed by the Probate Code. Thus, a trust beneficiary cannot claim third party beneficiary status under an agreement between the trustee and its agents or employees. *Saks v Damon Raike & Co.* (1992) 7 CA4th 419, 430, 8 CR2d 869.

The third party beneficiary may voluntarily waive its rights under the agreement after learning of the contract. The burden is on the party asserting the waiver to prove that the waiving party knew of the contract. *Bass v John Hancock Mut. Life Ins. Co.* (1974) 10 C3d 792, 112 CR 195.

See generally California Law of Contracts §§7.61-7.68 (Cal CEB 2007.

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§13.43 B. Requirements for Third Party Beneficiary Status

For a party to be a third party beneficiary, the agreement must be made *expressly* for its benefit, and that intent must appear from the contract and the circumstances surrounding its formation. *Dateline Builders, Inc. v City of Santa Rosa* (1983) 146 CA3d 520, 527, 194 CR 258. It is not sufficient that the third party merely benefit by the contract. *Eastern Aviation Group, Inc. v Airborne Express, Inc.* (1992) 6 CA4th 1448, 8 CR2d 355; *Kirst v Silna* (1980) 103 CA3d 759, 163 CR 230. The promisor's knowledge of a benefit to a third party is not sufficient to establish third party beneficiary status; the benefit to the third party must be a motivating factor (though not necessarily the sole factor) for the parties to have entered into the contract. See *Corrugated Paper Prods. v Longview Fibre Co.* (7th Cir 1989) 868 F2d 908, 912 (buyer assured seller that its purchase of product was not contingent on buyer's resale of product to identified subsequent purchaser).

EXAMPLE 1: If a buyer of a business assumes the business's liabilities, the original business's creditors are third party beneficiaries of the contract between the buyer and the seller. *R.J. Cardinal Co. v Ritchie* (1963) 218 CA2d 124, 135, 32 CR 545. See Restatement (Second) of Contracts §302, comment d (1981).

EXAMPLE 2: If one party agrees to indemnify another party and its agents, the agents are third party beneficiaries of the indemnification. See *Kaiser Eng'rs v Grinnell Fire Protection Sys.* (1985) 173 CA3d 1050, 219 CR 626.

EXAMPLE 3: An insured is not a third party beneficiary to the contract between the insurer and an independent claim adjuster hired by the insurer. *Thompson v Cannon* (1990) 224 CA3d 1413, 274 CR 608.

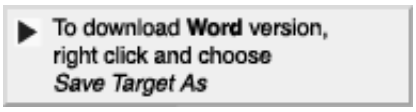
EXAMPLE 4: A subcontractor is not a third party beneficiary of a prime contract awarded by a public authority even when the subcontractor's bid is included in the prime contractor's successful bid. *Southern Cal. Acoustics Co. v C. V. Holder, Inc.* (1969) 71 C2d 719, 79 CR 319.

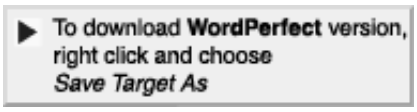
The promisor need not directly perform its obligations to the third party beneficiary for the contract to be made expressly for its benefit; the promisor need only understand that the promisee intends to benefit the third party beneficiary. *Marina Tenants Ass'n v Deauville Marina Dev. Co.* (1986) 181 CA3d 122, 128, 226 CR 321. The burden of proof is on the third party beneficiary to establish that it was an intended beneficiary. *Schonfeld v City of Vallejo* (1975) 50 CA3d 401, 123 CR 669, disapproved on other grounds in *Morehart v County of Santa Barbara* (1994) 7 C4th 725, 743, 29 CR2d 804. If the agreement expressly provides for payment to one who is not a party to the agreement, however, that party or entity is a third party beneficiary.

The third party beneficiary need not be the exclusive, or even the primary, beneficiary of the agreement. Although the beneficiary need not be named in the contract, he or she must be a member of a class referred to and identifiable in the contract. See *Karo v San Diego Symphony Orchestra Ass'n* (9th Cir 1985) 762 F2d 819, 822; *Outdoor Servs. v Pabagold, Inc.* (1986) 185 CA3d 676, 681, 230 CR 73; *Johnson v Holmes Tuttle Lincoln-Mercury, Inc.* (1958) 160 CA2d 290, 297, 325 P2d 193 (plaintiff was third party beneficiary).

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§13.44 C. Form: No Third Party Beneficiary Intended





13.44-1 No third party beneficiary intended

___*. No Third Party Beneficiary.* This Agreement is made solely for the benefit of the parties to this Agreement and their respective successors and assigns, and _ _[*except as provided in Section _ _*]_ _ no other person or entity may have or acquire any right by virtue of this Agreement.

Comment: The exception language, if used, can refer to the section on assignment or to any other provision that is intended to benefit a third party.

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14

Defining Events of Default

Michael A. Grayson
Alexander Fried
Jonathan Golden
Victor Hsu

I. CHECKLIST: EVENTS OF DEFAULT §14.1

II. USE OF EVENTS OF DEFAULT PROVISION
- A. Events Triggering Default Provision §14.2
- B. Form: Definitions of Event of Default and Default §14.2A
- C. Notice and Grace Periods §14.3
- D. Form: Notice of Defaults §14.3A
- E. Form: Nondefaulting Party's Right to Cure and Be Reimbursed §14.4
- F. Form: Introduction to Events of Default Provision §14.5

III. FAILURE TO PERFORM COVENANTS
- A. General Principles §14.6
- B. Excuse of Performance §14.7
- C. Form Default Provisions for Failure to Perform
  - 1. Form: Failure to Pay Amount Due §14.8
  - 2. Form: Failure to Perform Other Covenants §14.9
  - 3. Form: Anticipatory Breach §14.10
- D. Impossibility, Impracticability, and Force Majeure §14.11
  - 1. Form: Force Majeure Events Resulting in Excuse or Suspension of Performance §14.12
  - 2. Form: Force Majeure Events Resulting in Apportionment Costs §14.13

IV. BREACH OF REPRESENTATION OR WARRANTY, OR OTHER FACTUAL INFORMATION FOUND UNTRUE
- A. General Principles §14.14
- B. Form: Representation and Warranty Bringdown Certificate §14.14A
- C. Form: Breach of Representation or Warranty or of Other "Factual" Information Found Untrue §14.15

V. INSOLVENCY
- A. Function of Insolvency Clauses §14.16
- B. Effect of Federal Bankruptcy Code
  - 1. Insolvency Clauses in Executory Contracts Generally Invalid §14.17
  - 2. Insolvency Provision Not Invalidated §14.18
- C. Effect of California Fraudulent Transfer Law §14.19
- D. Form: Insolvency Provisions §14.20

VI. CROSS-DEFAULT
- A. General Principles §14.21
- B. Form: Cross-Default Clause §14.22
- C. Form: Cross-Default and Cross-Acceleration Clauses §14.23
- D. Guaranty and Letters of Credit §14.23A
  - 1. Form: Revocation of Guaranty §14.23B
  - 2. Form: Replacement Letter of Credit §14.23C

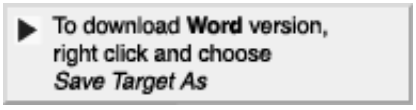
VII. PARTY DEEMS ITSELF INSECURE
- A. General Principles §14.24
- B. Form: Party Deems Itself Insecure §14.25

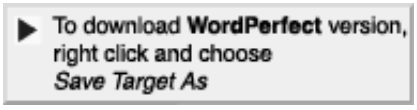
VIII. MISCELLANEOUS DEFAULT PROVISIONS §14.26

A. Form: Judgments Rendered Against Party §14.27
B. Form: Validity of Agreement Challenged §14.28
C. Form: Lien Not Perfected §14.29

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§14.1 I. CHECKLIST: EVENTS OF DEFAULT





- Failure to perform (see §§14.6-14.13)
- Excuses for nonperformance (see §14.7)
- Frustration of purpose
- Contract repudiation and anticipatory breach
- Failure of consideration
- Prevention of performance
- Judicial construction
- Statutory construction
- Waiver
- Impossibility; impracticability; force majeure (see §§14.11-14.13)
- Factual information untrue (see §§14.14-14.15)
- Bankruptcy and insolvency (see §§14.16-14.20)
- Cross-default (see §§14.21-14.23)
- Party deems itself insecure (see §§14.24-14.25)

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II. USE OF EVENTS OF DEFAULT PROVISION

§14.2 A. Events Triggering Default Provision

An "event of default" is an occurrence specified in the agreement that permits the nondefaulting party to exercise certain specified remedies. An "event of default" is generally different from a "default." For example, a lender may be entitled to accelerate the loan or exercise other remedies on an event of default but not on a default. An event of default (but not a default) may also trigger a penalty interest rate or give rise to other rights (*e.g.,* inspection rights). Also, an event of default may trigger a cross-default under another agreement, but a default does not necessarily do so. See §§14.21-14.22. For typical definitions of event of default and default, see §14.2A. For discussion of the available remedies if an event of default occurs, see chap 15.

Events of default must be tailored for individual transactions, but occurrences constituting events of default typically include the following:

- Failure to perform, including the failure to pay money when due (*e.g.,* principal, interest, or both) and the failure to perform other covenants (*e.g.,* financial performance standards, compliance with laws, or satisfaction of liens and judgments). See §§14.6-14.13.
- Breach of a representation or a warranty. See §§14.14-14.15.
- Bankruptcy or insolvency. See §§14.16-14.20.
- Default under another agreement (*i.e.,* cross-default). See §§14.21-14.23.
- Secured party deems itself insecure. See §§14.24-14.25.

The "events of default" section in the contract generally begins with an introduction (see §14.5), followed by a listing of the specific events of default.

NOTE: Commercial Code §1201 and §1202 contain general definitions governing transactions covered by the Code that may affect events of default. See, *e.g.,* Com C §§1201(b)(17) and 1202 (defining "fault," "notice," "knowledge," and related terms).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/14 Defining Events of Default/ §14.2A B. Form: Definitions of Event of Default and Default

§14.2A B. Form: Definitions of Event of Default and Default

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14.2A-1 Definitions of event of default and default

___. *Event of Default Defined.* "Event of Default" means any of the events specified in paragraph _ _[*number*]_ _. "Default" means occurrence, circumstance, or event, or any combination of the two, that, with the lapse of time and/or giving of notice, would constitute an Event of Default.

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§14.3 C. Notice and Grace Periods

Counsel representing the obligor ordinarily wants to include a grace period within which the defaulting obligor would have an opportunity to correct a situation, or a default, before it becomes an "event of default." The length of time for a grace period depends on the particular default. For example, the grace period for the payment of principal of, and interest on, a promissory note (if granted at all) is usually quite short, *e.g.,* 3 days. For noncompliance with other types of covenants, the parties typically agree to a longer grace period; 30 to 60 days is common. The defaulting party may also be granted additional time to cure a default incapable of being remedied within the time allowed if the cure is promptly commenced and diligently pursued. Certain breaches are noncurable by their terms, *e.g.*, breach of a financial covenant. Often, a distinction is made between a default occurring before expiration of the grace period (a "default") and a default that continues beyond expiration of the grace period (an "event of default").

Counsel for the obligor may also want to provide a notice requirement, so that the grace period starts only after the defaulting party receives notice (or the nondefaulting party sends notice) that a default has occurred. The decision should be made with the client for each default to ascertain the feasibility of cure and the likelihood of default. The parties may want to provide different notice and grace periods for different types of defaults because:

- Some defaults may be more material than others;
- Some defaults may be more within the control of the defaulting party than others (*e.g.,* the party's filing a voluntary petition in bankruptcy is within the party's control and may not warrant a grace period, but an involuntary filing is not within the party's control and may be tied to a grace period); and
- The defaulting party may, or should, have knowledge of some types of default at the same time or before the nondefaulting party has knowledge.

In many transactions, the agreement will contain a covenant requiring the obligor to give notice to the other party of any events of default or defaults that arise during the term of the agreement. Failure to give this notice ordinarily constitutes an immediate event of default. See form of notice in §14.3A.

WARNING: The actual form of the notice of default is crucial in the residential landlord-tenant relationship. CC §1946. See California Landlord-Tenant Practice §§8.41, 8.53-8.54, 8.80 (2d ed Cal CEB 1997).

In some transactions, one party may want the right to perform when the other party breaches an obligation (*e.g.,* a party's failure to insure collateral could be remedied by the nondefaulting party purchasing the insurance). A provision may be inserted to allow the nondefaulting party to perform the obligation if the defaulting party fails to do so within any grace period provided. The agreement should then also provide for the defaulting party to reimburse the nondefaulting party for expenses, indicating when the reimbursement must be paid and the interest, if any, to be charged. Performance by the nondefaulting party does not waive the default, however.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/14 Defining Events of Default/ §14.3A D. Form: Notice of Defaults

§14.3A D. Form: Notice of Defaults

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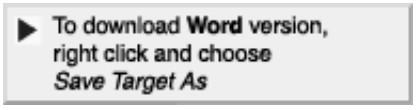
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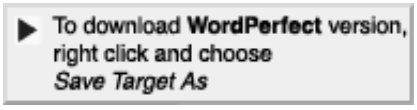
14.3A-1 Notice of defaults

___. *Notice of Default.* Promptly on discovery of an Event of Default or a Default under this Agreement or any other document executed in connection with this Agreement, Borrower shall deliver telephone notice to Lender (confirmed within 3 calendar days by written notice from Borrower), describing the event and all action Borrower proposes to take with respect to that event.

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§14.4 E. Form: Nondefaulting Party's Right to Cure and Be Reimbursed





14.4-1 Nondefaulting party's right to cure and be reimbursed

___. *Nondefaulting Party's Right to Cure and Be Reimbursed..* If _ _[*e.g., Borrower*]_ _ fails to perform any agreement or obligation contained in this Agreement, _ _[*e.g., Lender*]_ _ may itself perform, or cause the performance of, that agreement or obligation. In that event, _ _[*e.g., Borrower*]_ _ will, on demand, reimburse _ _[*e.g., Lender*]_ _ for all performance expenditures, and pay _ _[*e.g., Lender*]_ _ interest on the amount of those expenditures from the date of the expenditure until full reimbursement at the Default Rate. The performance of any act or payment by _ _[*e.g., Lender*]_ _ as provided in this Agreement does not waive or release any obligation or default or the part of _ _[*e.g., Borrower*]_ _.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/14 Defining Events of Default/ §14.5 F. Form: Introduction to Events of Default Provision

§14.5 F. Form: Introduction to Events of Default Provision

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14.5-1 Introduction to events of default

___. *List of Events of Default.* Each of the following constitutes an "Event of Default" under this Agreement:

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III. FAILURE TO PERFORM COVENANTS

§14.6 A. General Principles

Failure to perform a contract covenant without a legally accepted excuse for nonperformance constitutes a breach of that contract. *Erich v Granoff* (1980) 109 CA3d 920, 167 CR 538; Restatement (Second) of Contracts §235(2) (1981). The breach may result from failure to make payments or failure to perform other covenants required by the agreement (*e.g.,* insuring property, meeting financial performance standards, maintaining confidentiality). See forms in §§14.8-14.10 for "failure to perform" provisions.

A contract may attempt to distinguish between "monetary defaults" and "nonmonetary defaults." Because of the imprecise nature of these terms, however, they should not be used unless they are specifically defined. For example, is a monetary default only the failure to make a payment of principal or interest on a promissory note, or does it include failure to pay insurance premiums on property securing the note?

NOTE: Covenants are ongoing agreements to perform and are thus distinguishable from representations and warranties that are effective only for a specified date or dates. For discussion of defaults caused by breach of representations or warranties, see §§14.14-14.15. For further discussion of representations and warranties, see chap 7; for further discussion of covenants, see chap 9.

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§14.7 B. Excuse of Performance

The parties may agree to allow an excuse of performance so that, if a breach occurs, it does not necessarily constitute a default. A party's nonperformance of covenants under a contract may be excused by various occurrences. Impossibility and force majeure ("act of God") are generally excuses of performance specifically addressed in the agreement. See §§14.11-14.13.

The statutory and common law excuses of performance are:

- **Frustration of purpose.** Covenants and conditions may be excused if both parties recognize that the *value* of one party's performance is substantially destroyed by an unforeseeable and uncontrollable event, even if *performance* is still possible. *Dorn v Goetz* (1948) 85 CA2d 407, 410, 193 P2d 121.
- **Repudiation or anticipatory breach.** If one party repudiates its obligations under the contract before the condition or performance is due, the other party is then excused from performing its obligations. CC §1440; *Daum v Superior Court* (1964) 228 CA2d 283, 287, 39 CR 443. Anticipatory breach occurs when one party, without justification and before committing a breach, makes a clear, positive statement (or an act amounting to a clear, positive statement) to the other party, indicating that that party will not or cannot substantially perform its contractual duties. *Taylor v Johnston* (1975) 15 C3d 130, 137, 123 CR 641; *Gold Mining & Water Co. v Swinerton* (1943) 23 C2d 19, 29, 142 P2d 22. If anticipatory breach is probable, the parties should (a) state the conditions that would allow the party to declare that event, and (b) clearly provide the mechanics to resolve it. See form in §14.10 for an anticipatory breach provision.

WARNING: Inclusion of an anticipatory breach provision may create ambiguities about whether the parties intended to be able to terminate the contract at will.

- **Material failure of the consideration for the contract**. A party may be excused from performance if the other party materially fails to perform its obligations. The nondefaulting party may also have a right to rescind the contract if the contract has not been fully or partially performed by any party. See CC §1689(b)(2); *Wyler v Feuer* (1978) 85 CA3d 392, 403, 149 CR 626.
- **Nondefaulting party's actions.** One party's performance is excused if performance is prevented by the other party.
- **Judicial and statutory construction.** Judicial and statutory construction may limit or eliminate the operation of a covenant or a condition or otherwise limit relief in order to avoid forfeiture. CC §§1442, 3275, 3369. See *O'Morrow v Borad* (1946) 27 C2d 794, 800, 167 P2d 483; *Root v American Equity Specialty Ins. Co.* (2005) 130 CA4th 926, 30 CR3d 631. For example:
- If a covenant or a condition involves forfeiture, the party affected can avoid forfeiture by making full compensation to the other party, unless there is gross negligence or willful or fraudulent breach of duty.
- A covenant or a condition involving forfeiture or a penalty will not be specifically enforced unless it is based on nuisance or otherwise provided by law.
- If a covenant or a condition involves forfeiture, it is strictly interpreted against the party for whose benefit it is created.
- **Waiver.** A party may expressly or impliedly waive covenants and conditions included in a contract solely for that party's benefit. *Doryon v Salant* (1977) 75 CA3d 706, 712, 142 CR 378. Acceptance of defective performance, partial performance, or no performance may be construed as a waiver implied from conduct. A *material* part of the agreed exchange may not be expressly or impliedly waived, however; a more formal discharge, such as a release, accord and satisfaction, or novation, is required. Restatement (Second) of Contracts §84(1) (1981). For further discussion of waivers, see §§11.57-11.60.

Any excuse of performance that the parties agree to which is not based on statutory or common law should be expressly stated. The effect of certain excuses of performance, *e.g.,* frustration of purpose and insufficient consideration,

need not be stated if these excuses are based on common law.

PRACTICE TIP: The parties should also specify what remedies will be available in the event of an excused breach. For example, if one party terminates the contract because an "act of God" prevents that party from procuring supplies, the nonbreaching party may be prohibited from rescinding the contract, but it may be entitled to its out-of-pocket costs (including reasonable attorney fees) from the date of the execution of the controlling document, if any, to the date of the breach.

Division 2 of the California Commercial Code applies to transactions in goods. On repudiation or anticipatory breach in transactions in goods, see Com C §2610; see also §§2609 and 2611. On modification, rescission, and waiver, see Com C §2209.

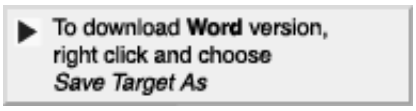
For further discussion, see California Law of Contracts §8.28 (Cal CEB 2007).

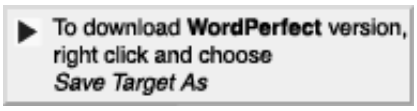
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C. Form Default Provisions for Failure to Perform

§14.8 1. Form: Failure to Pay Amount Due





14.8-1 Failure to pay amount due

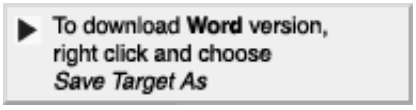
_ _[*E.g., Borrower*]_ _ **fails to pay any amount due under this Agreement**

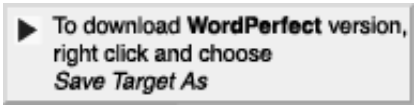
[*Optional: Grace period provided*]

and that default continues for _ _[*e.g., 5 calendar days*]_ _ **after** _ _[*e.g., that payment is due/Lender gives Borrower notice that the amount was not paid*]_ _**.**

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§14.9 2. Form: Failure to Perform Other Covenants





14.9-1 Failure to perform other covenants

[*Alternative 1: Basic provision*]

_ _[*E.g., Either party/Borrower*]_ _ **fails to perform or observe any term, covenant, or undertaking in this Agreement to be performed or observed by it**

[*If applicable, add one or more of the following options*]

[*Option 1: Grace period provided*]

and that default continues for _ _[*e.g., 30 calendar days*]_ _ **after** _ _[*e.g., that performance is due/the nondefaulting party gives the defaulting party notice of the failure to perform*]_ _

[*Option 2: Allowing additional time*]

unless within that time period the _ _[*defaulting party/Borrower*]_ _ **has promptly commenced and continues diligent efforts to remedy the default, in which event** _ _[*the defaulting party/Borrower*]_ _ **may have additional time as is necessary, but not more than** _ _[*e.g., 60 calendar days*]_ _ **after** _ _[*that performance is due/the nondefaulting party gives the defaulting party notice of the default*]_ _**, to remedy the default before an Event of Default occurs.**

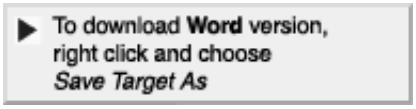
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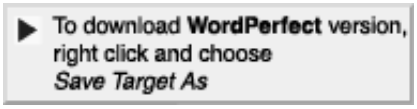
[*Alternative 2: Grace period based on defaulting party's knowledge*]

_ _[*E.g., Either party/Borrower*]_ _ **fails to perform or observe any term, covenant, or undertaking in this agreement to be performed or observed by it and that default continues for** _ _[*e.g., 30 calendar days*]_ _ **after (i)** _ _[*the nondefaulting party/Lender*]_ _ **gives** _ _[*the defaulting party/Borrower*]_ _ **written notice of that default or (ii) the President or Chief Financial Officer of** _ _[*the defaulting party/Borrower*]_ _ **has actual knowledge that the default exists or has occurred, whichever occurs first.**

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§14.10 3. Form: Anticipatory Breach





14.10-1 Anticipatory breach

_ _[*E.g., Either party/Borrower*]_ _ **informs the other party of its intention not to perform or observe a term or provision of this Agreement.**

Comment: Because anticipatory breach is a matter of law, this provision may be unnecessary. Counsel should consider whether its inclusion would create any ambiguity as to whether the parties intended the contract to be terminable at will.

For further discussion, see California Law of Contracts §8.71 (Cal CEB 2007).

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§14.11 D. Impossibility, Impracticability, and Force Majeure

Counsel and client should try to evaluate the likelihood of events that might render the contract impossible or impracticable to perform. The parties should then agree, based on the contractual effects, whether impossibility and impracticability should excuse performance, and therefore not constitute an event of default, if:

- It is objectively impossible to comply with the contract (*e.g.,* destruction of the contract's subject matter or death of the employee in a personal services contract); or
- It is impracticable to comply with the contract because of extreme and unreasonable difficulty, expense, injury, or loss that was not reasonably foreseeable when the parties entered into the contract.

CC §§1441, 1511(2), 1596. See *Mineral Park Land Co. v Howard* (1916) 172 C 289, 293, 156 P 458 (cost increase of 10 to 12 times original cost constituted impracticability); *Kennedy v Reece* (1964) 225 CA2d 717, 724, 37 CR 708 (cost increase of less than twice original cost did not constitute impracticability); Restatement (Second) of Contracts, chap 11 (1981).

If the impossibility or impracticability is temporary, the duty to perform may be suspended for the duration of the impossibility or impracticability rather than excused, unless delayed performance imposes a substantially greater burden on the performing party. *Oosten v Hay Haulers Dairy Employees & Helpers Union* (1955) 45 C2d 784, 291 P2d 17. The parties should ascertain at what point the event is no longer temporary (*e.g.,* if it continues for 6 months) and what types of remedies will be available in the event of suspension or excuse of performance.

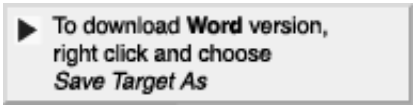
Parties can avoid the risks and transaction costs inherent in relying on statutory and common law rules governing impossibility and impracticability by drafting express clauses to excuse performance prevented by unforeseeable events outside the parties' control. These "force majeure" clauses may take a variety of forms:

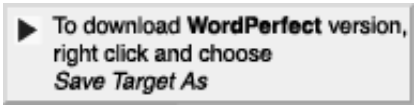
- Performance may be either permanently excused on the occurrence of a force majeure event or merely suspended until the event ceases (*e.g.,* destruction of the subject matter versus a labor strike).
- Losses and risks of the event may be apportioned.
- Notice of the event's occurrence and intent to invoke the clause may be required.
- Force majeure events may be tailored to the foreseeable risks of the transaction.

See forms in §§14.12-14.13 for force majeure provisions. For further discussion, see California Law of Contracts §8.32 (Cal CEB 2007).

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§14.12 1. Form: Force Majeure Events Resulting in Excuse or Suspension of Performance





14.12-1 Force majeure events resulting in excuse or suspension of performance

If any party fails to perform its obligations because of strikes, lockouts, labor disputes, embargoes, acts of God, inability to obtain labor or materials or reasonable substitutes for labor or materials, governmental restrictions, governmental regulations, governmental controls, judicial orders, enemy or hostile governmental action, civil commotion, fire or other casualty, or other causes _ _[*, except financial,*]**_ _ beyond the reasonable control of the party obligated to perform, then that party's performance will be excused**

[*If applicable, add one or more of the following options*]

[*Option 1: Certain terms excepted from force majeure provision*]

except for _ _[*specify obligations not excused, e.g., payment of minimum rental due from Lessee, payment of all earned royalties due*]**_ _.**

[*Option 2: Suspending rather than permanently excusing performance*]

for a period equal to the period of the cause for failure to perform

[*Option 3: Notice of event required*]

as long as the party who fails to perform gives the other party notice within _ _[*e.g., 30 calendar days*]**_ _ after the event causing the failure.**

[*Option 4: Events caused by defaulting party not reason for suspension or excuse of performance*]

Despite anything to the contrary in this paragraph, if the cause of a party's failure to perform results from any act by that party, then that cause will not excuse the performance of the provisions of this Agreement by that party.

Comment: For an example of a force majeure clause in an oil and gas lease, see California Law of Contracts §8.32 (Cal CEB 2007).

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§14.13 2. Form: Force Majeure Events Resulting in Apportionment Costs

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14.13-1 Force majeure events resulting in apportionment costs

If any party fails to perform its obligations because of strikes, lockouts, labor disputes, embargoes, acts of God, inability to obtain labor or materials or reasonable substitutes for labor or materials, governmental restrictions, governmental regulations, governmental controls, judicial orders, enemy or hostile governmental action, civil commotion, fire or other casualty, or other causes _ _[*, except financial,*]_ _ beyond the reasonable control of the party obligated to perform, then the resulting loss will be _ _[*specify how loss is to be apportioned*]_ _.

Comment: For an example of a force majeure clause in an oil and gas lease, see California Law of Contracts §8.32 (Cal CEB 2007).

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IV. BREACH OF REPRESENTATION OR WARRANTY, OR OTHER FACTUAL INFORMATION FOUND UNTRUE

§14.14 A. General Principles

A principal requirement to the formation of any contract is each party's consent, which must be free, mutual, and communicated to the other party. CC §§1550, 1565. Apparent consent is not free if it is obtained by duress, menace, fraud, undue influence, or mistake. CC §1567. See chap 3.

When a party consents to a transaction by entering into an agreement, it relies on factual information provided by the other party. Usually, each party represents or warrants that it has stated certain facts that the other party has relied on in making the contract. The contract may state that it is an event of default if a party provided information that was materially false or untrue, even if not necessarily fraudulent.

NOTE: An innocent misrepresentation (*i.e.,* not a willful or a fraudulent misrepresentation) may be of a material nature, and therefore constitute a breach, "if it would be likely to affect the conduct of a reasonable man with reference to the transaction in question." *Wood v Kalbaugh* (1974) 39 CA3d 926, 114 CR 673; *Costello v Roer* (1946) 77 CA2d 174, 178, 175 P2d 65, quoting Restatement of the Law, *Restitution* §8(2) (1937). If the representation or warranty is qualified so that a default is more remote, *i.e.,* the representation or warranty was based on the maker's knowledge and belief, or no independent inquiry was undertaken to verify the information, it is more difficult to establish that an event of default occurred.

EXAMPLE: A corporation represents in the agreement that there are no liens on any of its property. If in fact there are liens and these liens are material, the other party to the agreement could declare an event of default.

Some representations made at the time of the agreement may later prove to be not true. Therefore, counsel should review the wording of representations and warranties at the time of any reaffirmation. If a party cannot reaffirm a representation, that party should so notify the other party so that a written waiver may be obtained.

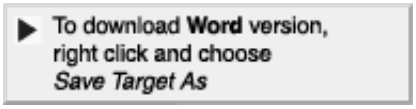
EXAMPLE: A party may represent at a loan closing that there is no litigation pending or threatened against it. The loan is later funded, and the representation "reaffirmed" at the time of funding. If litigation has arisen in the intervening period, the representation will be false at the time of funding. See form in §14.14A.

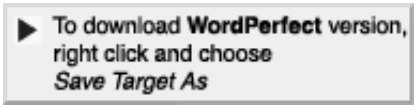
PRACTICE TIP: If a seller of goods discovers that the buyer received the goods on credit while insolvent, the seller may reclaim the goods on demand made within 10 days after receipt. However, if the buyer misrepresented its solvency in writing to the seller within 3 months before delivery, the 10-day limitation does not apply. Com C §2702.

For a form defining untrue factual information as a default, see §14.15. For discussion of representations and warranties generally, see §§7.5-7.15.

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§14.14A B. Form: Representation and Warranty Bringdown Certificate



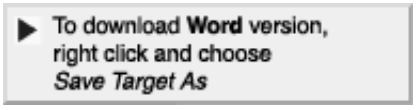


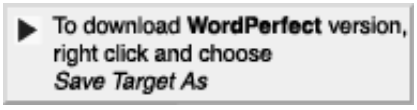
14.14A-1 Representation and warranty bringdown certificate

_ _[*Except as set forth on Schedule* _ _[*number*]_ _ *attached to this Agreement,*]_ _ **Borrower certifies that at the time of and immediately after giving effect to the funding of the Loan, Borrower's representations and warranties set forth in the Loan Documents are true and correct in all respects (or, in the case of any representation or warranty that is not qualified as to materiality, in all material respects) on and as of the date of funding (or, in the case of any representation and warranty that expressly relates to an earlier date, on and as of that earlier date).**

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§14.15 C. Form: Breach of Representation or Warranty or of Other "Factual" Information Found Untrue





14.15-1 Breach of representation or warranty or of other information

Any warranty, representation, certification, or other statement made by or on behalf of _ _[*e.g., Borrower*]_ _ and contained in this Agreement or in any other document furnished in compliance with or in reference to this Agreement is on the date made incorrect, false, misleading, or untrue

[*Add one of the following alternatives*]

[*Alternative 1: Materiality required for default*]

in any material respect.

[*Alternative 2: Previously qualified as to materiality*]

in any respect (or in any material respect if that warranty, representation, certification, or other statement is not by its terms already qualified as to materiality).

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V. INSOLVENCY

§14.16 A. Function of Insolvency Clauses

If insolvency is an event of default, the solvent party can cease its obligations under the contract and avoid dealing with the insolvent party's assignee, who was not a party to the original agreement and whose ability to perform may be questionable. Generally, a bankruptcy or insolvency clause allows a party to terminate a contract, to suspend its performance, or to exercise specific rights if the other party's impaired financial condition could affect that party's ability to perform under the contract. Thus, the solvent party need not choose between taking (1) the legal risk of breaching the contract (by suspending its own performance) and (2) the practical risk of continuing its performance without adequate assurance of the insolvent party's ability to perform.

The following events are generally included in a bankruptcy or insolvency default provision:

- Filing a petition for bankruptcy;
- Applying for or consenting to appointment of a trustee or a receiver;
- Consenting to or admitting jurisdiction of the bankruptcy court;
- Having an involuntary petition for bankruptcy filed against the party (without dismissal of the petition within a specified period of time);
- Making an assignment for the benefit of creditors;
- Having an order for relief entered against the party under bankruptcy laws; or
- Levying a writ of execution, writ of attachment, writ of possession, or, in the case of a partnership interest, a charging order.

PRACTICE TIP: Insolvency clauses are really a shorthand way to express one party's concern for protecting its bargain in the event of the financial deterioration of the other party. The party seeking to include such a clause in an agreement should recognize that its real concern is not bankruptcy; it is the possibility of being contractually bound to a financially strapped party. For example, financial difficulties may impair or destroy a lessee's ability to repair and maintain the leased property, to pay taxes and insurance premiums, and otherwise comply with lease terms. The attorney should identify these risks at the drafting stage and address them in the agreement through affirmative and negative covenants that, if breached, would provide a warning signal of potential financial problems. See Pietzman & Pesterfield, *Drafting Bankruptcy Provisions in Commercial Contracts and Leases*, 2 CEB Cal Bus L Prac 32 (Winter 1987).

See form in §14.20 for insolvency provisions.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/14 Defining Events of Default/ B. Effect of Federal Bankruptcy Code/§14.17 1. Insolvency Clauses in Executory Contracts Generally Invalid

B. Effect of Federal Bankruptcy Code

§14.17 1. Insolvency Clauses in Executory Contracts Generally Invalid

The federal Bankruptcy Code (11 USC §§101-1532) protects the debtor's assets, enabling creditors to be treated more fairly. The Bankruptcy Code generally prohibits the enforcement of insolvency clauses (so-called ipso facto clauses) in executory contracts and unexpired leases that attempt to terminate or modify an agreement after the commencement of a bankruptcy case based solely on (11 USC §365(e)(1)):

- The insolvency or financial condition of the debtor before the closing of the bankruptcy case;
- The commencement of the bankruptcy case; or
- The appointment of, or taking possession by, a trustee in a bankruptcy case or a custodian before the commencement of the bankruptcy case.

For purposes of the Bankruptcy Code, an "executory contract" has been described as:

> [a] contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.

Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn L Rev 439, 460 (1973). There is no Bankruptcy Code definition of "executory contract," but the Ninth Circuit has adopted the "Countryman test" quoted above. *Unsecured Creditors' Comm. v Southmark Corp. (In re Robert L. Helms Constr. & Dev. Co.)* (9th Cir 1998) 139 F3d 702. See also *In re Cochise College Park, Inc.* (9th Cir 1983) 703 F2d 1339, 1348.

Despite the insolvency provision, the debtor-in-possession trustee may, subject to court approval, assume and retain unexpired leases and executory contracts for the benefit of the estate, assume and assign them, or reject them. 11 USC §365(a), (f). Before allowing the debtor to reject a contract, courts in the Ninth Circuit consider three issues: (1) any resulting disproportionate damage to the other party, (2) the benefit to unsecured creditors that results from rejection, and (3) the prospects for a successful reorganization. See *Huang v Pierce (In re Chi-Feng Huang)* (BAP 9th Cir 1982) 23 BR 798, 800 (adopting "business judgment" test on whether to assume or reject executory contract).

Before the trustee or debtor-in-possession may assume an executory contract or an unexpired lease, it must (11 USC §365(b)(1)-(2)):

- Promptly cure, or provide adequate assurance that it will promptly cure, defaults under the contract or lease (other than a default of the insolvency clause or, in a real property lease, certain defaults arising from a failure to perform nonmonetary obligations);
- Compensate, or provide adequate assurance that it will promptly compensate, parties other than the debtor for any actual pecuniary loss to the parties resulting from any of the defaults; and
- Provide adequate assurance of future performance under the contract or lease.

When applicable law bars assignment to a hypothetical third party (11 USC §365(c)(1)), a debtor in possession may not assume a nonexclusive patent license if the licensor objects to the assumption. See *Perlman v Catapult Entertainment, Inc.* (*In re Catapult Entertainment, Inc.*) (9th Cir 1999) 165 F3d 747, 753. This decision has been criticized. See *In re Adelphia Communications Corp.* (Bankr SD NY 2007) 359 BR 65, 72 (when assumption will be effected by debtor-in-possession (rather than trustee), right to object to assignment does not by itself affect right to assume); *In re Aerobox Composite Structures, LLC* (Bankr D NM 2007) 373 BR 135, 140 (rule barring assumption and assignment of executory contracts and unexpired leases does not bar debtor-in-possession's assumption of contract; nondebtor party cannot compel debtor to reject contract).

Some special bankruptcy provisions apply to equipment leases. A trustee must timely perform all of the debtor's obligations first arising under an unexpired lease of personal property (other than personal property leased to an individual primarily for personal, family, or household purposes) 60 days or more after the order for relief in a case

under Chapter 11 of the Bankruptcy Code until the lease is assumed or rejected, unless the court orders otherwise. 11 USC §365(d)(5). For the trustee to assume an executory contract or an unexpired lease, it does not need to cure or provide compensation for a default with respect to "the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease." 11 USC §365(b)(2)(D).

Section 365(b) was "clarified to provide that when sought by a debtor, a lease can be cured at a nondefault rate (*i.e.,* it would not need to pay penalty rates)." HR Rep No 103-835 §220, reprinted at 5 US Code Cong & Ad News 3340, 3359 (1994).

Finally, the Bankruptcy Code's adequate protection requirements apply to "property that is subject to any unexpired lease of personal property (to the exclusion of that property being subject to an order to grant relief from the stay under section 362)." 11 USC §363(e). This provision clarifies the lessor's right to petition for adequate protection of its interest; however, by exercising that right, the lessor gives up the right to petition for lifting the automatic stay.

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§14.18 2. Insolvency Provision Not Invalidated

An insolvency provision is enforceable in certain types of cases:

- If one party completes its performance under the contract, the agreement is no longer an executory contract and the federal Bankruptcy Code provision invalidating insolvency clauses, 11 USC §365, does not apply. Nor does it apply if the contract or lease terminated or expired by its own terms before the date of the bankruptcy petition. *Texscan Corp. v Commercial Union Ins. Co.* (*In re Texscan Corp.)* (BAP 9th Cir 1989) 107 BR 227, aff'd (9th Cir 1992) 976 F2d 1269; *Moody v Amoco Oil Co.* (7th Cir 1984) 734 F2d 1200, 1212. However, the insolvency provision will not excuse the nondebtor party's remaining performance under the nonexecutory contract, such as to pay the remaining balance.
- A prospective lender or creditor is excused from completing a loan transaction or a financial accommodation to or for the benefit of the bankruptcy debtor, or issuing a security of the bankruptcy debtor. 11 USC §365(e)(2)(B). The loan agreement or financial accommodation is not assumable by the trustee or debtor-in-possession. 11 USC §365(c). See, *e.g., Farmer v Crocker Nat'l Bank (In re Swift Aire Lines, Inc.)* (BAP 9th Cir 1983) 30 BR 490 (letter of credit under which debtor is beneficiary is financial accommodation agreement). If a loan has already been made, however, courts do not generally enforce acceleration if loan payments are current and the debtor provides adequate assurance that the lender is protected as to future payments.
- Generally, under state law, personal service contracts may not be assigned or delegated. Accordingly, the trustee or debtor-in-possession may not assume personal service contracts unless the nondebtor party consents to the assumption. This prohibition applies whether or not the contract prohibits or restricts assignment of rights or delegation of duties, thus protecting the nondebtor party from prejudicial harm. 11 USC §365(e)(2)(A). Further, a debtor-in-possession may not assume a nonexclusive patent license over the nondebtor licensor's objection because federal patent law makes nonexclusive patent licenses personal and nondelegable. 11 USC §365(c)(1). *Perlman v Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.*) (9th Cir 1999) 165 F3d 747. But see *In re Adelphia Communications Corp.* (Bankr SD NY 2007) 359 BR 65, 72 (when assumption will be effected by debtor-in-possession (rather than trustee), right to object to assignment does not by itself affect right to assume); *In re Aerobox Composite Structures, LLC* (Bankr D NM 2007) 373 BR 135, 140 (rule barring assumption and assignment of executory contracts and unexpired leases does not bar debtor-in-possession's assumption of contract; nondebtor party cannot compel debtor to reject contract).

PRACTICE TIP: Counsel can try to inject an element of personal skill into the contract to bring the agreement under this rule and prevent assignment out of bankruptcy, but this approach may not always be sufficient to avoid invalidation of the insolvency clause.

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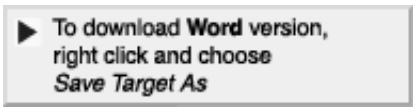
§14.19 C. Effect of California Fraudulent Transfer Law

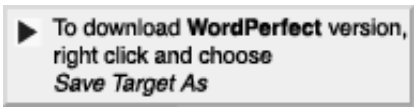
California courts do not enforce insolvency clauses that would effect an act of fraud to creditors. For example, a contract is void as a fraud against creditors if it would have permitted the employee to purchase a major asset of the employer for an unreasonably small consideration to put the asset beyond the employer's creditors' reach. *Severance v Knight-Counihan Co.* (1947) 29 C2d 561, 177 P2d 4.

PRACTICE TIP: If an insolvency clause triggers a right to purchase all or any of the interest in property, as may be desired in a corporate buy-sell agreement or a partnership agreement, the agreement should state that the seller is receiving reasonable value for the property or interest being purchased. Otherwise, the transaction may be vulnerable as an attempt to defraud creditors. However, the bankruptcy trustee may still void this provision as violative of the bankruptcy stay. 11 USC §362(a).

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§14.20 D. Form: Insolvency Provisions





14.20-1 Insolvency provisions

_ _[*E.g., Borrower*]_ _ **files a voluntary petition under any bankruptcy, reorganization, or insolvency law of any jurisdiction;**

_ _[*E.g., Borrower*]_ _ **consents to or applies for appointment of a trustee, receiver, custodian, or similar official for itself or for all or substantially all its assets;**

A trustee, receiver, custodian, or similar official is appointed to take possession of all or substantially all of _ _[*e.g., Borrower*]_ _**'s assets and is not dismissed within** _ _[*time period*]_ _ **after appointment;**

_ _[*E.g., Borrower*]_ _ **makes any assignment for the benefit of creditors, or other arrangement or composition under any insolvency law;**

An order for relief is entered against _ _[*e.g., Borrower*]_ _ **under any bankruptcy, reorganization, or insolvency law of any jurisdiction** _ _[*and is not dismissed or stayed within* _ _[*time period*]_ _ *after its entry*]_ _**; or any case, proceeding, or other action seeking such an order remains undismissed for** _ _[*time period*]_ _ **after its filing; or**

Any writ of attachment, garnishment, or execution is levied against all or substantially all of _ _[*e.g., Borrower*]_ _**'s assets; or all or substantially all of** _ _[*e.g., Borrower*]_ _**'s assets become subject to any attachment, garnishment, execution, or other judicial seizure, and the same is not satisfied, removed, released, or bonded within** _ _[*time period*]_ _ **after the date the writ was levied or the date of the attachment, garnishment, execution, or other judicial seizure.**

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VI. CROSS-DEFAULT

§14.21 A. General Principles

A cross-default provision gives additional protection to the nondefaulting party. One party may be in compliance with all terms of the principal agreement, but an event of default may occur in another agreement, which may cause the nondefaulting party to question the defaulting party's ability to perform under the agreement. This "cross-default" provision may specifically refer to ancillary agreements relating to the prime agreement (*e.g.,* a default under a related security or pledge agreement may constitute a default under a loan agreement) or to unrelated agreements entered into by the same party or parties but which may affect the obligor's performance under the principal agreement (*e.g.,* a default under a lease agreement between the parties may constitute a default under a lease agreement between the parties for other property). A cross-default provision may also provide that an event of default under an agreement between the defaulting party and a *third* party, such as another lender, triggers an event of default under the subject agreement. See form in §14.23.

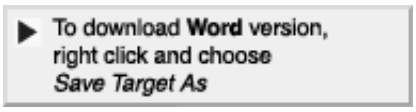
PRACTICE TIP: Generally, the cross-default provision is triggered by an event of default under the other agreement, and an event of default occurs under the other agreement only after any appropriate notice and grace period granted in that agreement lapses. Therefore, the cross-default provision usually does not provide an additional notice and grace period. Sometimes, however, the cross-default provision is triggered by a mere default (as opposed to an event of default) under the other agreement; that is, a default occurs under the other agreement without regard to notice or grace periods. This type of provision is advantageous to a lender, and disadvantageous to a borrower, because an event of default may be triggered even if the original default is waived or cured. One possible compromise is for the borrower to insist that the lender "declare" an event of default to exist as a result of the cross-default. See form in §14.23.

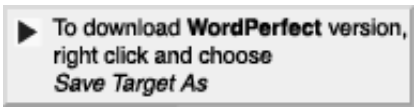
A "cross-acceleration" provision, on the other hand, provides that the acceleration of debt under an agreement between the defaulting party and another lender triggers an event of default under the subject agreement. From the obligor's point of view, a cross-default provision is less favorable than a cross-acceleration provision: A cross-default provision enables the lender to accelerate *its* loan and to exercise other remedies even in the absence of a payment or covenant default under its own agreement if there has been any event of default under the other agreement. This has the effect of incorporating by reference the most arduous covenant provisions from the other agreement. By contrast, a cross-acceleration provision enables the lender to act only when the other lender has taken the more drastic step of accelerating its loan.

See forms in §§14.22-14.23.

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§14.22 B. Form: Cross-Default Clause





14.22-1 Cross-default clause

A breach or an event of default occurs _ _[*or a breach or event occurs that with the giving of notice, passage of time, or both, would constitute an event of default*]_ _ **by** _ _[*e.g., Borrower*]_ _ **under**

[*If applicable, add one or more of the following options*]

[*Option 1: Default under any other agreement between the same parties*]

any other agreement or document between the parties to this Agreement.

[*Option 2: Default under related agreements*]

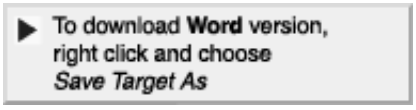
any other agreement or document associated with, entered into in connection with, or delivered according to this Agreement _ _[*including but not limited to* _ _[*specify other agreements*]_ _]_ _**.**

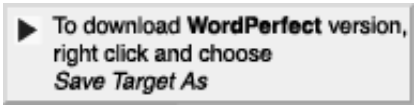
[*Option 3: Default under specified agreement*]

that certain _ _[*specify agreement*]_ _**.**

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§14.23 C. Form: Cross-Default and Cross-Acceleration Clauses





14.23-1 Cross-default and cross-acceleration clauses

[*Add one of the following alternatives*]

[*Alternative 1: Actual acceleration*]

_ _[*E.g., Borrower*]_ _ **fails to pay or perform any obligation in respect of any other loan or other agreement evidencing indebtedness of** _ _[*e.g., Borrower*]_ _ _ _[*in the then outstanding principal amount of more than $*_ _[*amount*]_ _]_ _**, if the effect of that failure is to cause the obligations under the other loan or agreement to be declared due before their stated maturity.**

[*Alternative 2: Actual acceleration or right to accelerate*]

_ _[*E.g., Borrower*]_ _ **fails to pay when due (subject to any applicable grace period), whether by acceleration or otherwise, of any indebtedness of** _ _[*e.g., Borrower*]_ _ _ _[*in the then outstanding principal amount of more than $*_ _[*amount*]_ _]_ _ **or fails to perform or observe any obligation or condition with respect to any indebtedness if:**

(i) the effect of that failure is to accelerate, or permit the acceleration of, the maturity of any indebtedness or cause any that indebtedness to be prepaid, purchased, or redeemed, or

(ii) the holder or holders of any that indebtedness, or any trustee or agent for those holders, causes or has the right to cause any indebtedness to become due and payable before its expressed maturity or to be prepaid, purchased, or redeemed.

[*Alternative 3: Cross-default on declaration of an event of default*]

Any event or condition occurs that enables (or, with the giving of notice or lapse of time or both, would enable) _ _[*e.g., the holder of other indebtedness*]_ _ **or any person acting on** _ _[*e.g., that holder's*]_ _ **behalf to accelerate the maturity of any indebtedness and** _ _[*e.g., Lender*]_ _**, in the exercise of its sole discretion, will declare an Event of Default to exist.**

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§14.23A D. Guaranty and Letters of Credit

Whenever a loan transaction includes a guaranty, one of the events of default should be revocation by the guarantor of the guaranty. See §14.23B. The other defaults, *e.g.*, the cross-default/cross-acceleration and bankruptcy defaults, should also be modified to include the guarantor.

If the loan is secured by a letter of credit and the letter of credit expires prior to the maturity date of the loan, the lender should add as an event of default to the loan agreement the failure to deliver a replacement letter of credit before the original expires. See §14.23C.

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§14.23B 1. Form: Revocation of Guaranty

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14.23B-1 Revocation of guaranty

The Guaranty is at any time for any reason be purportedly revoked by the Guarantor or be declared by the Guarantor to be null and void, or the validity or enforceability of the Guaranty is contested by the Guarantor, or a proceeding is commenced by the Guarantor seeking to establish the invalidity or unenforceability of the Guaranty, or the Guarantor denies that it has any liability or obligation purported to be created under the Guaranty.

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§14.23C 2. Form: Replacement Letter of Credit

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▶ To download **WordPerfect** version, right click and choose *Save Target As*

14.23C-1 Replacement letter of credit

Borrower fails to deliver a replacement letter of credit satisfactory to the Lender at least _ _[*e.g., 3*]_ _ business days before the stated expiration date of the Letter of Credit (or any replacement letter of credit).

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VII. PARTY DEEMS ITSELF INSECURE

§14.24 A. General Principles

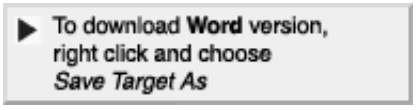
The general insecurity provision, used principally in loan transactions, provides that one party may declare an event of default if it deems itself insecure and if it in good faith believes its prospect of payment or performance to be impaired. This provision is problematic because it provides no ascertainable standard against which default may be measured. The application of this provision is subject to good faith requirements. Com C §1304.

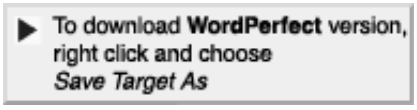
PRACTICE TIP: Counsel should incorporate standards defining when a party may deem itself insecure so that the party declaring default is less likely to be successfully challenged as acting arbitrarily or in bad faith.

See form in §14.25 for provision defining a party deeming itself insecure as a default.

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§14.25 B. Form: Party Deems Itself Insecure





14.25-1 Party deems itself insecure

[*Add one of the following alternatives*]

[*Alternative 1: Party insecure as result of other party's actions*]

The parties agree that _ _[*describe event, e.g., if any of the deliveries provided for in this contract are more than 7 calendar days late/if, during the first 90 calendar days of this contract, buyer fails to qualify for the prompt payment discount offered by seller/if any party breaches or fails to perform any other contract between the parties*]**_ _, _ _**[*name of party*]**_ _ may deem itself insecure about the ability of _ _**[*name of other party*]**_ _ to perform its obligations under this contract, and that insecurity, if reasonable, constitutes an Event of Default.**

[*Alternative 2: Party insecure as result of material adverse change*]

If _ _[*name of party*]**_ _ suffers or sustains a material adverse change in its business, operations, results of operations, assets, liabilities, or financial condition taken as a whole, as determined in _ _**[*name of other party*]**_ _'s good faith business judgment, _ _**[*name of other party*]**_ _ may deem itself insecure about the ability of _ _**[*name of party*]**_ _ to perform its obligations under this contract, and that insecurity, if reasonable, constitutes an Event of Default.**

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§14.26 VIII. MISCELLANEOUS DEFAULT PROVISIONS

Similar to cross-default provisions and provisions allowing a party to declare an event of default when it deems itself insecure, the agreement may contain language triggering an event of default if certain legal actions threaten performance of the agreement.

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§14.27 A. Form: Judgments Rendered Against Party

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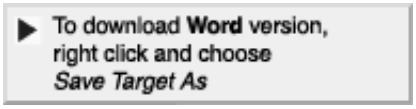
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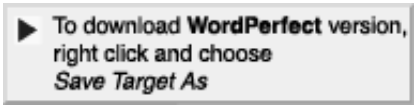
14.27-1 Judgments rendered against party

A final judgment or judgments (after the expiration of all times to appeal from the judgment or judgments) for the payment of money in excess of _ _[*amount*]_ _ in the aggregate is rendered against _ _[*e.g., Lessee*]_ _ and is not (i) fully covered by insurance or (ii) vacated, stayed, bonded, paid, or discharged for a period of _ _[*e.g., 30 calendar days*]_ _.

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§14.28 B. Form: Validity of Agreement Challenged





14.28-1 Validity of agreement challenged

Any material provision of this Agreement or any other document executed in connection with this Agreement is at any time for any reason be declared by a court of competent jurisdiction to be null and void, or _ _[*e.g., Borrower*]_ _ contests the validity or enforceability of this Agreement, or _ _[*e.g., Borrower*]_ _ commences a proceeding seeking to establish the invalidity or unenforceability of this Agreement or other document, or _ _[*e.g., Borrower*]_ _ denies that it has any liability or obligation purported to be created under this Agreement or other document.

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§14.29 C. Form: Lien Not Perfected

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▶ To download **WordPerfect** version, right click and choose *Save Target As*

14.29-1 Lien not perfected

This Agreement fails or ceases to create a valid and perfected and first-priority lien on or security interest in any Collateral purported to be covered by this Agreement, except to the extent permitted by the terms of this Agreement.

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15

Remedies

Barry A. Graynor
Victor Hsu

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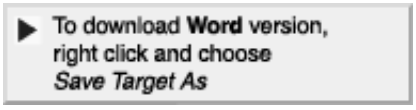
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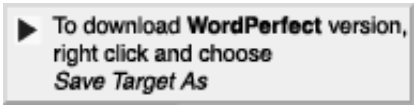
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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.1 I. CHECKLIST: REMEDIES

§15.1 I. CHECKLIST: REMEDIES





- Available remedies
- Liquidated damages (see §§15.4-15.5)
- Mitigation of damages (see §§15.8-15.9)
- Interest and penalties (see §§15.10-15.17)
- Attorney fees and costs (see §§15.18, 16.58-16.62)
- Statutes of limitation (see §§15.21-15.22)
- Limiting liability (see §§15.23-15.24)
- Specific performance (see §§15.25-15.26A)
- Rights and remedies are cumulative, not exclusive (see §§15.27-15.28)
- Purchase and sale agreements
- Commercial Code remedies (see Division 2; §§15.29-15.30)
- Warranties (see §§15.31-15.36)
- Personal property leases
- Commercial Code remedies for lease transactions (see Division 10; §§15.37-15.41)
- Warranties (see §§15.42-15.44)
- Loan and security agreements
- Acceleration (see §§15.45-15.50)
- Commercial Code remedies for secured transactions (see Division 9; §§15.51-15.53)

WARNING: The attorney should consider this checklist of topics in drafting the remedies section of a business agreement. The checklist is not intended to be exclusive. In particular, it does not address remedies relating to specialized areas of the law such as consumer, real property, or construction law transactions.

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§15.2 II. PRELIMINARY DRAFTING CONSIDERATIONS

This chapter discusses the crucial subject of contractual remedies—provisions that come into play when a failure in performance has occurred and one or more of the parties seeks to determine their respective rights and obligations.

Before drafting remedies clauses, the attorney should consider the following points:

Type of agreement. What type of agreement is being drafted? Depending on the agreement, certain bodies of law (such as the Commercial Code) may contain a detailed set of remedies that are automatically incorporated into the agreement.

Client. Who is the client? Different parties have conflicting interests that will be reflected in the type of remedies clauses they attempt to negotiate.

Negotiation considerations. As a practical matter, the parties may be unable or unwilling to spend significant resources negotiating and drafting detailed remedies clauses, particularly in the absence of specialized concerns. Accordingly, it is often sufficient to rely on standard "boilerplate" clauses and statutory remedies.

Nonremedies provisions. The attorney must always keep in mind that the purpose of the remedies section is to protect the client if the other party defaults. This purpose may be achieved in part by drafting specific default provisions into the agreement. To protect the client completely, however, the attorney must also consider:

- The recitals to the agreement, which may establish a factual basis for (a) recovery of consequential damages (see §§15.6-15.7), (b) an action for breach of the implied warranty of fitness for a particular purpose (see §§15.31-15.35), (c) the implied covenant of good faith and fair dealing (see §9.23), or (d) obtaining specific performance (see §§15.25-15.26).

NOTE: Statements of fact in the recitals, except recitals of consideration, are binding on the parties. Evid C §622; *Sanders Constr. Co. v San Joaquin First Fed. Sav. & Loan Ass'n* (1982) 136 CA3d 387, 186 CR 218.

- The agreement's representations and warranties (see chap 7), financial covenants (see chap 9), insurance and indemnity provisions (see chap 11), termination provisions (see chap 6), choice of law and forum selection provisions (see chap 16), arbitration provisions (see chap 16), and jury trial and other waivers (see chap 16); and
- Related documents and agreements, such as guaranties (see chap 22) or letters of credit.

Requirement of certainty. In general, an agreement should clearly set forth each material term of the contract, including terms concerning available remedies. For example, a contract for the sale of goods with one or more terms left open may fail for indefiniteness unless "there is a reasonably certain basis for giving an appropriate remedy." Com C §2204(3). See California UCC Sales and Leases §1.19, chap 4 (Cal CEB 2002). See also CC §1654 (contract interpreted against party who caused the uncertainty).

Similarly, an agreement cannot be specifically enforced if its terms "are not sufficiently certain to make the precise act which is to be done clearly ascertainable." CC §3390(5).

For further discussion of preliminary drafting considerations, see chap 14.

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§15.3 III. ETHICAL CONSIDERATIONS

All clauses, and particularly remedies clauses, may raise ethical considerations when the attorney is drafting the agreement. Certain clauses may be viewed as unreasonable or even unconscionable, or they may be held unenforceable for imposing a forfeiture. See §15.36.

Counsel should also be sensitive to the implied covenant of good faith and fair dealing (see, *e.g.,* Com C §§1201(b)(20), 1302(b), 1304); *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 6 CR2d 467. Under the Commercial Code, the obligations of good faith, diligence, reasonableness, and care may not be disclaimed by agreement. However, the parties may by agreement determine the standards by which the performance of those obligations is to be measured, as long as those standards are not manifestly unreasonable. Com C §1302(b).

Overzealous representation of a client may in fact harm the client's interests later if a clause proves to be unenforceable or if an "over-reaching" clause harms the business relationship between the parties or results in litigation. For example, specific performance is not an available remedy against a party if it is not just and reasonable or if that party's assent was obtained by unfair practices. CC §3391(2)-(3).

Similarly, knowingly including a clause that is likely to be unenforceable, especially if done as a "bargaining" chip, may raise ethical concerns. Under Cal Rules of Prof Cond 3-700(C) an attorney may request permission to withdraw in matters pending before a tribunal and to withdraw in other matters if:

- The client insists on presenting a claim or defense that is not warranted under existing law and cannot be supported by good faith argument for an extension, modification, or reversal of existing law; or
- The client insists, in a matter not pending before a tribunal, that the member engage in conduct that is contrary to the judgment and advice of the member but not prohibited under the Rules of Professional Conduct.

For further discussion of ethical considerations, see §§2.15-2.23.

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IV. REMEDIES PROVISIONS

A. Damages

§15.4 1. Liquidated Damages

Liquidated damages are a specified sum of money, determined by the parties at the time of contracting, that must be paid for breach of the contract, regardless of the amount of actual damages incurred. *McCarthy v Tally* (1956) 46 C2d 577, 297 P2d 981. Civil Code §1671 generally allows liquidated damages provisions in commercial contracts unless (a) the provision was unreasonable under the circumstances existing at the time the contract was made or (b) another statute is expressly applicable. See, *e.g*., *Weber, Lipshie & Co. v Christian* (1997) 52 CA4th 645, 60 CR2d 677. For the clause to be valid, the parties must clearly express their intention that the clause will operate as a liquidated damages provision, *i.e.,* a preestimate of damage. *ABI, Inc. v City of Los Angeles* (1984) 153 CA3d 669, 200 CR 563. If the specified amount is disproportionate to actual damages, however, the provision may be held unenforceable as a penalty. *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845.

If the contract involves the retail purchase or rental of personal property or services for personal, family, or household purposes, or the lease of real property for use as a dwelling, a liquidated damages provision in a contract is void unless it would be impracticable or extremely difficult to ascertain the actual damages. CC §1671(d). See also CC §§1675-1681 (governing liquidated damages provisions in real property purchase contracts).

In determining whether a provision is reasonable, courts consider all the circumstances existing at the time the contract was made. Official Comment to CC §1671.

When drafting a liquidated damages clause, counsel should set forth facts establishing why damages are difficult to ascertain and why the amount of damages chosen is reasonable. Although these statements in the agreement are not binding on the trier of fact, they bolster the argument that the parties made a reasonable effort to ascertain potential damages at the time the contract was entered into.

If a contract for the sale of goods provides for liquidated damages but does not comply with CC §1671, a remedy may be available under Division 2 of the Commercial Code. Com C §2718(1). See also Com C §2718(2)-(4) (governing return of buyer's deposit in the presence or absence of a valid liquidated damages clause). Similar provisions apply to personal property leases. Com C §10504.

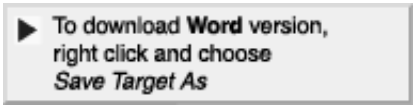
A liquidated damages clause may be used not only to preestablish the amount of damages but also to limit the amount of damages that may be recovered. *H.S. Perlin Co. v Morse Signal Devices* (1989) 209 CA3d 1289, 258 CR 1 (upholding liquidated damages provision limiting company's liability to $250 although actual damages were allegedly $958,000); *Wheeler v Oppenheimer* (1956) 140 CA2d 497, 295 P2d 128 (sales contract provision that, if seller did not complete sale, liability would be limited to "costs and expenses"; held not to be penalty). See §15.23-15.24.

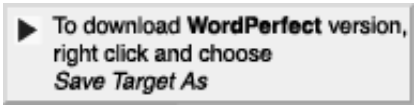
For further discussion of liquidated damages, see California Law of Contracts §§10.41-10.43 (Cal CEB 2007).

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§15.5 2. Form: Sample Liquidated Damages Provision





15.5-1 Sample liquidated damages

___. *Liquidated Damages.* Seller acknowledges that Buyer is relying on Seller to manufacture and deliver the Equipment in accordance with the provisions of this Agreement and that Buyer is intending to lease the Equipment to its customers in accordance with Seller's covenants as set forth in this Agreement. If Seller fails to make any item of Equipment available for delivery according to the attached delivery schedule, Buyer may, at its option, agree to accept the Equipment despite its late delivery, in which case Seller shall pay to Buyer as liquidated damages and not as a penalty the amount of $100 per item of Equipment for each day delivery is delayed beyond the scheduled date.

Comment: The first sentence of this clause helps to provide factual support for the reasonableness of the liquidated damages provision in the last sentence. The reasonableness of the clause depends on the actual dollar figure agreed on as the liquidated damages amount.

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§15.6 3. Consequential and Incidental Damages

For breach of an agreement, the measure of damages is generally the amount that will compensate the aggrieved party for all detriment proximately caused, or that, in the ordinary course of things, would be likely to result. CC §3300.

The Commercial Code distinguishes incidental damages from consequential damages. Incidental damages are all commercially reasonable expenditures that result from breach of the agreement. As examples of incidental damages, the Code lists:

- Expenses incurred by a seller in stopping delivery, storing or transporting the goods after breach, and returning or reselling the goods (Com C §2710); and
- Expenses incurred by a buyer in inspecting, receiving, transporting, and caring for goods rightfully rejected; any commercially reasonable expenses in connection with securing replacement goods; and any other reasonable expense incident to the seller's delay in performance or other breach (Com C §2715(1)).

Consequential damages include any loss resulting from general or particular *requirements and needs,* which the seller at the time of contracting had reason to know, and which could not be prevented from occurring. Com C §2715(2)(a). Consequential damages also include injury to person or property proximately resulting from any breach of warranty. Com C §2715(2)(b). Under the Commercial Code, unless the contract provides otherwise, only the buyer is entitled to consequential damages. Com C §2715(2). For further discussion of consequential damages, see *Serian Brothers, Inc. v Agri-Sun Nursery* (1994) 25 CA4th 306, 30 CR2d 382 (buyer entitled to foreseeable lost profits under Com C §2715(2)(a) for seller's breach of warranty).

Commercial Code §2719(3) provides that consequential damages may be limited or excluded unless the limitation or exclusion is unconscionable. See *Three-Seventy Leasing Corp. v Ampex Corp.* (5th Cir 1976) 528 F2d 993 (upholding contractual provision that excused seller from liability for consequential damages, including lost profits (construing California law)); *A&M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114 (exclusion of consequential damages held unconscionable).

NOTE: Differing standards of unconscionability seem to be applied by California courts depending on whether or not cases are decided under the Uniform Commercial Code. See *Perdue v Crocker Nat'l Bank* (1985) 38 C3d 913, 925, 216 CR 345 (acknowledging alternative analytical frameworks of unconscionability found in *Graham v Scissor-Tail, Inc.* (1981) 28 C3d 807, 171 CR 604, and *A&M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114); *Schnall v Hertz Corporation* (2000) 78 CA4th 1144, 1161, 93 CR2d 439 (finding that plaintiff's claim that fuel service charge in rental car contract was unconscionable was unfounded because fuel service charge neither "shocked the conscience" as required under *California Grocers Ass'n v Bank of America* (1994) 22 CA4th 205, 27 CR2d 396, nor did charge even meet the "less stringent standard" applied in *A&M Produce*). See also *California Grocers Ass'n, Inc. v Bank of America, supra* (stating that preference for unconscionability standard is the one found in *Graham* and declining to follow standard in *A&M Produce* because the standard in that case was far too subjective to provide adequate guidance for the court). On unconscionability, see §§3.14-3.14A.

Clauses that limit a buyer's remedy for breach of warranty to repair or replacement of the goods are particularly susceptible to challenge when repair or replacement, as the sole remedy, fails; in this situation, courts have held that a limitation on consequential damages is invalid. *Milgard Tempering, Inc. v Selas Corp.* (9th Cir 1990) 902 F2d 703 (applying Washington law; holding based on particular facts of case); *Fiorito Bros. v Fruehauf Corp.* (9th Cir 1984) 747 F2d 1309 (same). But see *S.M. Wilson & Co. v Smith Int'l, Inc.* (9th Cir 1978) 587 F2d 1363, in which the court upheld a limitation on consequential damages when parties of equal bargaining strength allocated the risk of failure of a complex piece of machinery designed for the buyer.

Accordingly, if the parties seek to *limit* the buyer's remedy for breach of warranty to repair or replacement of the goods and *exclude* consequential damages, they should provide for a "back-up" remedy (such as refund of the purchase price) if repair or replacement fails; they should place the warranty limitation in a separate section from the

consequential damages exclusion. See §15.35 for a sample form.

A provision that effectively excludes consequential damages does not preclude recovery of incidental damages. See Com C §2715(1); *Carbontek Trading Co. v Phibro Energy Inc.* (5th Cir 1990) 910 F2d 302. By agreement, however, the parties may also exclude recovery of incidental damages if the exclusion is not unconscionable or does not deprive a party of all effective remedies. See Official Comment 1 to UCC §2-719.

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§15.7 4. Form: Exclusion of Consequential and Incidental Damages

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▶ To download **WordPerfect** version, right click and choose *Save Target As*

15.7-1 Exclusion of consequential and incidental damages

___. *No Liability for Special, Incidental, or Consequential Damages.* In no event will _ _[*e.g., Seller*]**_ _ be liable for loss of profits or any special, incidental, or consequential damages, however caused, even if _ _**[*e.g., Seller*]**_ _ has been advised of the possibility of damages.**

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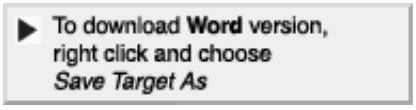
§15.8 5. Mitigation of Damages

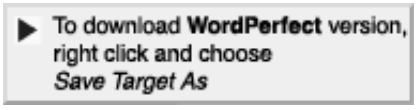
One who suffers injury from a breach of contract must do all he or she reasonably can to mitigate damages (*Johnson v Comptoir Franco-Belge, etc.* (1955) 135 CA2d 683, 288 P2d 151), but may recover any damages suffered in its reasonable efforts to mitigate. Com C §10520(b)(1); *W.C. Cook & Co. v White Truck & Transfer Co.* (1932) 124 CA 721, 13 P2d 549. Consider also Com C §2715(2)(a) (consequential damages resulting from the seller's breach include any loss of which the seller had reason to know at the time of contracting and which could not reasonably be prevented by purchasing replacement goods or otherwise). The breaching party has the burden of proving the inadequacy of efforts to mitigate consequential damages under §2715(2)(a). *Carnation Co. v Olivet Egg Ranch* (1986) 189 CA3d 809, 229 CR 261.

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§15.9 6. Form: Mitigation of Damages





15.9-1 Mitigation of damages

___. *Mitigation of Damages.* In the event of any default, _ _[*e.g., Lessor*]_ _ will use reasonable efforts to mitigate its damages, but these acts will not limit or modify any of _ _[*e.g., Lessor's*]_ _ rights under this Agreement, and _ _[*e.g., Lessee*]_ _ will pay to _ _[*e.g., Lessor*]_ _ a reasonable sum for attorney fees and other reasonable costs and expenses incurred by _ _[*e.g., Lessor*]_ _ in enforcing any right or privilege under this Agreement.

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B. Interest and Penalties

§15.10 1. Postdefault and Compound Interest

Loan agreements typically provide that, on the occurrence of an event of default, any overdue principal payments will bear interest at a rate higher than the stated interest rate for the loan. See §15.11. This type of clause must be analyzed to determine whether it is a valid liquidated damages provision. CC §1671. If the higher rate applies to the entire unpaid loan balance instead of only the amount in default, it may be held void as a penalty. *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845. When drafting a liquidated damages provision, usury laws must also be considered. See §§8.27-8.29, 21.28.

Late charge provisions that come into play only in the event of default do not make a loan usurious. *First Am. Title Ins. & Trust Co. v Cook* (1970) 12 CA3d 592, 90 CR 645. Nor is the usury law violated when interest is compounded annually at the maximum rate after default. If interest is compounded at the maximum rate at shorter intervals, however, the agreement may be usurious. *Heald v Friis-Hansen* (1959) 52 C2d 834, 345 P2d 457; *First Am. Title Ins. & Trust Co. v Cook, supra*. Interest may not be compounded unless the agreement to that effect is clearly expressed in writing and signed by the party to be charged. Cal Const art XV, §1; *Curry v Moody* (1995) 40 CA4th 1547, 48 CR2d 627 (ambiguous promissory note not construed to provide for compound interest); *McConnell v Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1983) 33 C3d 816, 191 CR 458.

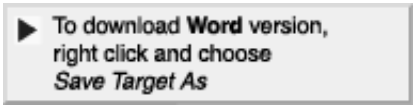
PRACTICE TIP: Lenders' attorneys should be wary of contract language in notes or loan agreements that requires the lender to exercise its option to accelerate before default interest begins to accrue on the loan. This language requires the lender to provide notice of acceleration to the borrower before default interest will begin to accrue. See *Beal Bank v Crystal Props., Ltd*. (*In re Crystal Props., Ltd*.) (9th Cir 2001) 268 F3d 743. Loan documents should provide that default interest is automatically triggered if any unpaid balance remains after maturity (by acceleration or otherwise) or on an event of default.

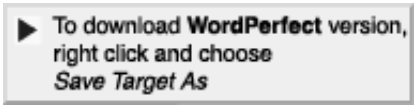
For further discussion, see California Law of Contracts §§10.41-10.43 (Cal CEB 2007).

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§15.11 2. Form: Postdefault Interest





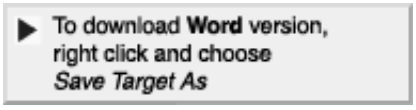
15.11-1 Postdefault interest

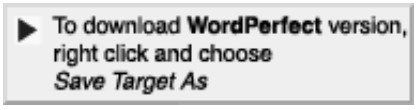
___. *Postdefault Interest.* In the event that any principal payments under this Agreement or the Note are not paid when due (whether at stated maturity, by acceleration, or otherwise), those payments will bear interest at _ _[*e.g., the Postdefault Rate*]_ _ for the period commencing on the due date until the same are paid in full, and that interest is payable on demand. The _ _[*e.g., Postdefault Rate*]_ _ is defined as a per annum rate equal to _ _ percent above the rate otherwise applicable under this Agreement or the maximum amount permitted by applicable law, whichever is lower.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.11A 3. Form: Late Charge

§15.11A 3. Form: Late Charge





15.11A-1 Late charge

___. *Late Charge.* In the event that any payments under this Agreement are not paid when due (whether at stated maturity, by acceleration, or otherwise), _ _[*e.g., Lessee*]_ _ will pay a late charge on the overdue amount equal to the lesser of _ _[_ _ *percent*]_ _ of the payment due or the maximum amount permitted by the law of the state where the leased goods are located.

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§15.12 4. Prepayment Penalties

Many loan agreements provide for a prepayment "penalty" if principal is voluntarily repaid before the stated maturity date. The agreement may also provide for a prepayment penalty on the principal balance paid before maturity when the loan has been accelerated, if this intention is clearly expressed. *Golden Forest Prop. v Columbia Sav. & Loan Ass'n* (1988) 202 CA3d 193, 248 CR 316; *Pacific Trust Co. TTEE v Fidelity Fed. Sav. & Loan Ass'n* (1986) 184 CA3d 817, 229 CR 269. Although prepayment charges are generally enforceable, they will not be allowed if "exorbitant" (*Lazzareschi Inv. Co. v San Francisco Fed. Sav. & Loan Ass'n* (1971) 22 CA3d 303, 99 CR 417), if they constitute unearned interest over the remaining life of the loan (*Furesz v Garcia* (1981) 120 CA3d 793, 174 CR 803), or if they are imposed only if the borrower had previously been late in paying interest (*Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 73 CR2d 378). Special provisions apply to prepayment penalties on residential loans. See CC §§2954.9-2954.11.

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§15.13 5. Form: Prepayment Penalty

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15.13-1 Prepayment penalty

___. *Prepayment Penalty.* If the principal balance of the Loan is prepaid, whether voluntarily or because of acceleration in accordance with Section _ _ _, Borrower shall pay a prepayment premium equal to _ _ percent of the principal amount prepaid, in addition to all other amounts due under this Agreement.

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6. Interest as Element of Damages

§15.14 a. Interest on Damages

Several Civil Code sections deal with the recovery of interest on damages for breach of contract:

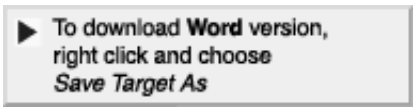
- CC §3287(a): When damages are certain, or are capable of being made certain by calculation, and the right to recover damages is vested on a particular day, interest on the amount of damages is also recoverable, accruing from that day. See *KGM Harvesting Co. v Fresh Network* (1995) 36 CA4th 376, 42 CR2d 286 (lettuce buyer entitled to prejudgment interest from a few days after date buyer filed complaint with U.S. Department of Agriculture because its damages were readily ascertainable from that date notwithstanding a minor error in calculation); *Olson v Cory* (1983) 35 C3d 390, 197 CR 843 (plaintiffs entitled to interest on their salary and pension claims because the claims were certain or capable of being made certain by calculation).
- CC §3287(b): When the claim is unliquidated, prejudgment interest may be recovered in the discretion of the court; this interest is to commence no sooner than the date the action was filed. CC §3287(b). See also *A&M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114.
- CC §3289: Any legal interest rate stipulated by a contract remains chargeable after its breach; if a contract entered into after January 1, 1986, does not stipulate a legal rate of interest, the rate is 10 percent per annum. *Al-Husry v Nilsen Farms Mini-Market, Inc.* (1994) 25 CA4th 641, 31 CR2d 28.
- CC §3289.5: For retail installment contracts, the rate of the contracted finance charge is the legal interest rate stipulated in the contract.

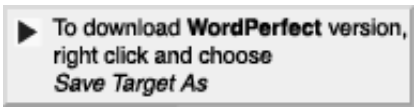
The parties should consider, however, that prejudgment interest is in the court's discretion when damages are unliquidated. Consequently, if an unreasonably high rate is selected, a court may be less likely to award any interest. The reasonableness of the rate would likely also be subject to general principles of good faith, unconscionability, and relief from forfeiture.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.15 b. Form: Interest on Recoverable Damages

§15.15 b. Form: Interest on Recoverable Damages





15.15-1 Interest on recoverable damages

___*. Interest on Recoverable Damages.* In the event either party is entitled to recover damages for breach of this Agreement, the damages will bear interest at a rate equal to _ _[*e.g., Postdefault Rate*]**_ _, commencing on the date of breach.**

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§15.16 c. Interest as Separate Item of Damages

Occasionally, a party may be forced to borrow money and pay interest because of the other party's breach. This interest may be recovered if the borrowing of money was a foreseeable consequence of the breach (see generally §15.6 on consequential damages). Accordingly, a contracting party may want to specify that damages will include its borrowing costs, including "points" or other out-of-pocket expenses relating to the loan. See *C. Norman Peterson Co. v Container Corp.* (1985) 172 CA3d 628, 218 CR 592.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.17 d. Form: Interest as Separate Item of Damages

§15.17 d. Form: Interest as Separate Item of Damages

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15.17-1 Interest as separate item

___. *Interest as Separate Item of Damages.* In addition to all other damages permitted by law, _ _[*e.g., Buyer*]**_ _ wi ll be entitled to recover the interest cost of borrowing money _ _**[*, and all out-of-pocket expenses related to borrowing money,*]**_ _ as an element of its contract damages, if _ _**[*e.g., Seller*]**_ _ breaches this Agreement.**

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C. Attorney Fees and Costs

§15.18 1. Availability

Except when specifically provided by statute or by the parties' agreement, attorney fees incurred in prosecuting an action are not usually recoverable. CCP §1021; *Reynolds Metals Co. v Alperson* (1979) 25 C3d 124, 158 CR 1. If the parties' contract provides that only one of them will be entitled to attorney fees in an action for breach of the contract, the other party will nevertheless be entitled to recover its reasonable attorney fees if it prevails. In other words, the law requires that the contractual right to attorney fees be reciprocal. CC §1717(a). See, *e.g., Exarhos v Exarhos* (2008) 159 CA4th 898, 903, 72 CR3d 409, modified 2008 Cal App Lexis 219 (because CC §1717 requires mutuality of remedy for attorney fee claims, beneficiary who sued on contract entered into by decedent was liable for fees despite his nonsignatory status). This right may not be waived. CC §1717(a); *Beverly Hills Prop. v Marcolino* (1990) 221 CA3d Supp 7, 270 CR 605. See *Hsu v Abbara* (1995) 9 C4th 863, 39 CR2d 824. In this action involving the sale of a home, the court stated that a party is entitled to attorney fees under CC §1717 "even when the party prevails on grounds that the contract is inapplicable, invalid, unenforceable or nonexistent, if the other party would have been entitled to attorney's fees had it prevailed." 9 C4th at 870. The court further held that when a party defeats recovery by the other party on the only contract claim in the action, that party is the prevailing party under CC §1717 as a matter of law; the trial court has no discretion to decide otherwise. See also *Curry v Moody* (1995) 40 CA4th 1547, 48 CR2d 627, in which the court held that the plaintiffs were not entitled to attorney fees, notwithstanding an attorney fees provision in a promissory note, because the defendants were not signatories to the note and were not sued on the note as if they were parties to it.

Because of the reciprocity effect of CC §1717, the attorney should consider whether, in some circumstances, it might be preferable not to include an attorney fees provision in the agreement. Alternatively, the attorney may consider limiting attorney fees to a specified percentage of, *e.g.,* the loan amount. *Reynolds Metals Co. v Alperson, supra*.

Attorney fees may also be awarded as an element of damages. See §15.6.

If the parties want the attorney fees provision to apply only to selected sections of the agreement, they should specify that they were each represented by counsel in the negotiation and execution of the contract (see §15.20); otherwise, that provision will be construed as applying to the entire contract. CC §1717(a).

NOTE: An attorney who chooses to litigate in propria persona rather than retain another attorney to represent him or her in an action to enforce a contract containing an attorney fee provision cannot recover reasonable attorney fees under CC §1717. *Trope v Katz* (1995) 11 C4th 274, 45 CR2d 241.

NOTE: Under certain statutes, a prevailing party may be awarded attorney fees even if the party would not otherwise be responsible for them. For example, in a pro bono or contingency fee case, an attorney will traditionally relieve the client of its obligation to pay attorney fees accrued. See *Rosenaur v Scherer* (2001) 88 CA4th 260, 282, 105 CR2d 674 (construing CCP §425.16, the strategic lawsuits against public participation (SLAPP) statute as allowing recovery of attorney fees accrued by prevailing party's attorney even though attorney had waived payment of fees from prevailing party-client).

NOTE: Former CCP §1021.1, concerning attorney fees in cases brought in Riverside County, was repealed in 2005.

For further discussion of attorney fees, see §§16.57-16.61 and California Law of Contracts §10.37 (Cal CEB 2007).

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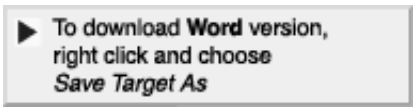
Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.19 2. Attorney Fees Generally

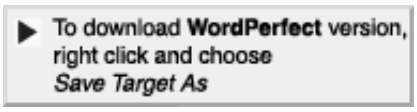
§15.19 2. Attorney Fees Generally

For general attorney fees provisions, see forms in §§16.60-16.61.

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§15.20 3. Form: Limiting Attorney Fees





15.20-1 Limiting attorney fees

[*Add one of the following alternatives*]

[*Alternative 1: Limited to actions on the contract*]

___. *Attorney Fees for Actions to Enforce Contract.* In any action brought to enforce any provision of this Agreement, the losing party will pay the prevailing party's reasonable attorney fees and costs.

[*Alternative 2: Limited to actions based on specific contract provisions*]

____. *Attorney Fees for Specific Actions.* The parties acknowledge that each has been represented by counsel in the negotiation and execution of this Agreement. Accordingly, Section _ _ _ _[*, which provides for attorney fees and costs,*]_ _ applies only to _ _[*e.g., the price provision of the Agreement*]_ _ and to no other provision.

Comment: See §15.18. The first alternative limits recovery of attorney fees to actions "brought to enforce" the agreement; attorney fees incurred in connection with tort claims arising out of the agreement would not be covered by this provision.

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D. Statutes of Limitation

§15.21 1. Waiver and Modification

A party to a contract may waive the statute of limitations as it applies to that party's breach. See CC §3513. A waiver executed before expiration of the limitation period is effective for 4 years after the date of the period's expiration. CCP §360.5. A waiver by an obligor on a promissory note of the statute of limitations is also binding on junior lienholders if the agreement is entered into before the expiration of the limitations period. *Kaichen's Metal Mart, Inc. v Ferro Cast Co.* (1995) 33 CA4th 8, 39 CR2d 233. The agreement in *Kaichen*'s extended the statute of limitations under both CCP §§360 (debtor's written acknowledgment of debt extends statute of limitations) and 360.5 (written waiver of statute of limitations extends limitations period). A provision shortening the limitation period is valid if the shortened period is not so unreasonable as to show undue advantage. *Fageol Truck & Coach Co. v Pacific Indem. Co.* (1941) 18 C2d 748, 117 P2d 669 (1-year limitation period in an insurance contract); *West v Henderson* (1991) 227 CA3d 1578, 278 CR 570 (6-month limitation period in commercial lease). However, a clause in a stock purchase agreement that limits the survival of representations and warranties to 1 year after closing does not necessarily create a 1-year limitation period. *Western Filter Corp. v Argan, Inc.* (9th Cir 2008) 540 F3d 947, 954.

In a contract for the sale of goods, the parties may reduce the 4-year limitation period to no less than 1 year, but they may not extend it. Com C §2725(1). See California UCC Sales and Leases §18.68 (Cal CEB 2002). The shortened limitation period applies to both tort and contract causes of action when the language in the agreement specifies that the buyer must commence an action under the agreement within a set period after the cause of action accrues. *Therma-Coustics Mfg. v Borden, Inc.* (1985) 167 CA3d 282, 213 CR 611.

The 4-year statute of limitations for breach of warranty under the Commercial Code generally begins to run on delivery of the goods. Com C §2725(2). However, if the warranty "explicitly extends to future performance of the goods," the statute begins to run on discovery of the defect. *Western Recreational Vehicles, Inc. v Swift Adhesives, Inc.* (9th Cir 1994) 23 F3d 1547 (applying Washington UCC). The Ninth Circuit held in this case that the "discovery" exception does not apply if the warranty lacked an explicit reference to a future temporal period. The court further held that the warranty disclaimers contained in invoices sent by the seller to the buyer were invalid because they were never negotiated or discussed by the parties but instead were added by the seller on its invoices after the sales.

PRACTICE TIP: To benefit from the "discovery" exception contained in Com C §2725(2), a buyer should negotiate a warranty with an explicit future temporal period, for example:

Seller hereby warrants that the goods will be free from defects for 36 months from the date of delivery.

For personal property leases (other than consumer leases), the parties may reduce the 4-year period of limitation to no less than 1 year; there is no restriction on extending the limitation period. Com C §10506(a).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.22 2. Form: Limitation on Bringing Action

§15.22 2. Form: Limitation on Bringing Action

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15.22-1 Limitation on bringing action

___. *Limitation on Bringing Action.* Any action arising under this Agreement or because of its breach must be commenced within _ _[*e.g., 1 year*]**_ _ after the cause of action accrues.**

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E. Provisions Limiting Liability

§15.23 1. Use

A liquidated damages clause limiting liability is closely related to an exculpatory clause eliminating liability altogether, usually for negligence. Exculpatory clauses must be analyzed under CC §1668 (contracts that exempt anyone from responsibility for his or her own fraud, willful injury, or violation of law, whether willful or negligent, are against public policy). See generally *Tunkl v Regents of Univ. of Cal.* (1963) 60 C2d 92, 32 CR 33, discussed in §11.49.

A release from liability against ordinary negligence will be upheld when no public interest is involved. See, *e.g., Westlye v Look Sports, Inc.* (1993) 17 CA4th 1715, 22 CR2d 781 (upholding release of defendant ski shop from liability for injury resulting from use of ski bindings; agreement was sufficiently clear and specific to be enforceable). However, a release from liability against gross negligence is generally void as against public policy. *City of Santa Barbara v Superior Court* (2007) 41 C4th 747, 777, 62 CR3d 527 (agreement relating to sports or recreational programs or services that purports to release liability for future gross negligence is generally unenforceable as matter of public policy under CC §1668).

An exculpatory clause should be stated in simple and unambiguous language and should be conspicuous, with properly labeled headings (*e.g.,* "LIMITATION OF LIABILITY"). *Hulsey v Elsinore Parachute Ctr.* (1985) 168 CA3d 333, 214 CR 194 (agreement was simple, clear, unambiguous, and printed in 10-point type). See also *Leon v Family Fitness Ctr. (#107), Inc.* (1998) 61 CA4th 1227, 71 CR2d 923 (release unenforceable because it was in undifferentiated type in the middle of a document).

An exculpatory clause may be held invalid if it violates the implied covenant of good faith and fair dealing. *Milton v Hudson Sales Corp.* (1957) 152 CA2d 418, 313 P2d 936.

When the contract is for the sale of goods, Com C §2719 provides that a clause limiting or excluding consequential damages for commercial loss is valid unless it is proved that the limitation or exclusion is unconscionable. *Nunes Turfgrass, Inc. v Vaughan-Jacklin Seed Co.* (1988) 200 CA3d 1518, 246 CR 823. See §§15.6-15.7.

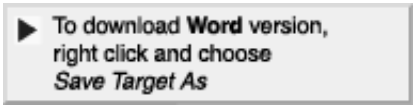
NOTE: If the contract includes a liquidated damages or exculpatory clause, it is probably not advisable to include a general cumulative rights and remedies clause. See §§15.27-15.28.

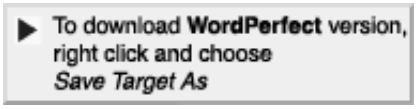
For further discussion of exculpatory provisions, see §§11.40-11.56.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.24 2. Form: Sample Limitation of Liability Provision

§15.24 2. Form: Sample Limitation of Liability Provision





15.24-1 Sample limitation of liability

___*. Limitation on Liability.* From the nature of the services to be performed, it is impracticable and extremely difficult to fix the actual damages, if any, that Buyer may incur as a result of Seller's failure to perform any of its obligations under this Agreement, or the System's failure to operate properly. If Seller is found liable for loss or damage due to its failure to perform or the System's failure to operate in any respect, Seller's liability will be limited to the refund to Buyer of an amount equal to the aggregate of 6 monthly payments or to the sum of $100,000, whichever is less, as liquidated damages and not as a penalty; and this liability will be exclusive.

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F. Specific Performance

§15.25 1. Availability

Specific performance of an agreement should be considered when an action for damages will not adequately compensate a plaintiff for harm caused by its breach. A classic example is a contract involving unique chattels like heirlooms. See generally CC §§3366-3369, 3384-3395, 3402. The remedy of specific performance may also be desirable in a contract to safeguard the confidentiality of trade secrets or other sensitive business information. See §15.26A.

In a contract for the sale of goods, if the seller fails to deliver or repudiates, the buyer may in a proper case obtain specific performance or replevy the goods. Com C §§2711(2)(b), 2716. Specific performance may be decreed when the goods are unique or in "other proper circumstances." Com C §2716(1). The Commercial Code expands the common law remedy of specific performance by broadening the definition of "unique" goods. See Official Comment 2 to UCC §2-716. "Other proper circumstances" may include the buyer's inability to obtain replacement goods through the process known as "cover." *Kaiser Trading Co. v Associated Metals & Minerals Corp.* (ND Cal 1970) 321 F Supp 923. Similar provisions apply to personal property leases. Com C §10521.

If specific performance is anticipated as a remedy, the parties should be sure to specify in the recitals or elsewhere in the agreement in what way in which the goods are unique, or the "other proper circumstances."

The presence of a liquidated damages clause, in which the *seller* waives its right to specific performance, does not prevent the *buyer* from obtaining specific performance. *Bleecher v Conte* (1981) 29 C3d 345, 213 CR 852. See §15.4-15.5.

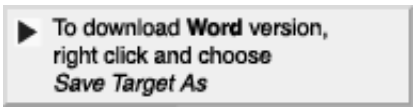
For additional discussion of the remedy of specific performance, see California UCC Sales and Leases §§18.46-18.47 (Cal CEB 2002).

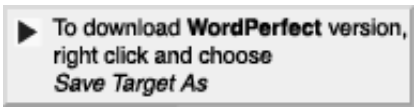
NOTE: The court may refuse to order specific performance of a purchase agreement if the plaintiff fails to demonstrate that he or she could have performed his or her obligations under the agreement. *Stanchfield v Hamer Toyota, Inc.* (1995) 37 CA4th 1495, 44 CR2d 565.

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§15.26 2. Form: Sample Specific Performance Provision





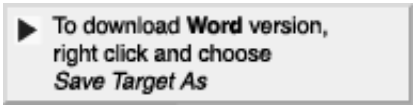
15.26-1 Specific performance

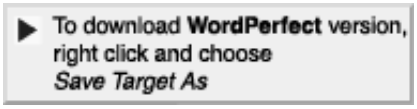
___. *Specific Performance.* All parties recognize and agree that the Property cannot be readily purchased or sold in the open market and that the rights and obligations set forth in this Agreement are unique and are of such a nature as to be inherently difficult or impossible to value monetarily. Therefore, in the event of a breach of this Agreement by any party, an action at law for damages or other remedies at law would be inadequate to protect the unique rights and interests of the parties to this Agreement. Accordingly, in any controversy concerning the purchase or sale of any of the Property subject to this Agreement, its provisions will be enforceable in a court of equity by a decree of specific performance. This remedy is not exclusive and is in addition to any other remedy available to the parties.

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§15.26A 3. Form: Specific Performance Provision in Confidentiality Agreement





15.26A-1 Specific performance confidentiality agreement

___. *Specific Performance.* **_ _**[*The recipient of the information*]**_ _ agrees that its breach of this Agreement will cause irreparable harm to _ _**[*the provider of the information*]**_ _, and in that event, in addition to other remedies provided by applicable law, _ _**[*the provider*]**_ _ will be entitled to immediate issuance of a temporary restraining order or preliminary injunction enforcing this Agreement.**

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G. Cumulative Rights and Remedies

§15.27 1. General Principles

A clause specifying that the parties' rights and remedies are cumulative, not exclusive, is commonly found in business agreements. From a practical standpoint, the selection of a particular remedy or remedies at the time of breach will depend on the then-existing circumstances, which can be difficult to predict when the agreement is executed. Accordingly, it is usually better for a party seeking to ensure performance that available remedies are as broad as possible. For example, if the client is a manufacturer, a suit for damages may be legally available against a defaulting supplier, but as a practical matter the client may prefer to accept a defective tender so that manufacturing is not interrupted. Under the Commercial Code, the client may accept a defective tender without prejudicing its right to sue for damages, as long as the agreement did not provide otherwise. Com C §§2607(2), 2714. See generally California UCC Sales and Leases, chaps 17-18 (Cal CEB 2002).

A clause specifying that rights and remedies are cumulative may simplify drafting and save the client both time and attorney fees. For example, the Commercial Code contains "default" remedies, *i.e.,* remedies that are implied by law in the agreement if the parties fail to specify contrary language. See, *e.g.,* Com C §§2703, 2711, 2719. These remedies are often sufficient for the parties' purposes, but counsel needs to be alert to any special circumstances that render the Code remedies undesirable from the client's standpoint, or that create a need for additional remedies.

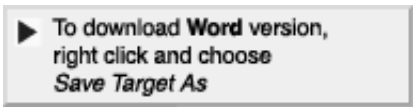
Contractual remedies may be "in addition to" the remedies provided by the Commercial Code or "in substitution for" them. Com C §2719(1)(a). Resort to a Commercial Code remedy is generally optional unless the parties expressly agree that the remedy is exclusive, in which case it will be the sole remedy. Com C §2719(1)(b). The rights and remedies available under the Commercial Code to a secured party are cumulative (Com C §9601(c)), as are those provided to parties in personal property lease transactions (Com C §10501(d)).

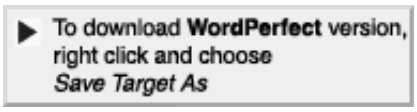
An intent to limit the aggrieved party's remedies to the one specified in the contract must be clearly indicated. *Nelson v Spence* (1960) 182 CA2d 493, 6 CR 312. See also *Michel & Pfeffer v Oceanside Props., Inc.* (1976) 61 CA3d 433, 443, 132 CR 179 (stating that it is a well-established rule that an intention to limit contractual remedies must be clearly expressed).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.28 2. Form: Cumulative Rights and Remedies

§15.28 2. Form: Cumulative Rights and Remedies





15.28-1 Cumulative rights and remedies

___. *Cumulative Rights and Remedies.* No right or remedy given to a party on the breach of any provision of this Agreement is intended by the parties to be exclusive; each is cumulative and in addition to any other remedy provided in this Agreement or otherwise available at law or in equity. No failure by the nonbreaching party to exercise, and no delay in exercising, any right operate as a waiver of that right. Nor will any single or partial exercise of any right, power, or privilege preclude any other or further exercise of a right, power, or privilege granted by this Agreement or otherwise.

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V. SALE AGREEMENTS

§15.29 A. UCC Remedies; Division 2

Division 2 of the California Commercial Code applies generally to transactions in goods. Com C §2102. It describes in general terms the seller's remedies when the buyer breaches the agreement (Com C §§2702, 2703-2710) and the buyer's remedies when the seller breaches the agreement (Com C §§2502, 2711-2717). For example, under Com C §2712, a buyer is entitled to damages in an amount equal to the difference between the contract price and the price the buyer was forced to pay for the substitute goods on the open market even if the buyer is able to pass on a substantial portion of the additional cost to its own customers. *KGM Harvesting Co. v Fresh Network* (1995) 36 CA4th 376, 42 CR2d 286. See also California UCC Sales and Leases, chap 1 (Cal CEB 2002).

As a practical matter, the remedies in Division 2 are adequate for relatively simple contracts. These remedies are designed to be cumulative and nonexclusive. If in a particular situation the parties wish to limit or alter the Division 2 remedies, they may do so (Com C §2719(1)(a)), subject to the limitation on liquidated damages (Com C §2718) and the principle of unconscionability (Com C §2719(3); CC §1670.5). When circumstances cause a contract's exclusive or limited remedy to fail in its essential purpose, however, remedy as provided in the Commercial Code is available. Com C §2719(2).

The following are examples of situations in which the parties may wish to supplement or vary Code requirements:

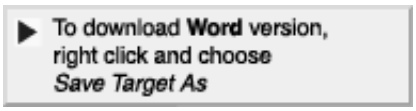
- **Resale of goods by seller when buyer breaches agreement.** Com C §2703. In general, for the seller to recover damages, the resale must be made in good faith and in a commercially reasonable manner. Com C §2706. See, *e.g., Allied Grape Growers v Bronco Wine Co.* (1988) 203 CA3d 432, 249 CR 872. The parties may want to specify in the agreement "the method, manner, time, place and terms" of any resale to establish their own definition of "commercial reasonableness." Com C §2706(2).
- **Cancellation of agreement on buyer's insolvency.** Under the Commercial Code, the seller's right to cancel does not automatically arise on the buyer's insolvency, although insolvency may give the seller other rights. Com C §2702. The seller may wish to broaden its right of cancellation to include this circumstance.
- **Limiting buyer's remedy for breach of warranty or defective tender to repair or replacement of defective goods.** See Com C §2719(1)(a). If the parties do not want this remedy (or any other limited remedy) to be cumulative or optional, the agreement should specify that repair or replacement is an "exclusive remedy," or words to that effect. See form in §15.35.

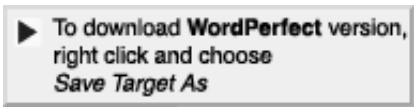
For a comprehensive discussion of the remedies afforded to a seller or buyer under Division 2, see California UCC Sales and Leases, chaps 17-18 (Cal CEB 2002). The practitioner should carefully examine those remedies to decide whether they should be expanded, limited, or excluded, depending on the client's needs and circumstances.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.30 B. Form: Applicability of Commercial Code Remedies

§15.30 B. Form: Applicability of Commercial Code Remedies





15.30-1 Applicability of Commercial Code remedies

___*. Commercial Code Remedies.* Seller and Buyer each have the remedies provided under the Commercial Code of the State of California for any breach, default, or nonperformance of any provision in this Agreement.

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C. Warranties

§15.31 1. Express and Implied

A warranty relates to the character, quality, identity, condition, or title to goods. *Keith v Buchanan* (1985) 173 CA3d 13, 20, 220 CR 392. Warranties may be express or implied. An express warranty is "any affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain." Com C §2313(1)(a). An express warranty may be created by the seller's words or conduct. An implied warranty is created by operation of law, on the assumption that the warranty is so essential to the bargain that the parties would have included it in their agreement had they thought of it. See Com C §2314. Implied warranties include:

- Warranty of title (Com C §2312(1));
- Warranty against infringement (Com C §2312(3));
- Warranty of merchantability (Com C §2314); and
- Warranty of fitness for a particular purpose (Com C §2315).

For discussion of the application of the implied warranty of merchantability, see *American Suzuki Motor Corp. v Superior Court* (1995) 37 CA4th 1291, 44 CR2d 526 (owners of sport utility vehicles not entitled to assert breach of implied warranty of merchantability because vast majority of vehicles had not been involved in rollover accidents; vehicles therefore fit for their ordinary purpose).

Other implied warranties may arise from the parties' course of dealing or their trade usages. Com C §2314(3). The agreement may also contain express warranties. See Com C §2313. See generally California UCC Sales and Leases, chap 3 (Cal CEB 2002).

For further discussion of warranties, see §§7.5-7.15.

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§15.32 2. Warranty Disclaimers

The parties are free to exclude or modify implied warranties (see form in §15.33), as long as they follow Commercial Code rules.

The warranty of title can be excluded or modified only by specific language in the agreement or by circumstances that give the buyer reason to know that the seller is conveying a limited title. Com C §2312(2). The warranty against infringement can be excluded or modified by agreement. Com C §2312(3).

Different rules apply to excluding or modifying the implied warranties of merchantability and fitness for a particular purpose. Here, the parties must comply with Com C §2316.

- To exclude or modify the implied warranty of merchantability, the word "merchantability" must be used and, if the exclusion is put in writing (although it need not be), it must be made conspicuous (Com C §1201(10)) by, *e.g.,* using larger type or a contrasting color. Com C §2316(2).
- To exclude or modify the implied warranty of fitness for a particular purpose, the words "fitness for a particular purpose" need not be used, but the exclusion must be by a writing and conspicuous. The words "There are no warranties that extend beyond the description on the face of this product" are sufficient to exclude all implied warranties of fitness. Com C §2316(2).
- Unless circumstances indicate otherwise, all implied warranties are excluded by expressions like "AS IS" or "WITH ALL FAULTS." Com C §2316(3)(a). Although not expressly required by the statute, these words too should be conspicuous.

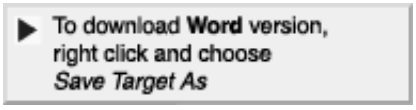
NOTE: An "AS IS" disclaimer does not exclude the warranty of title or the warranty against infringement. These warranties must be excluded by language expressly referring to them.

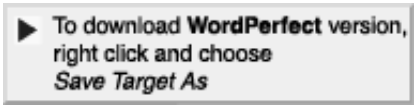
Whether a word or a phrase is conspicuous depends on the circumstances. Words are not automatically conspicuous simply because they are capitalized and in boldface print; the issue is whether, all things considered, a reasonable person would have noticed the word or phrase. Factors to consider are the sophistication of the parties, the circumstances of the negotiation and signing, and whether the section heading adequately describes the disclaimer. *Sierra Diesel Injection Serv. v Burroughs Corp.* (9th Cir 1989) 890 F2d 108; *Dorman v International Harvester Co.* (1975) 46 CA3d 11, 120 CR 516.

For additional discussion of warranty disclaimers, see §§7.10-7.13; California UCC Sales and Leases §§3.53-3.61 (Cal CEB 2002).

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§15.33 3. Form: Disclaimer of Sales Warranties





15.33-1 Disclaimer of sales warranties

___. Disclaimer of Sales Warranties.

[*Add one of the following alternatives*]

[*Alternative 1: "As is" disclaimer of warranties of merchantability and fitness*]

_ _[*E.G., THE EQUIPMENT*]**_ _ IS BEING SOLD TO BUYER ON AN "AS IS" AND "WHERE IS" BASIS. EXCEPT AS SPECIFICALLY SET FORTH IN THIS AGREEMENT, SELLER MAKES NO OTHER REPRESENTATIONS OR WARRANTIES.**

[*Alternative 2: Specific disclaimer of warranties of merchantability and fitness*]

SELLER HAS NOT MADE AND DOES NOT MAKE ANY WARRANTY OR REPRESENTATION WHATSOEVER, EITHER EXPRESS OR IMPLIED, ABOUT THE CONDITION, MERCHANTABILITY, DESIGN, OR OPERATION OF _ _[*E.G., THE EQUIPMENT*]**_ _, OR ITS FITNESS FOR ANY PARTICULAR PURPOSE, OR THE QUALITY OR CAPACITY OF THE MATERIALS IN _ _**[*E.G., THE EQUIPMENT*]**_ _ OR WORKMANSHIP IN _ _**[*E.G., THE EQUIPMENT*]**_ _; NOR ANY OTHER REPRESENTATION OR WARRANTY WHATSOEVER. THERE ARE NO WARRANTIES THAT EXTEND BEYOND _ _**[*THE DESCRIPTION ON THE EQUIPMENT/THOSE SET FORTH IN THIS AGREEMENT*]**_ _. _ _**[*E.G., THE EQUIPMENT*]**_ _ IS BEING SOLD TO BUYER ON AN "AS IS" AND "WHERE IS" BASIS.**

[*Alternative 3: Disclaimer of warranties of title and against infringement*]

SELLER DISCLAIMS:

(a) ALL WARRANTIES OF TITLE AND WARRANTIES OF SELLER'S RIGHT TO TRANSFER _ _[*E.G., THE GOODS*]**_ _;**

(b) ALL WARRANTIES THAT _ _[*E.G., THE GOODS*]**_ _ WILL BE FREE FROM SECURITY INTERESTS, LIENS, OR OTHER ENCUMBRANCES; AND**

(c) ANY WARRANTY THAT BUYER'S POSSESSION OF _ _[*E.G., THE GOODS*]**_ _ WILL NOT BE DISTURBED.**

IN ADDITION, SELLER MAKES NO WARRANTY THAT _ _[*E.G., THE GOODS*]**_ _ ARE OR WILL BE DELIVERED FREE OF ANY PERSON'S CLAIM OF PATENT, TRADEMARK, OR SIMILAR INFRINGEMENT. BUYER ASSUMES ALL RISKS (INCLUDING THE RISK OF SUIT) THAT _ _**[*E.G., THE GOODS*]**_ _, OR ANY USE OF _ _**[*E.G., THE GOODS*]**_ _, WILL INFRINGE EXISTING OR SUBSEQUENTLY ISSUED PATENTS, TRADEMARKS, OR COPYRIGHTS.**

Comment: Disclaimers should be written in conspicuous type.

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§15.34 4. Limiting Remedies for Breach of Warranty

In addition to excluding or modifying warranties, the parties may limit the remedies for breach of warranty. See Com C §2316(4). A limitation of remedies is distinct from a disclaimer; the parties may *disclaim* the implied warranty of merchantability and fitness for a particular purpose and *limit* the remedies for breach of an express warranty. Counsel should include disclaimer clauses and limitation clauses in two separate places in the agreement, to reduce the risk of confusion about whether, for example, a limitation of a remedy is intended to apply to only some of the warranties.

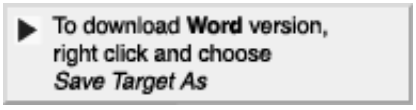
The parties may limit the remedies for breach of warranty through a clause liquidating or limiting damages (Com C §2718; see §§15.4-15.7) or modifying the remedies otherwise available (Com C §2719). For example, the parties may limit the buyer's remedies to return of the goods and repayment of the price or to repair and replacement of nonconforming goods or parts. Com C §2719(1)(a). If the limited repair or replacement remedy fails, however, the seller who does not repair or replace may be subject to any other remedy available to the buyer under the Commercial Code. Com C §2719(2). Some courts have construed this to mean that a limitation on consequential damages may be avoided or disregarded when the repair and replacement remedy fails. To avoid the possibility that the court will disregard a consequential damages limitation, the drafter should consider a "back-up" remedy in case the repair or replacement fails, such as refunding the purchase price or paying a stipulated sum as liquidated damages. See, *e.g., S.M. Wilson & Co. v Smith Int'l, Inc.* (9th Cir 1978) 587 F2d 1363. See also §15.6.

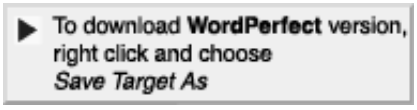
Remedy limitation provisions need not be conspicuous. Conspicuousness is a factor, however, when a clause is tested for unconscionability (see §15.36). *Computerized Radiological Servs. v Syntex Corp., supra*.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.35 5. Form: Limitation of Remedies for Breach of Warranty

§15.35 5. Form: Limitation of Remedies for Breach of Warranty





15.35-1 Limitation of remedies for breach of warranty

___*. Repair Or Replacement.* SELLER'S LIABILITY UNDER THIS AGREEMENT IS LIMITED TO REPAIRING OR REPLACING DEFECTIVE GOODS. HOWEVER, IF SELLER FAILS IN ITS ATTEMPT TO REPAIR THE DEFECTS, BUYER WILL BE ENTITLED TO A REFUND OF MONIES PAID TO SELLER UNDER THIS AGREEMENT.

___*. No Consequential Damages.* SELLER IS NOT BE LIABLE FOR BUYER'S LOSS OF PROFITS, BUSINESS GOODWILL, OR OTHER CONSEQUENTIAL DAMAGE, DESPITE ANY FAILURE TO REPAIR OR REPLACE THE GOODS. BUYER HAS ACCEPTED THIS RESTRICTION ON ITS RIGHT TO RECOVER CONSEQUENTIAL DAMAGES AS PART OF ITS BARGAIN WITH SELLER. BUYER REALIZES AND ACKNOWLEDGES THAT THE PRICE OF THE GOODS WOULD BE HIGHER IF SELLER WERE REQUIRED TO BE RESPONSIBLE FOR BUYER'S CONSEQUENTIAL DAMAGES.

Comment: The limitation should be written in conspicuous type. If the buyer is unsophisticated in legal matters, the seller should have the buyer initial both paragraphs (see §15.36).

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§15.36 6. Unconscionability

Courts may deny enforcement of unconscionable disclaimers and limitation of remedies for breach of warranty (particularly a limitation on consequential damages), even in commercial transactions. *A&M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114 (rejecting machinery seller's attempt to expressly disclaim warranties and thereby preclude recovery of consequential damages even though disclaimers technically complied with Com C §2316). See *Ilkhchooyi v Best* (1995) 37 CA4th 395, 45 CR2d 766 (provision requiring lessee to pay lessor portion of value of lessee's covenant not to compete held unconscionable under CC §1670.5). But see *Appalachian Ins. Co. v McDonnell Douglas Corp.* (1989) 214 CA3d 1, 262 CR 716 (distinguished *A&M Produce Co.* on its facts and held that disclaimer of warranty complying with Com C §2316 was enforceable). See also §15.6.

The Commercial Code does not define "unconscionability." The concept has generally been recognized to include an absence of meaningful choice for the party claiming unconscionability, together with contract provisions that are unreasonably favorable to the other party. Phrased another way, unconscionability has both a procedural and a substantive element. *Nagrampa v MailCoups, Inc.* (9th Cir 2006) 469 F3d 1257, 1280; *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 114, 99 CR2d 745; *Gatton v T-Mobile USA, Inc.* (2007) 152 CA4th 571, 579, 61 CR3d 344. The procedural element may be established if there was an inequality of bargaining power that resulted in no real negotiation and an absence of meaningful choice, or if the party seeking to enforce the contract used a long, wordy printed form in which the disputed provisions were buried; the substantive element may be met by inclusion of objectively unreasonable or unexpected provisions. *A&M Produce Co. v FMC Corp., supra*.

PRACTICE TIP: If the buyer is unsophisticated in legal matters, even in a commercial context, the seller should explain in the agreement, in lay terminology, the meaning of the implied warranties that are being excluded, and have the buyer initial this language as well as the disclaimer itself.

For further discussion of unconscionability, see §3.14. See also California UCC Sales and Leases §§18.69-18.71 (Cal CEB 2002).

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VI. PERSONAL PROPERTY LEASES

A. UCC Remedies

§15.37 1. Applicability of Commercial Code Division 10

Division 10 of the California Commercial Code applies to any transaction, regardless of form, that creates a lease. Com C §10102. (See Com C §10103(a)(10) for definition of "lease.") Because Division 10 (Leases) was adapted in large part from Division 2 (Sales), the rights and remedies of the lessor and lessee parallel those of the seller and buyer, respectively. There is relatively little case law interpreting Division 10 (or article 2A of the Uniform Commercial Code of other states); therefore, case law interpreting analogous provisions of Division 2 may be useful. See, *e.g., U.S. Roofing, Inc. v Credit Alliance Corp.* (1991) 228 CA3d 1431, 279 CR 533. See generally California UCC Sales and Leases, chap 19 (Cal CEB 2002).

For distinction between a lease and a security interest, see Com C §1201(b)(35); *Addison v Burnett* (1996) 41 CA4th 1288, 49 CR2d 132 (automobile lease did not create security interest under former Com C §1201(36) (now Com C §1201(b)(35))).

For further discussion, see California UCC Sales and Leases, chap 19 (Cal CEB 2002).

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§15.38 2. Finance Leases

If the lease is a "finance lease" as defined in Com C §10103(a)(7), the lessor acquires statutory rights not afforded other lessors. Generally, in a finance lease transaction (as defined in Division 10) the lessor is merely a financing entity; the lessor does not select, manufacture, or supply the goods. As a "finance lessor," the lessor does not make implied warranties of freedom from infringement, merchantability, or fitness for a particular purpose (Com C §§10211(b), 10212(a), 10213); risk of loss is transferred to the lessee (Com C §10219(a)); and, except for a finance lease that is a consumer lease, the lessee's promises under the lease contract are irrevocable and independent on its acceptance of the goods (the "hell or high water clause"). Com C §10407(a). However, to be conservative, most lessors include warranty disclaimers, risk of loss language, and a "hell or high water clause," in case the lease is found not to be a finance lease.

For further discussion, see California UCC Sales and Leases §§19.29-19.37 (Cal CEB 2002).

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§15.39 3. Remedies Available

Generally, Division 10 gives the parties flexibility in tailoring their rights and remedies if either the lessor or the lessee breaches the lease, while providing cumulative "fallback" remedies if the agreement remains silent on a given issue. Com C §§1302(b)-(c), 10501(b). Commercial Code §10508 describes in general terms the lessee's remedies when the lessor is in default; Com C §10523 describes the lessor's remedies when the lessee is in default.

The rights and remedies in Division 10 may be restricted or modified by the parties (Com C §10503(a)), subject to certain limitations such as good faith and unconscionability (*e.g.,* Com C §10503(b)-(c)). Damages may also be liquidated, subject to similar limitations and the requirements of CC §1671. Com C §10504; see §§15.4-15.5 for discussion of liquidated damages.

Like Division 2, Division 10 gives the lessee the right to recover incidental and consequential damages on the lessor's default (Com C §10520), subject to limitation by agreement of the parties. Com C §10503. The lessor is entitled to incidental, but not consequential, damages on the lessee's default. Com C §10530. See §15.6 for discussion of consequential damages.

For further discussion, see California UCC Sales and Leases §19.39 (Cal CEB 2002).

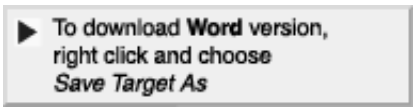
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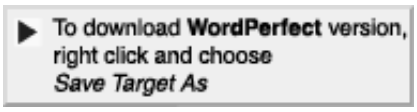
§15.40 4. Present Value

Several sections of Commercial Code Division 10 involve the concept of "present value." See, *e.g.,* Com C §§10518-10519, 10527-10529. Present value, simply stated, is the current value of a future payment, or series of payments, discounted at some compound or discount rate. See Com C §10103(a)(21). The amount of discounting is determined by the interest rate specified by the parties. If that rate is manifestly unreasonable, a court will apply a "commercially reasonable rate." Com C §10103(a)(21). The parties should specify the discount rate at the time the agreement is signed, to prevent a dispute over what is a "commercially reasonable rate." From the lessor's point of view, a low but reasonable discount rate is advantageous and may avoid the court's imposition of a higher rate, such as the prevailing prime rate.

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§15.41 5. Form: Remedies in Equipment Lease Agreement





15.41-1 Remedies in equipment lease agreement

___. *Lessor's Remedies on Default.* On the occurrence of any Event of Default and, as long as it continues, at any time after that Event of Default, Lessor may, in its sole discretion, do any one or more of the following, with or without notice to Lessee:

(a) Cancel this Lease and any other agreement between Lessor and Lessee;

(b) Declare all Rent and other sums payable under this Lease immediately due and payable;

(c) Take possession of the Equipment, wherever found, with or without legal process, thereby terminating Lessee's right to its possession, and require Lessee to assemble the Equipment and make it available to Lessor at the premises of Lessee or Lessor or other place to be designated by Lessor that is reasonably convenient to both parties. For this purpose, Lessor or its agent(s) may enter any premises of the Lessee or its agent(s), or any premises under their control, without liability for suit, action, or other proceeding by Lessee (any damages occasioned by this repossession is waived by Lessee);

(d) Proceed by appropriate court action to enforce performance by Lessee of this Lease; and

(e) Exercise any other right or remedy that may be available to it under Division 10 of the California Commercial Code or any other applicable law or in equity (it being understood that the occurrence of any Event of Default will substantially impair the value of this Lease to Lessor, entitling Lessor to exercise all rights and pursue all remedies available to it under Division 10).

___. *Waiver of Rights to Hearing.* Lessee hereby waives any and all rights to a judicial hearing before Lessor's repossession of the Equipment under this section.

___. *Cancellation of Lease.* A cancellation of this Lease occurs only on notice by Lessor and only on items of Equipment as Lessor specifically elects to cancel, and this Lease continues in full force and effect as to any remaining items.

___. *Repossession of Termination of Lessee's Rights.* In the event of any repossession or other termination of Lessee's rights under this Lease, Lessor may either re-lease the Equipment or any portion of it on the terms and to the persons as Lessor may elect, or sell the Equipment or any portion of it at public or private sale, without demand or notice of sale to Lessee, or presence of Lessee at the place of sale, to the fullest extent permitted by law. If the Equipment is sold, leased, or otherwise disposed of, Lessee will be liable to Lessor for, and Lessor may recover from Lessee any amounts that under the terms of this Lease may be then due or that may have accrued to the date of termination of this Lease, and Lessor may also recover from Lessee as damages for loss of the bargain and not as a penalty, whichever of the following amounts is applicable:

(a) If the Equipment is re-leased by Lessor, an amount equal to the excess of (X) the present value, at the time of termination, of the entire unpaid balance of all rentals for the Equipment that would otherwise have accrued from the date of termination to the end of the term of this Lease, over (Y) the then present value of the rentals that Lessor reasonably estimates to be obtainable for the Equipment during that period under a lease similar to this Lease; or

(b) If the Equipment is sold by Lessor, an amount equal to the excess, if any, of (X) the Casualty Value of the Equipment, determined as of the date of termination, over (Y) the net proceeds received by Lessor from the sale of the Equipment; together with any damages and expenses, including reasonable attorney fees, that the Lessor sustained by reason of the re-lease, sale, or the breach of any covenant, representation, or warranty in

this Lease, less any expenses saved as a consequence of the Lessee's default.

___. *Present Value of Future Rent.* For purposes of computing damages, the present value of all future Rent or any other amounts as of any particular date will be discounted at a rate equal to the discount rate of the Federal Reserve Bank of San Francisco plus ___ percent as of that date.

[*If appropriate, add*]

___. *Cure of Default.* Except for the payment of Rent and other sums required to be paid under this Lease, if Lessee provides Lessor with evidence in writing of actions taken by Lessee to cure any Event of Default, then, subject to Lessor's written consent (which consent may not be unreasonably withheld), Lessee may extend the time to cure an Event of Default for an additional period as may be reasonably necessary, acting with diligence and continuity, to cure the Event of Default.

[*Continue*]

___. *Single Recovery.* This Lease may not be interpreted as permitting Lessor to obtain more than a single recovery of the amount of Lessor's damages. No right or remedy may be exercised by Lessor that results in a duplication of payment to Lessor, whether at the time of exercise or subsequently.

Comment: This form is designed for a simple personal property lease transaction in which the parties intend to rely on the general remedies provided in the Commercial Code. It will ordinarily be combined with other remedies provisions such as a clause that the rights and remedies are cumulative, not exclusive (see §§15.27-15.28), and a power of attorney in favor of the lessor (see chap 23). Counsel should consult Division 10 to confirm that these general remedies do not need to be limited, modified, or expanded. Com C §10503.

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B. Warranties

§15.42 1. Comparison With Division 2 Warranties

Commercial Code Division 10 provides lessees with warranty rights similar to those that Division 2 provides to buyers. See generally Com C §§10211(a) (quiet enjoyment), 10211(b) (warranty against infringement), 10212(a)-(b) (implied warranty of merchantability), and 10213 (implied warranty of fitness).

Like Division 2 warranties, Division 10 warranties may be disclaimed as long as the disclaimer is in writing, is conspicuous, and otherwise complies with Division 10 (*e.g.,* to disclaim the implied warranty of merchantability, the disclaimer must mention "merchantability"). Com C §10214. The parties may also limit the remedies for breach of warranty (Com C §§10503(a), 10519(d)). Compare those sections with CC §1955 (except as otherwise agreed in leases for a term of more than 20 days, the lessor must secure the lessee's quiet enjoyment and put the leased property into a condition fit for the purpose for which it is leased). The lessor is of course responsible for any express warranties that it creates. Com C §10210.

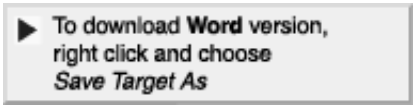
The benefit of the supplier's promises and warranties, even when made to the lessor, automatically extend to the lessee in a finance lease. Com C §10209(a). Nonetheless, it is prudent, particularly for the lessee's attorney, to provide for an explicit assignment of the supplier's promises and warranties from the lessor to the lessee. See form in §15.44.

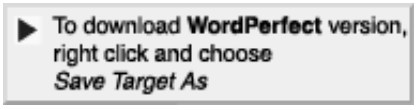
For further discussion, see California UCC Sales and Leases §§19.32, 19.40, 19.60-19.62 (Cal CEB 2002).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.43 2. Form: Disclaimer of Leasing Warranties

§15.43 2. Form: Disclaimer of Leasing Warranties





15.43-1 Disclaimer of leasing warranties

___. Disclaimer of Leasing Warranties. **LESSEE ACKNOWLEDGES THAT:**

LESSOR IS NOT (a) THE MANUFACTURER OF THE EQUIPMENT, OR (b) THE MANUFACTURER'S AGENT, OR (c) A DEALER IN THE EQUIPMENT; THE EQUIPMENT IS OF A SIZE, DESIGN, CAPACITY, DESCRIPTION, AND MANUFACTURE SELECTED BY THE LESSEE; LESSEE IS SATISFIED THAT THE EQUIPMENT IS SUITABLE AND FIT FOR ITS PURPOSES; AND LESSOR HAS NOT MADE AND DOES NOT MAKE ANY WARRANTY OR REPRESENTATION WHATSOEVER, EITHER EXPRESS OR IMPLIED, ABOUT THE CONDITION, MERCHANTABILITY, DESIGN, OR OPERATION OF THE EQUIPMENT, OR ITS FITNESS FOR ANY PARTICULAR PURPOSE, OR THE QUALITY OR CAPACITY OF THE MATERIALS IN THE EQUIPMENT OR WORKMANSHIP IN THE EQUIPMENT; NOR ANY OTHER REPRESENTATION OR WARRANTY WHATSOEVER. THERE ARE NO WARRANTIES THAT EXTEND BEYOND _ _[*THE DESCRIPTION ON THE EQUIPMENT/THOSE SET FORTH IN THIS LEASE*]**_ _. THE EQUIPMENT IS BEING LEASED TO LESSEE ON AN "AS IS" AND "WHERE IS" BASIS.**

Comment: This paragraph will ordinarily be sufficient to disclaim all warranties otherwise available to the lessee under Division 10 other than the warranty against interference (quiet enjoyment) and infringement. To disclaim these warranties, the language must specifically mention them. Com C §10214(d). This paragraph is typically used when the lessor is a finance lessor, *i.e.,* not the manufacturer or supplier of the equipment, even though the Commercial Code excludes these warranties (except for quiet enjoyment) in finance leases. See §15.32 on what constitutes a "conspicuous" disclaimer.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.44 3. Form: Assignment of Warranty Rights in Equipment Lease Agreement

§15.44 3. Form: Assignment of Warranty Rights in Equipment Lease Agreement

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15.44-1 Assignment of warranty rights in equipment lease

___. *Assignment of Warranty Rights.* Lessor assigns to Lessee any and all of Lessor's rights of warranty, if any, against the manufacturer of the Equipment, whether arising under the purchase contracts for the Equipment or implied by applicable law.

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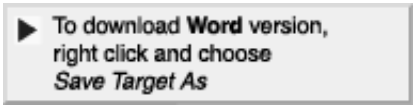
VII. LOAN AND SECURITY AGREEMENTS

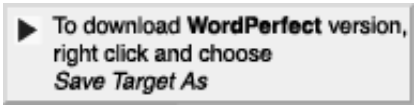
§15.45 A. General Remedies, Including Acceleration

In commercial loan agreements, the lender commonly has a right to accelerate the loan when the borrower defaults. Commercial Code §1309 applies a "good faith" requirement to provisions allowing the lender to accelerate payment or performance. The burden of establishing lack of good faith is on the party against whom the power has been exercised. Com C §1309. Courts are split on whether "good faith" should be evaluated under an objective standard of reasonableness or under a purely subjective test. See generally *Watseka First Nat'l Bank v Ruda* (Ill 1990) 552 NE2d 775. A lender must take affirmative action to notify the borrower of its intent to accelerate the loan even if the terms of the note or loan agreement do not require notice as a prerequisite to acceleration. This notice must be clear and unequivocal. *Beal Bank v Crystal Props., Ltd*. (*In re Crystal Props., Ltd*.) (9th Cir 2001) 268 F3d 743, 750.

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§15.46 B. Form: Acceleration





15.46-1 Acceleration

___. *Acceleration of Loan.* On the occurrence of any Event of Default specified in paragraphs _ _[*specify*]**_ _ _ _**[*relating to voluntary or involuntary bankruptcy and similar proceedings*]**_ _, the Commitment will be immediately and automatically terminated and the Loan and all other amounts payable by Borrower to Lender under this Agreement and the Note are immediately due and payable without any action on the part of Lender, Borrower, or any other person, and, on the occurrence of any other Event of Default, Lender may by notice to Borrower (i) declare the Commitment to be terminated, whereupon it will be so terminated, (ii) declare the Loan and all other amounts payable by Borrower to Lender under this Agreement and the Note to be immediately due and payable, whereupon the same will become due and payable without further presentment, notice, demand, or protest, all of which are expressly waived, and/or (iii) exercise any or all of the rights and remedies available to Lender under this Agreement _ _**[*or under the Security Agreement*]**_ _ or at law or in equity, as Lender may elect in its sole discretion.**

Unless the loan has been accelerated, and except for the payment of principal and other sums required to be paid under this Agreement, if Borrower provides Lender with written evidence of action taken by Borrower to cure any Event of Default, then subject to Lender's written consent (which consent may not be unreasonably withheld or delayed), Borrower may extend the period to cure the Event of Default as may be reasonably necessary, provided Buyer acts with diligence and continuity, to cure that Event of Default.

Comment: The first paragraph is a standard remedies provision found in most commercial loan agreements. If the transaction is also a secured loan, the rights and remedies in the security agreement must also be considered (see §§15.51-15.53). The second paragraph is nonstandard. Many borrowers are not in a strong enough negotiating position to obtain such a provision. For additional language extending the period to cure defaults, see §14.9.

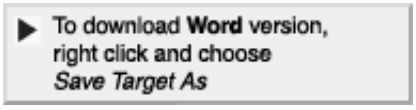
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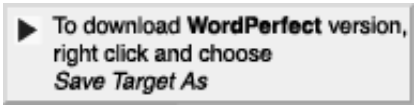
§15.47 C. Attornment

Sometimes a borrower will enter into a lease or other agreement with a third party. If the borrower defaults under that agreement, the borrower's lender may wish to intervene and cure the borrower's default to protect the lender's own interests (*e.g.,* the lender's interest in the borrower's property used as collateral for the loan). It is prudent for the lender to obtain an agreement in advance from the third party that it will accept the cure tendered by the lender. The third party's agreement is called an "attornment."

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§15.48 D. Form: Attornment





15.48-1 Attornment

___. *Attornment.* **_ _**[*E.g., The Bank*]**_ _ may, but is not obligated to, cure any default or breach of the _ _**[*e.g., Borrower*]**_ _ under the Lease. The Lessor agrees to accept any cure tendered by the _ _**[*e.g., Bank*]**_ _, as though tendered by the _ _**[*e.g., Borrower*]**_ _.**

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§15.49 E. Setoff

Loan agreements commonly allow the lender (if it is a bank) to set off and apply any deposits held by it for the account of the borrower against loan payments owed by the borrower. In addition, the lender wants to be certain that any loan payments it receives from the borrower are not subject to any counterclaim, right of setoff, or other claim that the borrower may have against the lender. See §15.50 for an example of a provision that accomplishes both goals.

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§15.50 F. Form: Setoff

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15.50-1 Setoff

___. *Setoff.* This Agreement does not limit any rights that Lender has by law to set off and apply deposits held by Lender at any of its offices to or for the credit or the account of Borrower against any and all of Borrower's obligations then due and payable under this Agreement or the Note.

The due payment and performance of Borrower's indebtedness, liabilities, and obligations under the Note and this Agreement are without regard to any counterclaim, right of setoff, or any other claim that Borrower may have against Lender and without regard to any other obligation of any nature that Lender may have to Borrower, and no counterclaim, setoff, or claim may be asserted by Borrower in any action, suit, or proceeding instituted by Lender for payment or performance of Borrower's indebtedness, liabilities, or obligations under the Note, this Agreement, or otherwise.

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§15.51 G. Secured Transactions

Division 9 of the Commercial Code applies to any transaction that creates a security interest in personal property or fixtures, and also to any sale of accounts, chattel paper, payment intangibles, or promissory notes. Com C §9109(a). Division 9 does not apply to "true leases." (See Division 10; see also §§15.37-15.44). Special rules apply when the security agreement covers both real and personal property. Com C §9604. See generally California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 9 (4th ed Cal CEB 2009). If the collateral involves investment securities, counsel must also consult Division 8 of the Commercial Code.

Chapter 6 (Com C §§9601-9629) sets forth the rights and remedies of a secured creditor after default. (Note that the Commercial Code does not define default; see chap 14 for suggested default provisions.) Under the Commercial Code, secured creditor remedies include judicial action (Com C §9601(a)); exercising collection rights (Com C §9607); taking possession of the collateral (Com C §9609); disposing of the collateral without judicial process (Com C §9610); or retaining the collateral in full or partial satisfaction of the obligation (Com C §9620). (In a consumer transaction, however, the secured creditor may not retain the collateral in partial satisfaction of the debt. Com C §9620(g).) Additional remedies may be provided by the security agreement. See §15.52.

If the security agreement so provides, and in any event, after default, the secured party may require the debtor to assemble the collateral and make it available to the secured party at a place to be designated by the secured party that is reasonably convenient to both parties. Requiring the debtor to assemble the collateral is a useful remedy, particularly if the collateral is widely dispersed. See, *e.g., Clark Equip. Co. v Armstrong Equip. Co.* (5th Cir 1970) 431 F2d 54.

The secured party is entitled to reimbursement for the reasonable expenses of retaking, holding, and preparing the collateral for disposition. To the extent provided in the agreement and not prohibited by law, the secured party is also entitled to reasonable attorney fees and legal expenses incurred. Com C §9615(a)(1).

Ordinarily, the secured party is entitled to a deficiency if the debtor defaults (see Com C §§9608(a)(4), 9615(d)(2); Secured Transactions in California Commercial Law Practice, chap 5 (2d ed Cal CEB 2001). In certain transactions, however, the loan obligation is "nonrecourse" to the debtor, *i.e.,* in a default (other than a breach of a representation or warranty) the secured party may proceed against the collateral only and may not look to the debtor for any deficiency. See form in §15.53.

For a comprehensive discussion of remedies available to a secured party, see Secured Transactions in California Commercial Law Practice, chap 5 (2d ed Cal CEB 2001).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.52 H. Form: Secured Party's Remedies on Default

§15.52 H. Form: Secured Party's Remedies on Default

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15.52-1 Secured party's remedies

___. Secured Party's Remedies on Default.

(a) If an Event of Default occurs and continues uncured, Secured Party may, without demand or notice of any kind (except as required by law), exercise any rights and remedies available to it under applicable law or in equity, including, without limitation, any or all of the following actions:

(1) personally, or by agents or attorneys (subject to compliance with any applicable mandatory legal requirements), take immediate possession of any or all of the Collateral, and for that purpose Secured Party may pursue the Collateral where it may be found, and enter any of Debtor's premises, with or without notice, demand, process of law, or legal procedure if this can be done without breach of the peace. If the premises where any portion of the Collateral is located are not under Debtor's direct control, Debtor will exercise its best efforts to ensure that Secured Party is promptly provided right of access to those premises, and to the extent Debtor's consent would otherwise be required before a right of access could be granted, Debtor irrevocably grants that consent. Debtor further irrevocably consents to Secured Party's taking possession of any other personal property located in or on the Collateral, and without liability for its care or safekeeping, placing that property in storage at Debtor's risk and expense;

(2) require Debtor, and Debtor be obligated and liable to Secured Party, to assemble the Collateral and make it available to Secured Party at a place to be designated by Secured Party that is reasonably convenient to both parties (it being acknowledged that Debtor's premises is reasonably convenient to Debtor);

(3) without removing the Collateral, render the Collateral unusable and dispose of the Collateral on Debtor's premises in accordance with paragraph (b) below;

(4) require Debtor to notify, at its own expense, any parties obligated on or with respect to any of the Collateral and to direct those parties to make payment to Secured Party of any amounts due or to become due;

(5) bring suit or proceedings in equity, at law or in bankruptcy, and whether for the specific performance of any covenant in this Agreement or in execution or aid of any power granted in this Agreement, for foreclosure, for the appointment of a receiver or receivers for the Collateral or any part of it, for recovery of judgment for the indebtedness, or for enforcement of any other proper, legal, or equitable remedy available under applicable law;

(6) take control of any Proceeds; and

(7) exercise all rights and remedies of a secured party under the California Commercial Code (regardless of whether that Code or similar law has been enacted in the jurisdiction where the rights or remedies are asserted).

(b) Without limiting the generality of the foregoing, if an Event of Default occurs and continues, Secured Party, without demand of performance or any other demand, advertisement, or notice of any kind (except the notice specified below of time and place of public or private sale) to or on Debtor or any other person (each and all of which demands, advertisements, or notices are hereby expressly waived), may sell, lease, or otherwise dispose of the Collateral or any part of it. Disposition may occur in any manner permitted by applicable law or by contract, in one or more parcels at public or private sale or sales, at the prices as Secured Party may deem best, for cash or on credit and on those other terms as Secured Party may determine in good faith to be commercially reasonable, or for future delivery without assumption of any credit risk.

Secured Party may bid and become the purchaser at any public auction and, if the Collateral is customarily sold on a recognized market or is the subject of widely distributed standard price quotations, at any private sale.

If Secured Party is the purchaser, it may use the amount of any indebtedness of Debtor then due and payable to it as a credit against the purchase price.

Unless the Collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, Secured Party will give Debtor reasonable written notice of the date, place, and time of any public sale, or the date and time after which any private sale or any other intended disposition is to be made. The requirements of reasonable notice will be met if notice is sent by certified mail, return receipt requested, to Debtor at the address shown in this Agreement at least 10 days before the date of any public sale or before the date on or after which any private sale or other disposition of the Collateral is to be made.

A sale of the Collateral may be held at any place designated in the notice (whether or not it is the location of any of the Collateral); the sale may be adjourned from time to time by announcement at the time and place appointed for the sale, and an adjourned sale may be held without further notice at the time and place announced.

Secured Party will apply the net Proceeds of any sale, lease, or other disposition to the payment in whole or in part of the Obligations of Debtor to Secured Party, in the order and priority provided by the Loan Agreement, after first deducting all reasonable costs and expenses of every kind incurred in, or incidental to, the retaking, holding, preparing for sale, or selling, leasing, or otherwise disposing of the Collateral and all other costs and expenses incurred by Secured Party in connection with the exercise of its rights and remedies under this Agreement, including reasonable attorney fees and legal expenses, and after the payment by Secured Party of any other amount required by any provision of law, including California Commercial Code §9615(a)(3) and (a)(4). Any surplus remaining will be paid to Debtor.

If any deficiency remains on the unpaid balance of principal of or interest on the Obligations after application of the Proceeds of the disposal of the Collateral as provided in this Agreement, then Debtor remains liable for payment, on demand, for the full amount of that deficiency. To the extent permitted by applicable law, Debtor waives all claims, damages, and demands against Secured Party, arising from the repossession, retention, or sale of the Collateral.

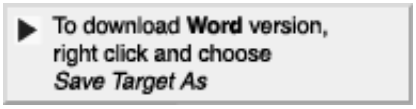
If Secured Party has proceeded to enforce any right under this Agreement by foreclosure, sale, entry, or otherwise, and those proceedings have been discontinued or abandoned for any reason, or have been determined adversely, then, and in every case, Debtor and Secured Party will be restored to their former positions and rights with respect to the Collateral.

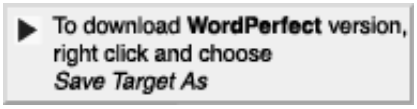
Comment: This form is designed for general use in a security agreement involving collateral such as equipment. Depending on the collateral and the circumstances of the parties, the secured creditor is advised to include other rights and remedies—in particular, a power of attorney to endorse any checks, drafts, or other writings to allow collection of the collateral.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.52A I. Form: Secured Party's Remedy on Default When Collateral Is Privately Held Stock

§15.52A I. Form: Secured Party's Remedy on Default When Collateral Is Privately Held Stock





15.52A-1 Secured party's remedy when collateral is privately held stock

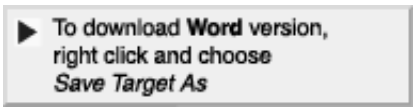
___. *Secured Party's Remedies on Default.* If any one or more Events of Default occurs and is continuing, then Secured Party has the rights and remedies with respect to all or any part of the Collateral and its proceeds as are provided by the Uniform Commercial Code and any other rights and remedies with respect to the Collateral that it may have at law, in equity, or under this Agreement. In any sale of any of the Collateral, whether at a foreclosure sale or otherwise, Secured Party is authorized to comply with any limitation or restriction in connection with the sale as it may be advised by counsel is necessary in order to avoid any violation of any applicable federal or state securities law (including compliance with any procedures that may restrict the number of prospective bidders and purchasers, require that prospective bidders and purchasers have certain qualifications, or restrict prospective bidders and purchasers to persons who will represent and agree that they are purchasing for their own account for investment and not with a view to the distribution or resale of the Collateral), or in order to obtain any required approval of the sale or of the purchaser by any governmental authority. Compliance will not result in the sale being considered or deemed not to have been made in a commercially reasonable manner, nor will Secured Party be liable or accountable to Debtor for any discount allowed by reason of the fact that the Collateral is sold in compliance with any limitation or restriction.

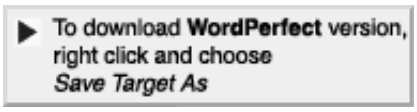
Comment: Because of securities law requirements, a secured party may need to place restrictions on the sale of collateral consisting of privately held stock, *e.g.,* limiting the sale to only "accredited investors." This form avoids any implication that such a restricted sale is not "commercially reasonable" for purposes of Com C §9610(b).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/15 Remedies/§15.53 J. Form: Nonrecourse Provision

§15.53 J. Form: Nonrecourse Provision





15.53-1 Nonrecourse provision

___*. Nonrecourse Provision.* Secured Party agrees that it will look solely to the Collateral and Proceeds of the Collateral's disposition for payment and performance of the Obligations, provided that nothing in this Section limits or precludes any rights or remedies Secured Party may have against Debtor because of any breach by Debtor of any of its representations or warranties in this Agreement.

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16

Dispute Resolution Procedures

Palmer Brown Madden
Justene M. Adamec

I. CHECKLIST: MECHANICS FOR RESOLVING DISPUTES §16.1

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  - 4. Provisions to Bind Parties Foreign to Agreement
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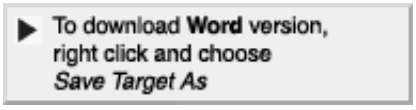
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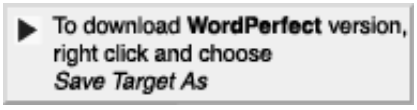
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§16.1 I. CHECKLIST: MECHANICS FOR RESOLVING DISPUTES





- Identify likely disputes
- Identify parties bound by dispute resolution procedure (see §§16.3-16.9)
- Parties related to signatories (see §16.4)
- Third party (see §16.5)
- Limits of the subject matter to be resolved by dispute resolution mechanism (see §16.10)
- Estimate cost and timing of different dispute resolution mechanisms for likely disputes
- Negotiation (see §§16.11-16.12)
- Mediation (see §§16.13-16.16)
- Arbitration (see §§16.17-16.41)
- Reference (see §§16.42-16.46)
- Litigation (see §§16.47-16.64)
- Selection of decision maker (see §§16.16, 16.30-16.35, 16.42, 16.46)
- Provisions for discovery (see §16.25)
- Waivers (see §§16.48-16.52)
- Jury trial (see §16.48)
- Statute of limitations (see §§16.50-16.51)
- Ordinary negligence (see §16.52)
- Location of dispute resolution proceeding (see §16.28)
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- Choice of law (see §§16.55-16.56)
- Attorney fees (see §§16.57-16.61A)
- Insurance (see §§16.62-16.63)
- Indemnity (see §§11.13-11.39, 16.64)

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§16.2 II. LITIGATION OR ALTERNATIVE DISPUTE RESOLUTION?

Parties with a dispute can go to court and resolve their dispute according to general rules of civil procedure. As court congestion and the cost of litigation increase, however, parties are seeking methods of alternative dispute resolution ("ADR") as a means of resolving disputes. Alternative dispute resolution is often (but not always) quicker and less costly than litigation. Parties who decide to use ADR may choose a person of appropriate experience and skill to render a binding decision, which can reduce the uncertainties of litigation. Further, if the parties have an ongoing relationship—whether legal, business, personal, or a combination—solving disputes in a less formal setting may preserve, rather than destroy, that relationship.

The most common ADR methods are (1) contractually bound negotiation (see §§16.11-16.12); (2) mediation (Bus & P C §§465-471.5) (see §§16.13-16.16); (3) arbitration by private agreement or under statute (CCP §§1141.10-1141.31, 1280-1294.2) (see §§16.17-16.41); and (4) reference (CCP §§638-645.1) (see §§16.42-16.46). Whether the parties chose litigation or ADR, counsel should review issues of the location of the resolution process (including choice of forum and choice of law), attorney fees, and waivers. See §§16.48-16.61A.

Counsel advising clients to include an ADR mechanism in a contract should explain the differences among the various procedures. Counsel and client must assess the parties' needs, resources, and relationship to ascertain the best method and whether they should create customized rules that provide for more efficient dispute resolution than is offered by the court's general procedures.

PRACTICE TIP: Practitioners all too often fail to cover all possibilities when drafting ADR provisions in agreements. The result is expensive satellite litigation. If ADR is to be used, counsel should thoroughly consider the ramifications of this choice.

PRACTICE TIP: Counsel often provide for initialing of an alternative dispute provision in an agreement or a checkbox system for electing an alternative dispute resolution procedure. Counsel should take care that any such provision is properly completed, because any failure to do so may cause the provision to be unenforceable. See *Bushley v Credit Suisse First Boston* (9th Cir 2004) 360 F3d 1149.

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III. EFFECT OF DISPUTE RESOLUTION PROCEDURES

§16.3 A. Who Is Bound by Dispute Resolution Procedures?

The agreement should specify who is to be bound by the dispute resolution provisions. In addition to the parties to the agreement:

- Are persons related to a signatory to the agreement required to participate in the contractually established dispute resolution process?
- Should the procedure accommodate third parties who are not bound by the contract's dispute resolution provisions but are likely to be involved in a dispute?

These two questions are the most frequent cause of wasteful satellite litigation and raise the greatest potential for frustrating the parties' expectations. If the drafter has not specified who is bound by the agreement's dispute resolution procedure, the parties may be forced to litigate that issue in court before proceeding with arbitration. CCP §1281.2(c); *Retail Clerks Union v L. Bloom Sons Co.* (1959) 173 CA2d 701, 703, 344 P2d 51 (court must resolve whether alleged alter ego bound by arbitration provision). Accordingly, the dispute resolution provision should specify exactly who is bound by it.

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§16.4 1. Persons Related to Signatories

Generally, a party that is not a signatory of the agreement cannot be bound by the agreement's dispute resolution procedure. *American Builder's Ass'n v Au-Yang* (1990) 226 CA3d 170, 178, 276 CR 262. There are exceptions to this general rule if the nonsignatory has a preexisting relationship with a signatory. See *Michaelis v Schori* (1993) 20 CA4th 133, 24 CR2d 380 (employees of arbitrating party can enforce arbitration provision); *Keller Constr. Co. v Kashani* (1990) 220 CA3d 222, 225, 269 CR 259 (general partner bound by arbitration provision signed on behalf of limited partnership); *Harris v Superior Court* (1986) 188 CA3d 475, 233 CR 186 (employee acting on employer's behalf bound by employer's obligations under arbitration agreement).

NOTE: A forum-selection clause may be enforced against a nonsignatory who is "closely related to the contractual relationship." See *TAAG Linhas Aereas de Angola v Transamerica Airlines, Inc.* (9th Cir 1990) 915 F2d 1351, 1354 (third party beneficiary bound by forum-selection clause); *Net2phone, Inc. v Superior Court* (2003) 109 CA4th 583, 587, 135 CR2d 149. In contrast, enforcement of an arbitration clause against a nonsignatory requires more than a nonparty's connection to the contract. See, *e.g., Lee v Southern Cal. Univ. for Prof. Studies* (2007) 148 CA4th 782, 786, 56 CR3d 134 (class representative who did not sign arbitration provision not required to arbitrate even though some class members had signed arbitration provision); *Buckner v Tamarin* (2002) 98 CA4th 140, 143, 119 CR2d 489 (parent's arbitration agreement with medical providers did not bind adult daughters on their wrongful death claims); *Benasra v Marciano* (2001) 92 CA4th 987, 990, 112 CR2d 358 (corporate officer's signing of arbitration agreement in representative capacity does not require arbitration of personal claims); *Kaneko Ford Design v Citipark, Inc.* (1988) 202 CA3d 1220, 1229, 249 CR 544 (arbitration clause in contract between designer and third party not binding on property owner).

A nonsignatory is bound by an arbitration provision if the provision or the contract containing the provision is incorporated by reference into an agreement to which the nonsignatory is a party. *Slaught v Bencomo Roofing Co.* (1994) 25 CA4th 744, 30 CR2d 618. The court may amend an arbitration award to include an alter ego of the party to the arbitration. *Hall, Goodhue, Haisley & Barker, Inc. v Marconi Conf. Ctr. Bd.* (1996) 41 CA4th 1551, 49 CR2d 286.

Counsel should specify which parties potentially related to a signatory are and are not to be bound by the provision. See form in §16.7 for language specifying the parties to be bound.

NOTE: An arbitration award against a principal does not bind a guarantor. CC §2855.

NOTE: An appellate court has held that an arbitrator may enforce discovery orders against a nonparty, but the nonparty has a right to judicial review of the arbitrator's order. *Berglund v Arthroscopic & Laser Surgery Ctr. of San Diego, LP* (2008) 44 C4th 528, 532, 79 CR3d 370.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/16 Dispute Resolution Procedures/§16.5 2. Including Third Parties

§16.5 2. Including Third Parties

It is not always possible to bind all necessary third parties to a dispute to the resolution mechanisms of the agreement; some parties may not be signatories or related to signatories to the agreement. If it is likely that a party to a dispute would not be bound by the contractual dispute resolution procedure, then counsel and the parties to the contract must weigh the desirability of arbitration or mediation against the possibility of multiple proceedings.

EXAMPLE: An owner of real property and a contractor enter into a contract for the construction of a building. The construction contract has an arbitration clause. A dispute arises that involves a subcontractor who is not a party to the contract. The dispute between the owner and the contractor is arbitrable, but it is not possible to force a subcontractor who is involved in the dispute to be a party to the arbitration. As a result, the dispute must be both arbitrated and litigated.

The usual outcome of the failure to bind third parties to the arbitration agreement is expensive satellite litigation over efforts to stay either the arbitration or the litigation. See CCP §§1281.2, 1281.4; *Henry v Alcove Inv.* (1991) 233 CA3d 94, 284 CR 255 (arbitration stayed because of conflict with litigation). If arbitration is stayed, a substantial delay will probably ensue while the issues to be litigated are resolved in court, resulting in extra expense, the risk of inconsistent results in the two proceedings, and unexpected consequences. See *Thibodeau v Crum* (1992) 4 CA4th 749, 6 CR2d 27 (res judicata doctrine bars subsequent litigation of claim between defendant and third party that could have been asserted in prior arbitration).

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§16.6 3. Drafting Approaches to Bind Parties Foreign to Agreement

If it is likely that parties foreign to the agreement will be involved in future disputes, counsel should provide in the agreement that the party to the contract who enters into a separate contract with the third party will provide in that separate contract that the third party will participate in the dispute resolution mechanism established in the original agreement. See form in §16.8 for language binding third parties to the dispute resolution mechanism.

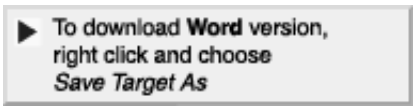
The parties foreign to the contract may be parties to a different contract containing an arbitration provision. If so, counsel should consider adding a provision covering consolidation of the arbitrations. See CCP §1281.3; form in §16.9.

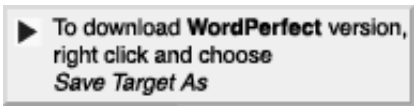
If it is not possible to ensure that parties foreign to the agreement will be bound to the dispute resolution mechanism set forth in the contract, the drafter should consider whether an ADR provision will unnecessarily complicate dispute resolution. It may be preferable to have all parties before a court than to have some parties before an arbitrator and others before a court.

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4. Provisions to Bind Parties Foreign to Agreement

§16.7 a. Form: Parties Bound





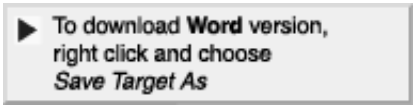
16.7-1 Parties bound

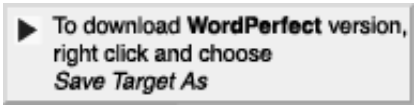
___. *Parties Who Will Be Bound by Agreement.* In addition to the signatories to this Agreement, _ _[*identify party to be bound, e.g., the general partner of the ABC partnership*]**_ _ will be bound by these dispute resolution procedures. No other party will be bound by these procedures.**

Comment: Counsel should provide a signature line for each party bound by the dispute resolution procedure. If a related party is bound *only* to the dispute resolution procedure, the signature line for that party should state "Only as to paragraph _ _ _ concerning dispute resolution."

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§16.8 b. Form: Binding Third Parties to Dispute Resolution Mechanism





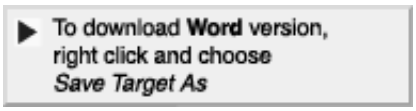
16.8-1 Binding third parties to dispute resolution mechanism

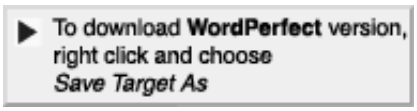
___. *Binding Third Parties to Dispute Resolution Procedures.* Each party to this Agreement will make its best effort to provide in any contract related to this Agreement that the parties to the related contract will participate in the dispute resolution procedure set forth in this Agreement. Each party to this Agreement will furnish proof to all other parties to this Agreement of the related agreement at the time of entering into that agreement. Any party failing to bind third parties to the dispute resolution procedure established by this Agreement shall indemnify, defend, and hold harmless the other party against all liability, claims, costs, loss, damage, settlement, and expense (including reasonable attorney fees, accounting fees, expert witness fees, costs, and expenses) _ _[*reasonably*]_ _ incurred because of that failure.

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§16.9 c. Form: Providing for Consolidation





16.9-1 Consolidation

___. *Consolidation of Arbitration.* To the maximum extent possible, any arbitration under this Agreement will be consolidated with any arbitration proceeding in which related issues are being resolved. The parties will take all action necessary or desirable to achieve consolidation.

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§16.10 B. What Disputes Are Covered by Alternative Dispute Resolution Procedure?

The dispute resolution provisions of the agreement should specify what types of disputes are covered by the procedure set forth in the contract. Because ADR is a matter of contract, the parties can agree to submit only certain disputes to negotiation, mediation, arbitration, or reference, reserving the right to litigate other disputes. *O'Malley v Wilshire Oil Co.* (1963) 59 C2d 482, 30 CR 452; *Coon v Nicola* (1993) 17 CA4th 1225, 21 CR2d 846 (contract to submit precontractual claims to arbitration enforced). However, if the court finds that there is no enforceable contract, the arbitration provision will be equally unenforceable. *Lopez v Charles Schwab & Co.* (2004) 118 CA4th 1224, 13 CR3d 544. In some situations, the parties may want to specify certain disputes for ADR and leave other disputes to be litigated. For example, the parties may expect that any disputes over pricing would relate only to the parties to the contract and would best be resolved through arbitration, while disputes over alleged defects could involve third parties foreign to the contract and would therefore more appropriately involve litigation. Sometimes time-sensitive issues are made arbitrable while other issues are not.

WARNING: Just as in litigation, if any claims fall within the scope of the arbitration clause but the injured party does not present them to the arbitrator, that party will be barred from subsequently raising those claims. *Thibodeau v Crum* (1992) 4 CA4th 749, 6 CR2d 27.

A general provision stating that the parties agree to resolve "all disputes regarding the contract" by arbitration may allow the parties to arbitrate contract claims but still litigate tort claims related to the contract. See *Tate v Saratoga Sav. & Loan Ass'n* (1989) 216 CA3d 843, 854, 265 CR 440. An agreement calling for arbitration of all claims "arising from or relating to the contract," however, leads to arbitration of both tort and contract claims. See *Berman v Dean Witter & Co.* (1975) 44 CA3d 999, 1003, 119 CR 130. If it is the parties' intent to arbitrate contract claims and litigate tort claims, it would be the better practice to state this precisely in the contract.

PRACTICE TIP: Applying different dispute resolution procedures to different claims can result in two or more proceedings for a single dispute, increasing the time and cost involved. Counsel and the parties must weigh these costs against the desire for a particular type of dispute resolution mechanism for different claims relating to the contract in deciding whether to have one or more forums available.

For form language submitting all or only specific issues to ADR, see §§16.12 (contractually required negotiation), 16.15 (mediation), 16.27, 16.29 (arbitration), and 16.47 (reference).

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IV. SPECIFIC METHODS OF ALTERNATIVE DISPUTE RESOLUTION

A. Contractually Required Negotiation

§16.11 1. General Principles

The parties may want to formally consult with each other before litigating or arbitrating a dispute. For example, the agreement could require that either (a) the parties set their claims out in writing, and provide all documents that support their claims, before going to litigation or arbitration; or (b) the parties negotiate in person before invoking any formal dispute resolution procedure. A provision requiring negotiation should specify who are to be parties to the negotiation.

PRACTICE TIP: As in formal dispute resolution procedures, the participants in the negotiations should have the authority to make binding decisions. It may therefore be useful to require the participation of a senior executive with decision-making power.

WARNING: In most business contexts, prompt resolution is crucial. If long time periods are provided for contractual negotiations, this procedure may be too time consuming to be workable.

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§16.12 2. Form: Formal Negotiation Process

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16.12-1 Negotiation process

___. *Negotiation Process.* Before invoking the dispute resolution mechanism set forth in Section _ _ of this Agreement, a party will serve on the other party to the Agreement (a) written notice of the claim, specifying the exact amount claimed and the provision of the Agreement or other authority for the claim; and (b) a copy of all supporting documents.

Within _ _[*e.g., 10 business days after service*]**_ _, the responding party will serve on the serving party (a) a written response, setting out its position and specifying the contract or other provisions relied on; and (b) a copy of all supporting documents.**

Within _ _[*e.g., 5 business days after service of the response*]**_ _, the parties will meet to discuss resolution of the claim. Each party may bring _ _**[*e.g., up to three people*]**_ _ to this negotiation _ _**[*, at least one of whom is a corporate officer who is not involved in the performance of this Agreement*]**_ _. The written claim notice and response and the documents produced, but not the subsequent discussion, are admissible in any subsequent proceeding. After negotiation, either party may _ _**[*litigate the dispute/invoke the dispute resolution procedure set forth in Section _ _ of this Agreement*]**_ _.**

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B. Mediation

§16.13 1. Description of Mediation

Mediation is a voluntary process involving an impartial third party who acts as a *facilitator*, not a decision maker, to help disputing parties reach a decision. Mediation procedures are not statutorily defined; parties relying on mediation choose the style of dispute resolution and the rules to be followed. Some dispute resolution services and organizations publish mediation rules.

Discussions during the course of mediation are generally inadmissible as evidence and not subject to discovery in any civil action or administrative proceeding unless the parties agree otherwise. Evid C §§1119(a), 1122. Similarly, the mediated agreement is generally inadmissible as evidence unless the agreement provides otherwise or the parties consent to its admissibility. Evid C §§1119(b), 1123, 1152.5(a)(2). The agreement is admissible, however, to show fraud, duress, or illegality. Evid C §1123(d), 1152.5(a)(5).

Several government and private nonprofit agencies conduct mediations on a sliding-scale fee basis, and these local agencies are a good source of information about the mediation process. Mediation services are also provided by small private companies and by larger organizations, such as the American Arbitration Association (AAA). Independent mediators sell their services by the hour or day. While many mediators are lawyers, nonlawyer mediators are also available. Some parties prefer nonlawyer mediators, believing that they are less focused on the law and more apt to conduct the proceedings like a business negotiation. Other parties favor lawyers because they want to enter mediation knowing the likely legal consequences of the dispute. Some participants prefer retired judges for their experience in deciding disputes.

For further discussion, see California Law of Contracts §§9.54-9.55 (Cal CEB 2007).

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§16.14 2. Contract Provisions for Mediation

The agreement should specify the mediation process and rules, if the parties have a preference. Specific matters may be excluded from mediation or, alternatively, matters subject to mediation may be identified. See §16.15.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/16 Dispute Resolution Procedures/§16.15 3. Form: Mediation Required

§16.15 3. Form: Mediation Required

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16.15-1 Mediation required

___. *Mediation Required.* Before invoking the binding dispute mechanism set forth in Section _ _ of this Agreement, the parties shall first participate in mediation of any dispute arising under this Agreement

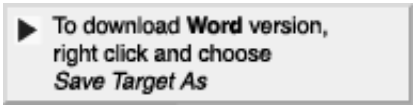
[*If appropriate, add*]

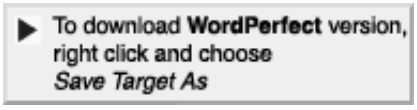
, other than controversies or claims relating to _ _[*specify excluded issues*]**_ _.**

Comment: For alternative clauses, see California Law of Contracts §§9.54-9.55 (Cal CEB 2007).

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§16.16 4. Form: Mechanics of Mediation





16.16-1 Mechanics of mediation

___. *Mechanics of Mediation.* The mediator will be _ _[*name or description of mediator*]**_ _ or, if _ _**[*he/she*]**_ _ is unavailable, then _ _**[*name or description of alternate mediator*]**_ _. The mediation will be held at _ _**[*location*]**_ _. The mediation will be conducted according to the rules of _ _**[*specify*]**_ _. The cost of mediation will be borne by the parties equally.**

At least _ _[*e.g., 10 business days*]**_ _ before the date of the mediation, each side shall provide the mediator with a statement of its position and copies of all supporting documents. Each party shall send to the mediation a person who has authority to bind the party. If a subsequent dispute will involve third parties, such as insurers or subcontractors, they shall also be asked to participate in the mediation.**

If a party has participated in the mediation and is dissatisfied with the outcome, that party may invoke the dispute resolution provisions in Section _ _ of this Agreement.

Comment: For alternative clauses, see California Law of Contracts §§9.54-9.55 (Cal CEB 2007).

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§16.17 C. Arbitration

Arbitration allows parties to resolve a dispute before a third party—the arbitrator—who hears and considers the evidence and then renders a final and binding decision. With rare exceptions, agreements to arbitrate must be in writing. See *Law Offices of Ian Herzog v Law Offices of Joseph M. Fredrics* (1998) 61 CA4th 672, 71 CR2d 771. The courts favor arbitration for its speed, economy, and ability to relieve the pressure on court calendars; public policy also strongly favors arbitration. *Madden v Kaiser Found. Hosps.* (1976) 17 C3d 699, 706, 131 CR 882. But see *Baar v Tigerman* (1983) 140 CA3d 979, 189 CR 834 (arbitration voided for arbitrator's failure to timely deliver award). An arbitration clause is enforceable unless grounds for revocation exist. CCP §1281. A clause may also be held unenforceable if the court finds that it was not called to the attention of the signatory. See *Metters v Ralphs Grocery Co.* (2008) 161 CA4th 696, 74 CR3d 210 (employee not bound by arbitration provision in document that did not appear to be a contract).

An arbitration clause may, but need not, prohibit the parties from resorting to civil litigation. See *Perry v Thomas* (1987) 482 US 483, 96 L Ed 2d 426, 107 S Ct 2520. Within the broad limits of due process, the parties may provide custom-crafted dispute resolution mechanisms. Compare *Graham v Scissor-Tail, Inc.* (1981) 28 C3d 807, 171 CR 604 (invalidating arbitration agreement when unfair procedure found) with *Dryer v Los Angeles Rams* (1985) 40 C3d 406, 220 CR 807 (enforcing arbitration agreement in adhesion contract). In *Discover Bank v Superior Court* (2005) 36 C4th 148, 30 CR3d 76, the supreme court held that under California law a provision waiving class-wide arbitration was unconscionable in a contract of adhesion under which individual consumers are cheated out of small sums of money. See *Independent Ass'n of Mailbox Ctr. Owners, Inc. v Superior Court* (2005) 133 CA4th 396, 34 CR3d 659 (striking ban on class-wide arbitration from franchise agreement). See also *Gatton v T-Mobile USA, Inc.* (2007) 152 CA4th 571, 579, 61 CR3d 344 (minimal degree of procedural unconscionability from adhesive nature of service contract and high degree of substantive unconscionability from class-wide arbitration waiver precluded enforcement of arbitration provision).

EXAMPLE: One type of customized arbitration is "baseball arbitration." In this type of arbitration, the agreement provides that before the arbitration each side make a last best offer that is not communicated to the arbitrator. Thereafter, whichever side's final offer is closest to the arbitrator's award becomes the final award.

The superior court may order nonbinding arbitration if the amount in controversy does not exceed $50,000 (CCP §1141.11) (but note the right to demand a trial de novo under CCP §1141.20). See A Litigator's Guide to Effective Use of ADR in California (Cal CEB 2005).

The Federal Arbitration Act (FAA) (9 USC §§1-16) provides that a party may enforce an arbitration provision in a transaction involving interstate commerce. 9 USC §2. The standard for "involving commerce" is as broad as the commerce clause. *Southland Corp. v Keating* (1984) 465 US 1, 79 L Ed 2d 1, 104 S Ct 852. The slightest nexus with interstate commerce has been held sufficient to bring the arbitration provision within the FAA. *Allied-Bruce Terminix Cos. v Dobson* (1995) 513 US 265, 130 L Ed 2d 753, 115 S Ct 834; *A.J. Taft Coal Co. v Randolph* (Ala 1992) 602 So2d 395. The FAA is applicable in both federal and state courts. *Moses H. Cone Mem. Hosp. v Mercury Constr. Corp.* (1983) 460 US 1, 25, 74 L Ed 2d 765, 786, 103 S Ct 927. A federal court must have subject matter jurisdiction to hear a petition to compel arbitration under the FAA. *Vaden v Discover Bank* (2009) ___ US ___, 173 L Ed 2d 206, 129 S Ct 1262. Application of the FAA may have a different effect than application of California's normal rules. Accordingly, counsel need to consider the FAA when advising clients.

For further discussion, see California Law of Contracts §§9.30-9.53 (Cal CEB 2007).

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§16.18 1. Advantages of Arbitration

Among the positive aspects of arbitration are the following:

- Arbitration is usually speedier than litigation, although some arbitration proceedings continue for years without resolution. See *Baar v Tigerman* (1983) 140 CA3d 979, 189 CR 834 (arbitration voided because of arbitrator's failure to timely deliver award). Speed can be ensured by requiring the arbitrator to submit a ruling within a specified time period.
- Arbitration is usually less expensive than litigation, but this is not always true. Essentially, the same preparations must be made for arbitration as for trial.
- Arbitration does not normally involve substantial discovery, which may simplify resolution of the dispute and lessen the cost of dispute resolution.
- Arbitration awards are not subject to time-consuming scrutiny by an appellate court.
- Experts knowledgeable about the issues in dispute (*e.g.,* architects, accountants) can serve as arbitrators.
- Arbitration can be conducted confidentially, avoiding public airing of trade secrets and other confidential matters.
- Arbitration follows less strict rules of evidence than court proceedings, *e.g.,* allowing the admission of hearsay, which may expedite resolution. See CCP §1282.2(d).
- Arbitrators have the power to make compromises in the dispute, giving each party some relief; in court, disputes must often be resolved entirely for one party or the other.
- Arbitrators, who are often compensated by the hour, do not have the same time pressures as a trial court judge to reach a decision and move on to the next case.

For further discussion, see California Law of Contracts §9.31 (Cal CEB 2007).

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§16.19 2. Disadvantages of Arbitration

Among the negative aspects of arbitration are the following:

- Arbitrators are free to follow broad principles of equity and need not follow the law. *Moncharsh v Heily & Blase* (1992) 3 C4th 1, 10 CR2d 183. They also have broad powers to define the appropriate remedy, and the remedy will not be set aside by the courts so long as it bears some rational relationship to the breach. *Advanced Micro Devices v Intel Corp.* (1994) 9 C4th 362, 381, 36 CR2d 581. A party who wants its dispute resolved in strict accordance with the law may be frustrated by arbitration.
- Arbitration awards are almost always final and not subject to effective judicial review. Even when available, judicial review does not extend to the merits of the dispute, the sufficiency of evidence to support the award, or the arbitrator's reasoning. CCP §1286.2; *Moncharsh v Heily & Blase, supra* (error of law apparent on face of complaint not reviewable); *Santa Clara-San Benito Chapter of Nat'l Elec. Contractors' Ass'n v Local Union No. 332* (1974) 40 CA3d 431, 437, 114 CR 909. Thus, if an arbitrator ignores a legal principle that should be controlling, the losing party has no recourse.
- In 2008, the California Supreme Court held that parties may contract for judicial review of the arbitrator's decision under the California Arbitration Act (CCP §§1280-1294.2). *Cable Connection, Inc. v DIRECTV, Inc.* (2008) 44 C4th 1334, 82 CR3d 229. The same is not true under the Federal Arbitration Act (9 USC §§1-16). *Hall St. Assocs., LLC v Mattel, Inc.* (2008) ___ US ___, 170 L Ed 2d 254, 128 S Ct 1396; *Christensen v Smith* (2009) 171 CA4th 931, 90 CR CR3d 57.

PRACTICE TIP: The clause in *Cable Connection* reads, "The arbitrators shall not have the power to commit errors of law or legal reasoning and the award may be vacated or corrected on appeal to a court of competent jurisdiction for any such error." 44 C4th at 1340. Absent an express provision for judicial review of any error, courts will not enforce a provision merely requiring that an arbitrator follow the law. See *Christensen v Smith, supra.*

- There is a risk associated with having a single trier of fact, rather than the collective judgment of 12 jurors. Moreover, there is no separation between a judge who rules on the law (including whether evidence is inadmissible) and a jury that rules on the facts; the arbitrator plays both roles.
- The general lack of discovery rights in arbitration may impede a party's ability to present its case. See CCP §1283.05 (limiting depositions). This lack can be especially harmful if there is substantial expert testimony but no opportunity to depose the expert.
- If third parties are a part of the dispute but cannot be brought into the arbitration, it may be better to have all parties appear before a court than to have some parties arbitrate while others litigate.
- Arbitration agreements can spawn expensive satellite litigation. See *Erickson, Arbuthnot, McCarthy, Kearney & Walsh, Inc. v 100 Oak St.* (1983) 35 C3d 312, 323, 197 CR 581 (alleged fraud in inducing contract does not make arbitration agreement invalid); *Stirlen v Supercuts, Inc.* (1997) 51 CA4th 1519, 60 CR2d 138 (arbitration provision in adhesion contract for employment unenforceable because unconscionable); *Henry v Alcove Inv.* (1991) 233 CA3d 94, 284 CR 255 (impact of arbitration on parties in dispute but not involved in arbitration); *C.V. Starr & Co. v Boston Reinsurance Corp.* (1987) 190 CA3d 1637, 236 CR 167 (party in pending court action not compelled to arbitrate).
- The speed of arbitration may work to the parties' detriment. If the parties are forced into arbitration too quickly, they may not have time to settle the dispute on their own.
- The parties will not have access to the court's settlement procedures.
- The arbitrator can award punitive damages unless they are excluded by agreement. *Rifkind & Sterling, Inc. v Rifkind* (1994) 28 CA4th 1282, 33 CR2d 828.
- Deciding to use arbitration does not eliminate completely the role of the courts. For example, unless the arbitration clause is self-executing, a party must petition the court to appoint an arbitrator. CCP §1281.2. Moreover, arbitrators' judgments are not self-executing. The prevailing party must move to confirm the award to

enforce a judgment. CCP §§1285-1287.6. There is also the risk that a party opposed to arbitrating a claim may challenge the duty to arbitrate by asserting that the contract was obtained by fraud that "permeates" the agreement (*King v Prudential-Bache Sec., Inc.* (1990) 226 CA3d 749, 755, 277 CR 214), or that the contract is unconscionable (*Graham v Scissor-Tail, Inc.* (1981) 28 C3d 807, 827, 171 CR 604), or on certain other limited grounds, *e.g.,* waiver of the right to arbitrate (*Engalla v Permanente Med. Group, Inc.* (1997) 15 C4th 951, 981, 64 CR2d 843).

For further discussion, see California Law of Contracts §9.32 (Cal CEB 2007).

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§16.20 3. Which Disputes Can Be Arbitrated?

Most contract disputes and tort claims may be arbitrated under California law. *Lewsadder v Mitchum, Jones & Templeton, Inc.* (1973) 36 CA3d 255, 111 CR 405. There are some limits, however, on the right to arbitrate:

- All arbitration provisions in contracts conveying real property must conform to certain requirements on the form of the provision (see CCP §1298), and parties cannot arbitrate claims for personal injury, wrongful death, or latent defects arising from real estate sales. CCP §1298.7. There is a question as to whether these limitations survive the Federal Arbitration Act (FAA) if there is any interstate commerce nexus. See *Doctor's Assocs., Inc. v Casarotto* (1996) 517 US 681, 134 L Ed 2d 902, 116 S Ct 1652.
- Dispute resolution procedures can be created in adhesion contracts (*Dryer v Los Angeles Rams* (1985) 40 C3d 406, 220 CR 807), but the court enforces the dispute resolution procedure only if it is fair. See *Murphy v Check 'N Go of Cal., Inc*. (2007) 156 CA4th 138, 145, 67 CR3d 120 (provision directing all claims to arbitrator, including claims of unconscionability, unenforceable); *Graham v Scissor-Tail, Inc.* (1981) 28 C3d 807, 171 CR 604 (provision calling for nonneutral arbitration not enforced); *Independent Ass'n of Mailbox Ctr. Owners, Inc. v Superior Court* (2005) 133 CA4th 396, 415, 34 CR3d 659 (consumers may argue that mandatory arbitration agreement fee provision is substantively unconscionable if it requires payment of unaffordable fees to initiate process); *Gutierrez v Autowest, Inc.* (2003) 114 CA4th 77, 7 CR3d 267; *Patterson v ITT Consumer Fin. Corp.* (1993) 14 CA4th 1659, 18 CR2d 563 (provision calling for out-of-state arbitration and fees disproportionate to amount at issue not enforced). But see *Painters Dist. Council No. 33 v Moen* (1982) 128 CA3d 1032, 181 CR 17 (arbitration provisions in adhesion contract enforced).
- A clause that appears unilateral by the language "I agree … to arbitrate" can be interpreted as mutual and therefore binding. *Roman v Superior Court* (2009) 172 CA4th 1462, 92 CR3d 153. However, in conjunction with other defects, such a clause may be held procedurally unconscionable. 172 CA4th at 1471, citing *Higgins v Superior Court* (2006) 140 CA4th 1238, 1253, 45 CR 293.

PRACTICE TIP: Although "I agree" may make the provision clearer to an unsophisticated signer, its use should be avoided in favor of more mutual language.

- The court will not enforce an arbitration provision if the party seeking enforcement has waived the right to arbitration. See *Davis v Blue Cross* (1979) 25 C3d 418, 158 CR 828 (defendant waived right to compel arbitration by acting in breach of obligation of good faith and fair dealing). But see *St. Agnes Med. Ctr. v Pacificare of Cal.* (2003) 31 C4th 1187, 8 CR3d 517 (merely beginning litigation does not waive right to arbitration).
- Challenges to the validity of the contract as a whole are not subject to arbitration under California law. *Green v Mt. Diablo Hosp. Dist.* (1989) 207 CA3d 63, 71, 254 CR 689. However, if the alleged illegality goes to only a portion of the contract that does not include the arbitration agreement, the entire controversy, including the issue of illegality, remains arbitrable. *Moncharsh v Heily & Blasé* (1992) 3 C4th 1, 30, 10 CR2d 183. In contrast, challenges under the FAA to the validity of a contract as a whole (see §16.17), and not specifically to the arbitration clause, must first go to the arbitrator and not the court. *Buckeye Check Cashing, Inc. v Cardegna* (2006) 546 US 440, 163 L Ed 2d 1038, 126 S Ct 1204. In *Buckeye*, the Supreme Court confirmed that (1) arbitration provisions are severable from the remainder of the contract as a matter of substantive federal arbitration law; (2) the issue of contract validity, unless the challenge is to the arbitration clause itself, must be considered by the arbitrator in the first instance; and (3) these rules apply in state as well as federal courts. 546 US at 445, 163 L Ed 2d at 1043. See *Southland Corp. v Keating* (1984) 465 US 1, 12, 79 L Ed 2d 1, 104 S Ct 852; *Prima Paint Corp. v Flood & Conklin Mfg. Co.* (1967) 388 US 395, 400, 18 L Ed 2d 1270, 87 S Ct 1801.
- The California Supreme Court has held that a petition to arbitrate cannot be denied because the statute of limitations has run on the claims that the parties had agreed to arbitrate. The statute of limitations is an affirmative defense that must be decided by the arbitrator. *Wagner Constr. Co. v Pacific Mechanical Corp.* (2007)

41 C4th 19, 24, 58 CR3d 434. But see *Freeman v State Farm Mut. Auto. Ins. Co.* (1975) 14 C3d 473, 1221 CR 477 (petition denied when applicable statute, Ins C §11580.2, imposed deadline for commencing arbitration). To avoid the outcome in *Wagner,* counsel should consider specifying a time limit to make an arbitration demand. See §§16.50-16.51.

- There is a continuing controversy over the use of arbitration derived from employment contracts. See, *e.g., Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 99 CR2d 745 (agreement must be substantively fair and set forth minimum standards for ensuring fairness); *Davis v O'Melveny & Myers, LLC* (9th Cir 2007) 485 F3d 1066 (availability of alternative employment did not prevent take-it-or-leave-it arbitration policy from being oppressive; opting out of arbitration meant declining further employment with defendant, and few employees are able to refuse employment because of arbitration agreement); *Parker v McCaw* (2005) 125 CA4th 1494, 1507, 24 CR3d 55 (*Armendariz*'s unconscionability rule inapplicable when substantial employment contract was negotiated by counsel rather than generic). But see *EEOC v Luce, Forward, Hamilton & Scripps* (9th Cir 2003) 345 F3d 742 (expressly allowing compulsory arbitration agreements in employment relationships). See also Advising California Employers and Employees, chap 20 (Cal CEB 2005).
- Courts will not enforce arbitration provisions if to do so would invalidate a statutory scheme, such as the Consumer Legal Remedies Act (CLRA) (CC §§1750-1756) or the Unfair Competition Law (UCL) (Bus & P C §§17200-17209). *Cruz v Pacific Care Health Sys.* (2003) 30 C4th 303, 133 CR2d 58.

PRACTICE TIP: When a party asserts a claim under the UCL seeking both injunctive and restitutionary relief and the dispute is subject to arbitration, the proper procedure is to sever the injunctive relief claim and compel arbitration of the restitutionary relief claim only. See *Aral v Earthlink, Inc.* (2005) 134 CA4th 544, 552, 36 CR3d 229 (discussing UCL). See also *Cruz v Pacific Care Health Sys.* (2003) 30 C4th 303, 133 CR2d 58 (discussing CLRA and UCL); *Broughton v Cigna Healthplans* (1999) 21 C4th 1066, 1088, 90 CR2d 334 (discussing CLRA).

- An agreement to arbitrate unwaivable public rights, whether statutory or nonstatutory, must meet the minimum standards of *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 99 CR2d 745, and not be unconscionable. *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 1076, 130 CR2d 892.

With few exceptions, however, the parties may create whatever dispute resolution process they desire. Because of the risks of a challenge to an arbitration provision in an employment or consumer contract, counsel should consider the alternative of a CCP §638 reference. See §16.42.

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§16.21 4. Contract Provisions for Arbitration

Counsel should set out the dispute resolution provision in large, bold type and require the other party to initial the provision, especially if the parties are not of equal bargaining power. Compare *Izzi v Mesquite Country Club* (1986) 186 CA3d 1309, 1318, 231 CR 315 (party's failure to read purchase agreement arbitration provision does not make it unenforceable), with *Spence v Omnibus Indus.* (1975) 44 CA3d 970, 119 CR 171 (criticizing arbitration provision buried in small type), and *Wheeler v St. Joseph Hosp.* (1976) 63 CA3d 345, 133 CR 775 (voiding arbitration provision not explained to hospital patient). See also *Higgins v Superior Court* (2006) 140 CA4th 1238, 1253, 45 CR 293 (specifically referring to fact that arbitration provision did not require initialing). Arbitration provisions in real estate contracts must include specific language, be in bold type, and be initialed by the parties. CCP §1298.

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§16.22 a. Commencing Arbitration

If the arbitration provision is not self-executing, CCP §§1280-1294.2 establish a simple process for starting an arbitration: One party files a petition to compel arbitration and, after a response to the petition is filed, makes a noticed motion to compel arbitration. The party may combine a petition to compel arbitration with a request for interlocutory relief, such as a temporary restraining order or writ of attachment. CCP §1281.8.

If the arbitration provision is self-executing, it is not necessary to go to court in order to start the arbitration. *King v Larsen Realty, Inc.* (1981) 121 CA3d 349, 354, 175 CR 226. To make the provision self-executing, it must provide:

- A method for selecting an arbitrator if one party refuses to participate;
- A procedure for going forward if the other party does not answer; and
- An agreement that the hearing may proceed without the other party.

See form in §16.28 for language of a self-executing arbitration provision.

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§16.23 b. Effect of Arbitration

Counsel should specify whether the arbitration is to be binding or nonbinding. If the parties want to use arbitration as a part of a settlement process, but also wish to retain the right to go to court, the arbitration should be nonbinding. See §16.27.

The agreement should specify the issues that the parties do and do not wish to arbitrate. The arbitrator may consider only the disputes covered by the arbitration agreement. *Mansdorf v California Physicians' Serv.* (1978) 87 CA3d 412, 151 CR 388. However, if the agreement expressly provides that the question of arbitrability will be submitted to arbitration, the arbitrator decides this question. In the absence of any such provision, the courts decide whether the dispute is arbitrable. *First Options of Chicago, Inc. v Kaplan* (1995) 514 US 938, 131 L Ed 2d 985, 115 S Ct 1920.

The arbitrator's award is not self-enforcing. If a party does not voluntarily perform as ordered by the arbitrator, the prevailing party may file a petition in the superior court to enforce the award. If the award is challenged, the court gives limited review to the arbitrator's award, considering any evidence of the arbitrator's misconduct, but does not review the award for errors of fact or law. *Moncharsh v Heily & Blase* (1992) 3 C4th 1, 10 CR2d 183. The court then either confirms the award and enters a judgment, which is enforced in the same manner as any civil judgment, or vacates the award. See CCP §§1285-1286 for enforcement of an arbitration award.

If arbitration is limited to contract breaches only, no punitive damages may be awarded. For arbitrations of other matters, the arbitrator may award punitive damages to the prevailing party, unless the parties agreed otherwise. See *J. Alexander Sec. v Mendez* (1993) 17 CA4th 1083, 21 CR2d 826.

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§16.24 c. Selection of Arbitrator and Arbitration Rules

Once the parties decide to provide for arbitration, they must decide what type of arbitrator they desire. Choosing the arbitrator in the agreement, or providing for a means to make the choice, reduces the tension inherent in selecting an arbitrator after a dispute arises. Unless the parties agree otherwise, arbitration is conducted by a single arbitrator. A minimum of 10 to 20 days should be allowed to select a single arbitrator. If requested, private arbitration services will submit a list of names from their panels. Providing that the arbitration will proceed under the rules of a particular organization, such as the American Arbitration Association (AAA), may be an agreement to more than one arbitrator. The AAA, for example, requires three arbitrators when the amount in dispute is over a certain amount.

Some questions the parties must address are the following:

- **Should there be a single arbitrator or a panel of arbitrators?** A panel, which brings several minds to the problem, is often perceived as more likely to reach a reasonable outcome. Also, having multiple arbitrators allows the panel to include attorneys as well as industry experts. It can be expensive to have a three-person panel with each side represented by counsel, however, and scheduling a quick hearing date may be more difficult. Some like the concept of two party arbitrators who collectively select a neutral arbitrator. But again, it can be quite expensive to have a three-person panel with each side represented by counsel.

PRACTICE TIP: The right to a specific number of arbitrators may constitute a substantial contractual right. In the context of resolving conflicting arbitration provisions in separately negotiated, unambiguous contracts, one court erred in ordering a consolidated arbitration proceeding before a single arbitrator when one contract required a three-arbitrator panel. *Parker v McCaw* (2005) 125 CA4th 1494, 1507, 24 CR3d 55.

- **Should the arbitrator or arbitrators be neutral?** It is not necessary that all the arbitrators be neutral. *Dinong v Superior Court* (1981) 120 CA3d 300, 174 CR 590 (two nonneutral arbitrators selected a third neutral arbitrator). Arbitrators do have a duty, however, to disclose any facts that might create an appearance of partiality. *Schmitz v Zilveti* (9th Cir 1994) 20 F3d 1043. Proposed arbitrators must make broad disclosures of potential conflicts, and must under certain circumstances disqualify themselves. CCP §§1281.9-1281.95.
- **What type of arbitrator do the parties desire?** The parties can select a retired judge, an attorney, a person who is in the same business as the parties (architect, accountant, etc.), someone else, or any combination of these.
- Several commercial arbitration services provide arbitrators. The American Arbitration Association (AAA) has long provided panels of arbitrators who can be lawyers, retired judges, or industry experts. The AAA has also instituted the "Large Complex Case Panel" program (LCCP), which uses well-regarded attorneys and judges and follows special rules tailored to complex disputes.
- Some services employ retired judges to serve as arbitrators. This option is preferred by parties who want arbitrators who have had judicial experience.

WARNING: Some services charge hourly for time in *and* outside the hearing, others charge by the number of parties involved, and still others charge only an administrative fee for the first day of a hearing (adding the arbitration fee for subsequent days). Counsel should review the fees charged to decide which of the services will be most appropriate. High costs can render an arbitration provision unconscionable. See generally *Kam-Ko Bio-Pharm Trading Co.-Australasia v Mayne Pharma (USA) Inc.* (9th Cir 2009) 560 F3d 935.

- If the dispute is likely to require the interpretation of an agreement, the parties may want the arbitrator (or one of the arbitrators) to be an attorney who is familiar with the particular type of agreement.
- Arbitrators who possess special expertise, such as architects or accountants, may understand the facts and issues better than generalists. If the parties want the arbitrators to have specialized knowledge, the agreement should state the minimum qualifications that the arbitrator must possess to eliminate needless haggling over an arbitrator's competence. Arbitrators who do not possess the relevant characteristics may not

be used absent agreement of the parties. Names of arbitrators meeting special requirements may be available through commercial arbitration services.

- **Do the parties want to name a particular person as arbitrator?** If so, counsel should make sure the selected party is willing and able to serve. Counsel should then provide a back-up mechanism to select an alternative arbitrator if the named person is unavailable. See forms in §§16.30-16.31 and 16.35 for language of back-up mechanisms.
- **What rules should apply?** The parties should consider designating in the agreement the type of rules that are to apply, *e.g.,* the AAA Commercial Arbitration Rules or AAA Construction Industry Rules. Designating the ground rules avoids the time and expense of arguments over procedure. The parties should ensure that the rules they choose do not create new problems. In *Harper v Ultimo* (2003) 113 CA4th 1402, 7 CR3d 418, for example, an arbitration clause that provided for arbitration under the rules of the Better Business Bureau without attaching them to the agreement was held procedurally unconscionable because those rules limited the claimant's recovery and the scope of the claims that could be pursued, and substantively unconscionable because the homeowners lacked even a theoretical possibility of being made whole. See California Law of Contracts §§9.33-9.37 (Cal CEB 2007).

PRACTICE TIP: If the parties wish to designate particular rules to govern the arbitration agreement, the agreement should clarify whether the rules that apply are those in effect at the time of the contract or those in effect at the time of the dispute. When dealing with parties of unequal bargaining power, it is good practice to specify that the applicable rules are those in effect at the time of the contract and to include a copy of those rules as an attachment to the agreement.

If the agreement does not provide for selecting an arbitrator, or if the parties do not agree to arbitrate after a dispute arises, or if the parties do not follow the method for selecting the arbitrator specified in the agreement, then a party may petition the court to appoint an arbitrator. The court will nominate five persons chosen from a list supplied jointly by the parties, by a government agency, or by a private disinterested association dealing with arbitration. The parties have 5 days after receiving notice of the nominees to select an arbitrator, either from the list or otherwise. If they do not make a selection, the court chooses the arbitrator from the list of nominees. CCP §1281.6.

NOTE: The parties can jointly ask the court to nominate arbitrators who have particular qualifications, such as experience in construction litigation or in drafting commercial leases.

See forms in §§16.30-16.35 for language describing the selection process.

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§16.25 d. Discovery in Arbitration

There is little right to prehearing discovery in arbitration, unless this issue is covered in the contract. See CCP §1283.05. In a dispute involving a claim for more than $50,000, however, one can demand a list of witnesses (including experts) and a list of documents to be introduced at the hearing. CCP §1282.2(a)(2)(A). Because the Code does not provide for significant discovery, all discovery is conducted as part of the arbitration process (*e.g.,* if a party wants to examine documents, they must be subpoenaed to the arbitration) unless the contract provides otherwise.

If the parties desire, they can provide for discovery rights with the assistance of the arbitrator. An arbitrator can also convene the arbitration for an exchange of documents and then recess it to give the parties the opportunity to examine the documents produced before proceeding further. Alternatively, the parties can provide for discovery in the agreement. CCP §1283.1(b). The most useful discovery typically involves an exchange of documents and some limited depositions. Some providers of arbitrators, such as JAMS, provide in their rules for certain discovery rights. See the JAMS rules.

NOTE: For arbitration of personal injury and wrongful death cases, the parties are conclusively presumed to have the same rights to take depositions and obtain discovery as are available in civil actions before the superior court (CCP §1283.05(a)), except that a party may take a deposition only if authorized by the arbitrator (CCP §1283.05(e)). For all other arbitrations, these rights must be incorporated in the agreement if they are to be available. CCP §1283.1.

See California Law of Contracts §9.37 (Cal CEB 2007).

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§16.26 e. Other Mechanics of Arbitration

The agreement can specify the procedure that the arbitrator must follow. For example, the parties may want the arbitrator to follow the rules of evidence as if the matter were being tried in a court, or to provide a reasoned statement of decision that sets out the basis for the award and that gives the parties an opportunity to comment. See §16.37. If the agreement specifies procedures, the court reviews the arbitrator's award to determine if the arbitrator followed the agreement. If the arbitrator does not follow the agreement, the award will be set aside. *Bonshire v Thompson* (1997) 52 CA4th 803, 60 CR2d 716.

PRACTICE TIP: Provisions that specify the arbitration procedure may spawn expensive satellite litigation and should be drafted carefully and only as necessary.

The parties may want to provide that the arbitration record will be kept confidential. This issue can be particularly important in a trade secret case.

The agreement can also specify a timeline for the arbitration. Short deadlines will spur all concerned to proceed in a timely manner, increasing the chances of achieving prompt resolution, but they also work against settlement. See §16.36.

WARNING: If the agreement specifies a deadline for the arbitrator's decision and the decision is not timely rendered, the effectiveness of the decision may be in doubt. The losing party may argue that the decision, being untimely, is beyond the arbitrator's jurisdiction and therefore void.

The agreement can specify the location of the arbitration, which is especially useful if the agreement is between parties from distant locations. This step avoids the possibility of disagreements over location after the parties are at loggerheads.

The agreement can specify that a court reporter transcribe the arbitration, and, if he or she does so, how payment of the reporter is to be allocated.

Witnesses other than parties appearing under subpoena are entitled to the same appearance fees and mileage as witnesses in superior court civil actions. Payment is made by the party that subpoenas the witness or, if the witness is subpoenaed by a neutral arbitrator, the responsibility for paying these costs is the same as that for paying the arbitrator's expenses. CCP §1283.2.

NOTE: No attorney fees can be awarded in arbitration unless a court could have awarded them; *i.e.,* attorney fees must be allowed by the agreement or by statute. *Thompson v Jespersen* (1990) 222 CA3d 964, 272 CR 132. See §§16.57-16.61A. Even if there is an attorney fees provision, the arbitrator has substantial discretion regarding whether to award fees. See *Moshonov v Walsh* (2000) 22 C4th 771, 94 CR2d 597; *Moore v First Bank of San Luis Obispo* (2000) 22 C4th 782, 94 CR2d 603.

The agreement must also provide for paying for the arbitration. A typical provision requires each party to pay a prorata share of the arbitration, with the arbitrator allocating the cost as part of the award. See forms in §§16.38-16.39. The agreement can also include a default provision to address the consequences if one party refuses to pay its share. See form in §16.39. If a party to an arbitration is unable to pay its share of the arbitration fees, under an agreement that incorporates AAA rules, an arbitrator has discretion to allow the arbitration to proceed on condition that the other party advances the remaining fees. *Lifescan, Inc. v Premier Diabetic Servs., Inc.* (9th Cir 2004) 363 F3d 1010.

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5. Forms for Starting Arbitration

§16.27 a. Form: Arbitration Required

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▶ To download **WordPerfect** version, right click and choose *Save Target As*

16.27-1 Arbitration required

___. *Arbitration Required.* The parties will submit all disputes relating to this Agreement (whether contract, tort, or both)

[*Add, if appropriate*]

, other than controversies or claims relating to _ _[*indicate excluded issues*]**_ _,**

[*Continue*]

to _ _[*binding/nonbinding*]**_ _ arbitration, in accordance with California Code of Civil Procedure §§1280-1294.2, as set forth in Section _ _ of this Agreement. Either party may enforce the award of the arbitrator under Code of Civil Procedure §1285. The parties understand that they are waiving their rights to a jury trial.**

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§16.28 b. Form: Beginning Arbitration—Self-Executing Arbitration Procedure; No Arbitrator Previously Selected

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16.28-1 Beginning arbitration

___. *Beginning Arbitration.* The party demanding arbitration will submit a written claim to the other party, setting out the basis of the claim and proposing the name of an arbitrator. The responding party has _ _[*e.g., 10 business days*]**_ _ in which to respond to this demand in a written answer. If this response is not timely made, or if the responding party agrees with the person proposed as the arbitrator, then the person named by the demanding party will serve as the arbitrator. If the responding party submits a written answer rejecting the proposed arbitrator then, unless the parties agree on an arbitrator,**

[*Add one of the following alternatives*]

[*Alternative 1: Either party may apply to court for arbitrator*]

either party may apply to the superior court for the appointment of an arbitrator. The superior court will propose five names. Each party may, within 5 days after receipt of the proposed names, strike _ _[*e.g., one name*]**_ _ from the list. Thereafter, the court will appoint as arbitrator a person whose name has not been struck from the list. The arbitrator is empowered to enter a default award if a party fails to participate in the arbitration.**

[*Alternative 2: Arbitration service will select arbitrator*]

on the request of either party, _ _[*e.g., the American Arbitration Association*]**_ _ will select an arbitrator.**

[*Continue*]

The arbitration will take place in _ _[*city and state*]**_ _, at a time and place selected by the arbitrator.**

Comment: On court appointment of arbitrators, see CCP §1281.6.

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§16.29 c. Form: Applicable Rules

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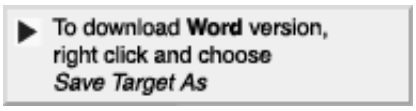
16.29-1 Applicable rules

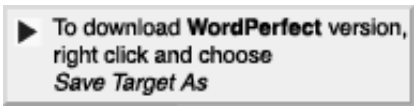
___. *Rules of Arbitration.* Any controversy or claim relating to this Agreement (whether contract, tort, or both), or the breach of this Agreement, will be arbitrated by and in accordance with the then existing arbitration rules of _ _[*name of arbitration service*]_ _ at their office in _ _[*specify location*]_ _. _ _[*Name of desired arbitrator*]_ _ will preside over these proceedings or, if _ _[*he/she*]_ _ is unavailable, the proceedings may be tried before another _ _[*name of arbitration service*]_ _ arbitrator as is acceptable to all parties. Failing agreement, the parties shall so notify _ _[*name of arbitration service*]_ _ and an arbitrator will be appointed.

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6. Form Provisions for Selecting Arbitrator

§16.30 a. Form: Predispute Selection of Arbitrator



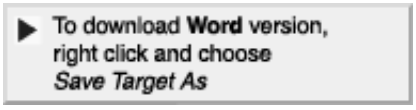


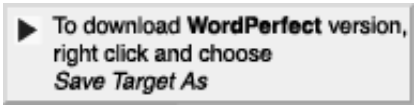
16.30-1 Predispute selection of arbitrator

___. *Name of Arbitrator.* The arbitrator will be _ _[*name of arbitrator*]**_ _. If for any reason _ _**[*he/she*]**_ _ is not available, a party may apply to the superior court for the designation of five possible arbitrators _ _**[*indicate qualifications, if desired*]**_ _. Each party may then strike _ _**[*e.g., two names*]**_ _ from the list within the next 5 days. The court will then appoint as arbitrator a person whose name has not been struck from the list.**

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§16.31 b. Form: Postdispute Selection of Arbitrator by Parties



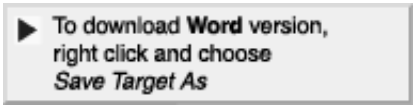


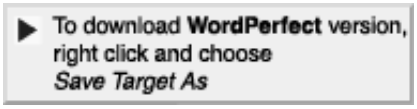
16.31-1 Postdispute selection of arbitrator

___. *Selection of Arbitrator.* Within _ _[*e.g., 10 business days*]**_ _ after a dispute subject to arbitration arises, the parties will select an arbitrator. If the parties are unable or unwilling to agree on an arbitrator within that time, each party will designate _ _**[*an arbitrator/a representative*]**_ _ within _ _**[*e.g., 5 business days*]**_ _ thereafter, and those two _ _**[*arbitrators/representatives*]**_ _ will designate _ _**[*a third arbitrator/the arbitrator*]**_ _ within _ _**[*e.g., 5 business days*]**_ _ after their designation. If either party fails to select _ _**[*an arbitrator/a representative*]**_ _ within the designated period, then on the request of either party, _ _**[*specify private arbitration service*]**_ _ will select that _ _**[*arbitrator/representative*]**_ _.**

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§16.32 c. Form: Qualifications





16.32-1 Qualifications

___. *Qualification of Arbitrator.* _ _[*The arbitrator/All arbitrators*]_ _ **will be** _ _[*e.g., lawyers/licensed/professional engineers/accountants/familiar with the semiconductor industry*]_ _**, and must have at least** _ _ **years' experience in his or her field.**

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§16.33 d. Form: List of Possible Arbitrators

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16.33-1 List of possible arbitrators

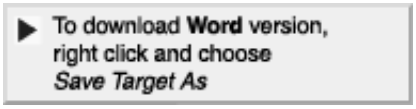
___. *List of Arbitrators.* Each arbitrator will be chosen from the following list: _ _[*Specify acceptable arbitrators*]**_ _.**

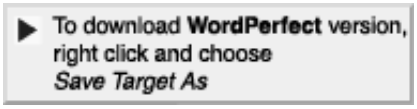
Comment: If a list is used, it should include enough potential arbitrators so that if some are unwilling or unable to serve, others will be available. If possible, counsel should first verify that the people listed are willing to serve.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/16 Dispute Resolution Procedures/§16.34 e. Form: Disclosure and Approval of Prior Relationship

§16.34 e. Form: Disclosure and Approval of Prior Relationship



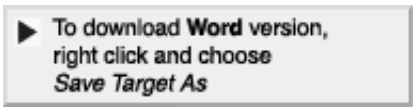


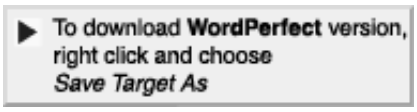
16.34-1 Disclosure and approval of prior relationship

___. *Disclosure of Prior Relationships..* No one who has ever had any business, financial, family, or social relationship with any party to this Agreement may serve as an arbitrator unless the related party informs the other party of the relationship and the other party consents in writing to the use of that arbitrator.

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§16.35 f. Form: Two-Party Arbitrators and Neutral Arbitrator





16.35-1 Two-party arbitrators and neutral arbitrator

___. *Designation of Arbitrator.* Within _ _[*e.g., 5 business days*]_ _ after a demand has been made to arbitrate the dispute, each party shall designate an arbitrator. Within _ _[*e.g., 5 business days*]_ _ thereafter, the two arbitrators will select a third arbitrator. If for any reason they cannot agree on a third arbitrator, they may apply to the superior court for the name of a neutral party. The three arbitrators will hear all the evidence, and a majority vote determines the award of the arbitrators.

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7. Forms for Mechanics of Arbitration

§16.36 a. Form: Timeline for Arbitration

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16.36-1 Arbitration timeline

___. *Timeline for Arbitration.* The demand for arbitration must be submitted in writing. The responding party shall serve any reply within _ _[*e.g., 10 business days*]**_ _. The parties will select the arbitrator within the next _ _**[*e.g., 15 business days*]**_ _. A prearbitration hearing will be held within the next _ _**[*e.g., 10 business days*]**_ _. The arbitration must be completed and a decision rendered within _ _**[*e.g., 60 calendar days*]**_ _ after the prearbitration hearing. The arbitrator will establish any deadlines necessary to accomplish this goal.**

Comment: Note that more time must be allowed for a three-arbitrator panel than for a single arbitrator.

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§16.37 b. Form: Requiring Arbitrator to Provide Written Decision

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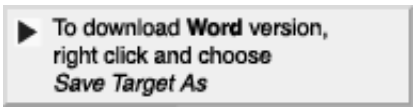
16.37-1 Arbitrator must provide written decision

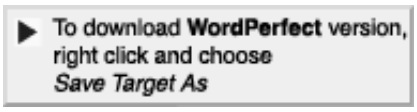
___. *Arbitrator to Submit Written Decision.* Within _ _[*e.g., 15 days*]**_ _ after completion of the arbitration, the arbitrator will submit a tentative decision in writing, specifying the reasoning for the decision and any calculations necessary to explain the award. Each party has _ _**[*e.g., 15 days*]**_ _ in which to submit written comments to the tentative decision. Within _ _**[*e.g., 10 days*]**_ _ after the deadline for written comments, the arbitrator will announce the final award.**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/16 Dispute Resolution Procedures/§16.38 c. Form: Payment of Arbitration Costs (Short Form)

§16.38 c. Form: Payment of Arbitration Costs (Short Form)



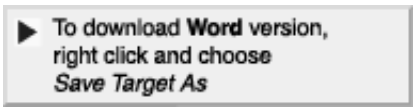


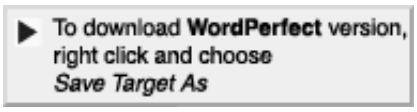
16.38-1 Payment of arbitration costs (short form)

___. *Payment of Arbitration Costs.* Before arbitration commences, each party shall pay the arbitrator half of the expected cost of the arbitration. At the conclusion of arbitration, the arbitrator may award the prevailing party some or all of the arbitration costs.

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§16.39 d. Form: Payment of Arbitration Costs (Long Form)





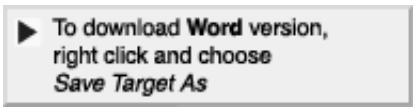
16.39-1 Payment of arbitration costs (long form)

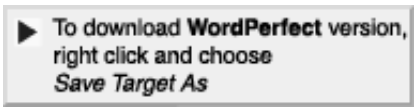
___. *Payment of Arbitration Costs.* Each party to the arbitration shall pay a prorata share of the arbitrator's expenses and fees, and the other arbitration expenses incurred or approved by the arbitrator, excluding attorney fees, witness fees, and other expenses incurred by a party for his or her own benefit. The parties must estimate their costs and pay their estimated share before commencement of the arbitration. Any extra arbitration costs will be paid within _ _[*e.g., 10 business days*]_ _ after the close of the proceeding and before the award. A party that fails to pay its share will not be allowed to participate in the arbitration. If a party fails to pay its share, the other parties shall pay pro rata the cost of the party that failed to pay. The arbitrator will add that payment to the final award in a manner as to return the parties to the position they would have been in, to the greatest extent possible, if all had paid their share.

The arbitrator may award the prevailing party his or her expenses and fees of arbitration, including reasonable attorney fees and witness fees, in whatever proportion the arbitrator decides.

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§16.40 e. Form: Limited Discovery in Arbitration



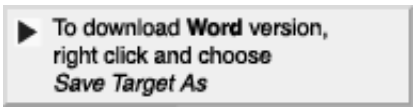


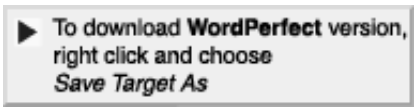
16.40-1 Limited discovery in arbitration

___. *Limited Discovery in Arbitration.* No more than _ _[*e.g., 30 calendar days*]**_ _ before the arbitration, a party may serve a document request calling for any document that would be discoverable in civil litigation. The party served with this request shall deliver the requested documents and any objections within _ _**[*5 business days*]**_ _. The arbitrator may resolve any dispute over the exchange of documents. Thereafter, each party may take no more than _ _**[*e.g., three*]**_ _ depositions, each of which will last no more than 4 hours each. The arbitrator may resolve any dispute over the depositions as they would be resolved in civil litigation.**

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§16.41 f. Form: Arbitrator's Powers





16.41-1 Arbitrator's powers

[*Add one of the following alternatives*]

[*Alternative 1: Statutory powers*]

___. *Arbitrator's Powers.* The arbitrator has the powers provided in California Code of Civil Procedure §§1282.2-1284.2.

[*Alternative 2: Enumerated powers*]

___. *Arbitrator's Powers.* The arbitrator has the following powers:

a. To issue subpoenas for the attendance of witnesses and subpoenas duces tecum for the production of books, records, documents, and other evidence;

b. To order depositions to be used as evidence;

c. To enforce the rights, remedies, procedures, duties, liabilities, and obligations of discovery as if the arbitration were a civil action before a California superior court;

d. To conduct a hearing on the arbitrable issues;

e. To administer oaths to parties and witnesses;

f. To enter and serve a written award within _ _[*e.g., 3 business days*]_ _ after the arbitration hearing is concluded; and

g. To correct the award on the grounds for correction stated in California Code of Civil Procedure §1286.6(a) and (c) within 10 days after serving a signed copy of the award on the party asking for correction.

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§16.41A g. Form: Judicial Review of Award

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16.41A-1 Judicial review of award

The arbitrators shall not have the power to commit errors of law or legal reasoning, and the award may be vacated or corrected on appeal to a court of competent jurisdiction for any such error.

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D. Reference

§16.42 1. Description of Procedure

The reference procedures in CCP §§638-645.1 combine features of arbitration and litigation. Parties to an agreement may agree to have the superior court appoint a referee to try some or all parts of a dispute. CCP §638.

There are two types of references: (1) general references (CCP §638), to which the parties consent, and (2) special references (CCP §639), which the court can impose on the parties in limited circumstances. The referee's report from a general reference is binding; the referee's report from a special reference is advisory. See *Ruisi v Thieriot* (1997) 53 CA4th 1197, 1208, 62 CR2d 766. A general reference referee's decision is submitted to a clerk of the superior court within 20 days after all testimony is heard (CCP §643), and the clerk, as an administrative matter, enters the judgment as if the matter had been tried by the court. CCP §644. Judgment is reviewable on appeal as if it were a superior court decision. CCP §645. This procedure allows parties to elect a process that combines a speedy initial resolution with the protection of appellate review. See Comment, *Private Means to Public Ends: Implications of the Private Judging Phenomenon in California*, 17 UCD L Rev 611 (1984).

The parties may agree to a reference after a dispute arises, or they may provide for reference in a written contract before any dispute occurs, in which event any party to the contract may move the court for an order directing reference. CCP §638. Even if all parties do not consent to a reference, a party may apply to the court for a reference or the court may order a reference on its own motion in specific types of cases (*e.g.,* accounting) for the convenience of the court. CCP §639. If the parties stipulate to the appointment of a specific individual as a temporary judge with powers exceeding those in §639 and that individual is unable to complete the proceedings, the court cannot substitute a different referee without the parties' consent. *Kim v Superior Court* (1998) 64 CA4th 256, 75 CR2d 468.

The reference provision may specify the source for the reference judge, such as (1) one of the private "rent-a-judge" companies, (2) a list of available retired judges maintained by a local court, or (3) a list of arbitrators maintained by a private arbitration organization. Parties may object to the appointment of a particular referee for lack of competence, actual or apparent conflict of interest, bias, or prejudice. CCP §641. If the parties cannot agree on a referee, the court will select one. CCP §640.

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§16.43 2. Advantages of Reference

Reference offers significant advantages for parties involved in a business dispute:

- There is no jury, yet one may obtain appellate review.
- The proceedings can be informal.
- A decision is rendered by an especially qualified person.
- The referee is not an arbitrator, but instead is required to follow the rules of evidence.
- The decision maker is focused on the referred matter.
- The proceedings are conducted during hours convenient for the parties.
- The cost of even an experienced decision maker is generally more than offset by the time saved if strict time limits are set at the start.

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§16.44 3. Disadvantages of Reference

The disadvantages of reference include the following:

- The cost of a private judge is substantial. Hours, and therefore expense, can add up quickly.
- The decision is an appealable order. CCP §645.
- The process is more formal than arbitration.

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§16.45 4. Costs of Reference

The reference procedure requires the parties to pay all costs, including the referee's compensation. The costs of reference should be balanced against the benefits of speed in resolving the dispute. The court may order the parties to pay the referee's fees (unless the referee is a court officer or employee) in any fair and reasonable manner, including apportionment among the parties, but the parties may agree in writing to a rate of compensation. CCP §§645.1, 1023. The parties must also bear the cost of a court reporter.

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§16.46 5. Form: Reference

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16.46-1 Reference

___. *Reference.* If any controversy or claim arises relating to this contract (whether contract, tort, or both)

[*Add, if appropriate*]

, other than controversies or claims relating to _ _[*specify excluded issues*]**_ _,**

[*Continue*]

either party may apply to the superior court for the appointment of a referee to hear the dispute in accordance with the California Code of Civil Procedure §§638-645.1. The parties have all rights of discovery permitted by the Code in civil litigation, except that the time periods may be shortened by agreement or by order of the referee, and the extent of discovery is also limited, with the goal of completing all discovery within _ _[*e.g., 60 calendar days*]**_ _. The referee must submit a reasoned statement of decision, citing both the law and the evidence relied on. After entry of judgment by the superior court, the judgment may be reviewed in the court of appeal under California Code of Civil Procedure §645.**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/16 Dispute Resolution Procedures/§16.47 V. LITIGATION

§16.47 V. LITIGATION

In the absence of alternative dispute resolution, litigation is the remaining avenue for resolving controversies that arise under or in connection with the agreement. General rules of civil procedure control how litigation will proceed, but some issues can be resolved by contract between the parties.

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A. Waiver of Rights

§16.48 1. Principles of Jury Trial Waiver

The California Supreme Court has held that predispute jury trial waivers are not allowed. *Grafton Partners L.P. v Superior Court* (2005) 36 C4th 944, 32 CR3d 5. The California Constitution states that the right to a jury trial may only be waived in a manner authorized by statute. See Cal Const art I, §16. Code of Civil Procedure §631 prescribes six ways to waive jury trial, each of which involves the court after a case has been filed. A predispute contractual jury waiver is not authorized. However, arbitration, which effectively waives a jury, is authorized by statute and is permissible. A mere waiver of jury, forcing a court trial, is not. *Grafton Partners L.P. v Superior Court, supra*.

Unless action by the legislature modifies *Grafton*, parties to contracts governed by California law should consider fair and conspicuous contract provisions requiring arbitration (see §§16.16-16.41) or judicial reference (see §§16.42-16.46) as alternatives to jury trial waiver provisions. See *Woodside Homes of Cal., Inc. v Superior Court* (2006) 142 CA4th 99, 104, 47 CR3d 683 (reiterating availability of judicial reference after *Grafton*).

In federal court, however, federal law determines whether the right to a jury trial may be waived by an advance agreement. The Ninth Circuit has held that a jury trial waiver is an enforceable contractual right, although these waivers are to be construed narrowly. *Paracor Fin., Inc. v General Elec. Capital Corp.* (9th Cir 1996) 96 F3d 1151, 1166 n21.

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§16.49 2. Form: Waiver of Jury Trial [Deleted]

This section has been deleted because predispute jury trial waivers are no longer allowed in California courts. See *Grafton Partners L.P. v Superior Court* (2005) 36 C4th 944, 32 CR3d 5, discussed in §16.48.

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§16.50 3. Shortening Statute of Limitations

The parties may agree to a private statute of limitations, provided that the period is not so short as to give a party undue advantage. *Fageol Truck & Coach Co. v Pacific Indem. Co.* (1941) 18 C2d 748, 753, 117 P2d 669; *Capehart v Heady* (1962) 206 CA2d 386, 388, 23 CR 851 (approving 3-month lease period). The provision should specify the types of actions (*e.g.,* tort, contract, or all) covered by the private statute, and whether any nonbinding negotiations, mediation, or other similar actions toll the effective date of the private or statutory statute of limitations. But see *Graham Oil Co. v ARCO Prod. Co.* (9th Cir 1994) 43 F3d 1244 (rejecting limit on punitive damages and short statute of limitations on grounds that they were inconsistent with Petroleum Marketing Practices Act).

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§16.51 4. Form: Private Statute of Limitations

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16.51-1 Private statute of limitations

___. *Private Statute of Limitations.* Despite any statute to the contrary, any claim arising from or relating to this Agreement (whether contract, tort, or both) must be brought within _ _[*specify time period*]**_ _ after it arises.**

[*Add, if appropriate*]

, provided that any _ _[*e.g., negotiations/mediation*]**_ _ undertaken by the parties under Section _ _ of this Agreement tolls the time period within which the claim must be brought.**

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§16.52 5. Miscellaneous Waivers

At least in arm's-length negotiations between parties of equal strength, the parties can agree to include other waivers or limitations:

- The parties can waive ordinary negligence. *Gardner v Downtown Porsche Audi* (1986) 180 CA3d 713, 716, 225 CR 757.
- The parties can waive merchantability or fitness for a particular purpose. Com C §§2314-2316. See §7.11.
- The parties can agree that goods or property will be taken "as is." *Lingsch v Savage* (1963) 213 CA2d 729, 29 CR 201.
- The parties can limit the amount of damages. *Wheeler v Oppenheimer* (1956) 140 CA2d 497, 499, 295 P2d 128. See §11.41.

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B. Choice of Forum

§16.53 1. General Principles

It may be advantageous to specify the location where disputes may be resolved. *Berard Constr. Co. v Municipal Court* (1975) 49 CA3d 710, 122 CR 825 (party may consent to personal jurisdiction).

A jurisdiction provision can be either mandatory and exclusive, requiring that any action be brought in the named forum, or permissive and inclusive, allowing the action to be brought in the named courts as well as any others where jurisdiction may lie.

Following are examples of mandatory forum selection clauses:

- "To the extent permitted by the applicable laws the parties elect Hamburg to be the place of jurisdiction." *Intershop Communications, AG v Superior Court* (2002) 104 CA4th 191, 198, 127 CR2d 847.
- "This Agreement shall be governed by the law of Ontario, Canada and any claims arising hereunder shall, at the Licensor's election, be prosecuted in the appropriate court of Ontario." *CQL Original Prods., Inc. v National Hockey League Players' Ass'n* (1995) 39 CA4th 1347, 1352, 46 CR2d 412.
- "Any appropriate state or federal district court located in the Borough of Manhattan, New York City, New York shall have exclusive jurisdiction over any case of controversy arising under or in connection with this Agreement." *Cal-State Business Prods. & Servs., Inc. v Ricoh* (1993) 12 CA4th 1666, 1672 n4, 16 CR2d 417.
- "Any and all litigation that may arise as a result of this Agreement shall be litigated in Dade County, Florida." *Lu v Dryclean-U.S.A. of Cal., Inc.* (1992) 11 CA4th 1490, 1492, 14 CR2d 906.

Following are examples of permissive forum selection clauses:

- "The courts of California, County of Orange, shall have jurisdiction over the parties in any action at law relating to the subject matter or the interpretation of this contract." *Hunt Wesson Foods, Inc. v Supreme Oil Co.* (9th Cir 1987) 817 F2d 75, 76.
- "The company has expressly submitted to the jurisdiction of the State of California and United States Federal courts sitting in the City of Los Angeles, California, for the purpose of any suit, action or proceeding arising out of this Offering." *Berg v MTC Electronic Technols. Co.* (1998) 61 CA4th 349, 357, 71 CR2d 523.

A mandatory forum selection clause is valid and enforceable, unless it is unreasonable, unjust, invalid because of fraud, duress, or other similar actions, or contravenes strong public policy of the forum in which the suit is brought. *Carnival Cruise Lines, Inc. v Shute* (1991) 499 US 585, 113 L Ed 2d 622, 111 S Ct 1522; *M/S Bremen v Zapata Off-Shore Co.* (1972) 407 US 1, 9, 32 L Ed 2d 513, 92 S Ct 1907; *Smith, Valentino & Smith, Inc. v Superior Court* (1976) 17 C3d 491, 496, 131 CR 374; *Patterson v ITT Consumer Fin. Corp.* (1993) 14 CA4th 1659, 18 CR2d 563 (rejecting forum selection clause in consumer contract on grounds of unconscionability).

Assuming it is reasonable, a mandatory forum selection clause usually will be upheld without any forum non conveniens analysis. By contrast, a permissive forum selection clause is subject to a traditional convenience analysis. The burden of proof is on the defendant, as the party moving to stay the action on forum non conveniens grounds. *Intershop Communications, AG v Superior Court* (2002) 104 CA4th 191, 127 CR2d 847.

In contrast to provisions regarding jurisdiction, a contractual provision specifying the venue of a future action on the contract is illegal and void because venue is a matter to be decided only by the courts, applying considerations of general convenience and expediency. *General Acceptance Corp. v Robinson* (1929) 207 C 285, 289, 277 P 1039; see CCP §395(c). This prohibition should not apply to contractual provisions specifying the location of alternative dispute resolution proceedings.

An alternative approach to jurisdiction, which is useful if the parties are located far apart and wish to reduce the likelihood of litigation, is a reciprocal forum selection clause specifying that the exclusive jurisdiction for any action is the jurisdiction in which the defendant is located.

Counsel can draft the forum selection clause to apply to both tort and contract claims. *Manetti-Farrow, Inc. v Gucci*

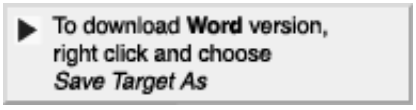
Am., Inc. (9th Cir 1988) 858 F2d 509, 514. The provision can also be imposed against third party beneficiaries. *TAAG Linhas Aereas de Angola v Transamerica Airlines, Inc.* (9th Cir 1990) 915 F2d 1351, 1354.

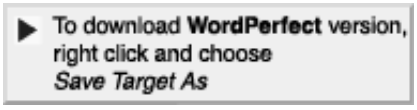
If a consent to jurisdiction clause is included in the agreement, the parties should designate an agent for receipt of process to avoid the inability of locating a potential defendant when litigation papers must be served. The party appointed as agent should accept the appointment in writing, if possible.

WARNING: Care should be taken that forum selection clauses do not adversely affect rights. In *Jones v Humanscale Corp.* (2005) 130 CA4th 401, 29 CR3d 881, an arbitration award was upheld even though the arbitrator erroneously applied out-of-state law, undermining the fundamental public policy in California to avoid enforcing noncompetition agreements.

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§16.54 2. Form: Choice of Forum





16.54-1 Choice of forum

___. *Choice of Forum.* Any dispute that arises under or relates to this Agreement (whether contract, tort, or both) will be resolved in _ _[*type of court, e.g., a superior court*]_ _ **in** _ _[*name of state*]_ _ **or** _ _[*indicate alternative dispute resolution mechanism, e.g., by way of an arbitration*]_ _ **in** _ _[*name of city and state*]_ _**.**

[*If applicable, add the following option*]

[*Option: Appointing agent for service of process*]

By executing and delivering this Agreement:

(a) _ _[*Name of first party*]_ _ **appoints** _ _[*e.g., CT Corporation System*]_ _ **at** _ _[*address*]_ _ **as its authorized agent for service of process, which appointment will not be revoked unless** _ _[*name of second party*]_ _ **consents in writing to the appointment of another agent for service of process.**

(b) _ _[*Name of second party*]_ _ **appoints** _ _[*e.g., CT Corporation System*]_ _ **at** _ _[*address*]_ _ **as its authorized agent for service of process, which appointment will not be revoked unless** _ _[*name of first party*]_ _ **consents in writing to the appointment of another agent for service of process.**

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C. Choice of Law

§16.55 1. General Principles

Under California law, a contract is interpreted according to the law of the place where it is to be performed or, if the place of performance is not indicated, the law of the place where the contract is made. CC §1646. For some disputes, the law of more than one state may apply. The parties may then agree, within limits, which laws will govern their relationship.

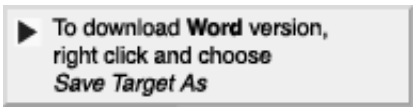
Choice of law provisions are generally enforceable. *Volt Info. Sciences, Inc. v Board of Trustees* (1989) 489 US 468, 103 L Ed 2d 488, 109 S Ct 1248 (upholding choice of California law instead of federal law); *Gamer v duPont Glore Forgan, Inc.* (1976) 65 CA3d 280, 135 CR 230 (upholding choice of law provision permitting interest rate legal in New York but in excess of California's usury law rate). They are also enforceable in adhesion contracts. *Bos Material Handling, Inc. v Crown Controls Corp.* (1982) 137 CA3d 99, 186 CR 740. However, state courts are not required to enforce contractual terms that are unconscionable or contrary to public policy under general contract law principles. *Discover Bank v Superior Court* (2005) 36 C4th 148, 166, 30 CR3d 76.

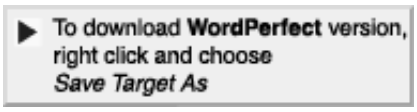
As a general rule, the law selected must be that of a state with substantial contact with the transaction. *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 465, 11 CR2d 330. A choice of law provision is enforceable if (1) either (a) the parties have a substantial relationship to the state or (b) there is some other reasonable basis, and (2) no fundamental policy of the state whose law would otherwise apply is violated. Incorporation within the designated state satisfies the first prong. *Hambrecht & Quist Venture Partners v American Med. Int'l, Inc.* (1995) 38 CA4th 1532, 46 CR2d 33. The parties may designate California law as controlling, however, even if there is no reasonable relationship between the contract and California, if the amount of the transaction exceeds $250,000 and the transaction is not for labor or personal services or personal, family, or household purposes, and application of California law is not contrary to Com C §1301(a), (c). CC §1646.5. Under the second prong of the test, a choice of law provision is unenforceable if it would permit enforcement of a contract clause diametrically opposed to a provision of California law reflecting a strong public policy. *Application Group, Inc. v Hunter Group, Inc.* (1998) 61 CA4th 881, 72 CR2d 73 (noncompetition clause in employment contract between Maryland corporation and California employee). In *ABF Capital Corp. v Grove Props. Co.* (2005) 126 CA4th 204, 214, 23 CR3d 803, the court refused to enforce a contractual choice of law clause designating New York law as controlling. Because the reciprocity of attorney fees in CC §1717 is considered a fundamental policy of the state of California, California's interest in ensuring that its residents are treated equitably with regard to attorney fee provisions outweighed New York's interest. *ABF Capital Corp. v Grove Props. Co*., *supra*.

WARNING: Failure to identify which state's law should govern may result in an expensive choice of law battle.

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§16.56 2. Form: Choice of Law





16.56-1 Choice of law

___. *Choice of Law.* This Agreement, and any dispute arising from the relationship between the parties to this Agreement, will be governed by _ _[*e.g., California*]_ _ law, _ _[*excluding/including*]_ _ any laws that direct the application of another jurisdiction's laws.

Comment: The parties must decide whether they want the controlling state's conflict of law rules to apply, and then include a provision applying or excluding those rules.

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D. Attorney Fees Provision

§16.57 1. General Principles

Absent either a contractual provision to the contrary or a statutory basis, each party must bear the cost of its own attorney. CCP §1021. Parties may specifically provide in the agreement that the prevailing party will be awarded reasonable attorney fees and costs. CC §1717. See also *Shannon v Northern Counties Title Ins. Co.* (1969) 270 CA2d 686, 688, 76 CR 7.

PRACTICE TIP: In general, the remedy of attorney fees is mutual as a matter of law; a provision authorizing the award of attorney fees to one party in an action on the contract is treated as authorizing an award to the prevailing party, preventing the oppressive use of one-sided attorney fee provisions. CC §1717(a); *Reynolds Metals Co. v Alperson* (1979) 25 C3d 124, 128, 158 CR 1. However, the remedy is not mutual in the face of a unilateral fee-shifting statute. For example, the Cartwright Act (see Bus & P C §§16720-16804) expressly authorizes the recovery of attorney fees only by prevailing plaintiffs. Bus & P C §16750(a). Therefore, a prevailing defendant cannot use an alternative contractual fee provision to claim entitlement to attorney fees for successfully defending Cartwright Act claims and non-Cartwright Act claims that overlap claims under the Act. *Carver v Chevron U.S.A., Inc.* (2004) 119 CA4th 498, 504, 14 CR3d 467 (distinguishing *Reynolds* as not involving conflicting contractual right to and statutory bar against attorney fees).

A nonsignatory who is sued on a contract as a party to it may obtain an award of attorney fees under CC §1717 if the plaintiff in the action would be entitled to attorney fees if the plaintiff had prevailed in enforcing the contractual obligation against the nonsignatory. *Reynolds Metals Co. v Alperson, supra*. See also *Dell Merk, Inc. v Franzia* (2005) 132 CA4th 443, 454, 14 CR3d 467 (nonsignatory customer suing general contractor not entitled to attorney fees because signatory lender not entitled to fees); *Real Prop. Servs. Corp. v City of Pasadena* (1994) 25 CA4th 375, 30 CR2d 536 (signatory sued by nonsignatory entitled to attorney fees because nonsignatory would have been entitled to fees if it had prevailed); *Montgomery v Bio-Med Specialties, Inc.* (1986) 183 CA3d 1292, 1295, 228 CR 709 (nonsignatory shareholders intervening in action against corporation for default on note containing attorney fees provision entitled to attorney fees because shareholders would have been liable to plaintiff for fees if action had succeeded); *Wilhite v Callihan* (1982) 135 CA3d 295, 301, 185 CR 215 (nonsignatory landholder who prevailed in suit by holder of deed of trust granted attorney fees on theory of "practical liability"). See also *Artesia Med. Dev. Co. v Regency Assoc.* (1989) 214 CA3d 957, 266 CR 657 (no attorney fees awarded because unlawful detainer action not contractual action); *Big Bear Mun. Water Dist. v Bear Valley Mut. Water Co.* (1989) 207 CA3d 363, 254 CR 757 (voluntary intervenor who would not have been liable for attorney fees if opposing party prevailed not entitled to attorney fees).

A court may determine which party (if any) prevailed on the contract and the amount of any attorney fees award, subject to certain statutory rules. CC §1717(a), (b)(1). The prevailing party is the one who recovers the greater relief in the contract action, unless the court finds that there is no prevailing party. CC §1717(b)(1). If a defendant claims to have tendered full payment, and deposits in court for the plaintiff the full payment amount, the defendant is the prevailing party if the court finds that full payment was tendered. CC §1717(b)(2).

The reciprocity of attorney fees in CC §1717 is considered a fundamental policy of the state of California. *ABF Capital Corp. v Grove Props. Co.* (2005) 126 CA4th 204, 214, 23 CR3d 803. As such, it cannot be altered by choosing the attorney fees statutory scheme of another state.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/16 Dispute Resolution Procedures/§16.58 2. Considerations for Attorney Fees Provision

§16.58 2. Considerations for Attorney Fees Provision

In deciding whether to include a provision for payment of attorney fees, counsel should consider the following:

- Is it likely that an attorney fees provision will favor one side? Landlords in commercial leases usually want to include an attorney fee provision, while developers of single-family homes usually do not.
- In a dispute, will the attorney fees provision stimulate litigation if, without this provision, the parties would be more likely to compromise?
- Is one party financially stronger than the other? If so, the deep-pocket party who can afford to litigate will have an advantage unless the other party has a chance to recover its attorney fees.
- Are disputes likely to be over small amounts of money? If so, an attorney fees provision may result in litigation over fees that are greater than the amount in dispute.
- Do the parties want to provide for attorney fees in some types of disputes, but not in others? This type of division is enforceable if both parties are represented by counsel and the contract recites that fact. CC §1717(a).
- Which party is more likely to breach the contract? That party would not want an attorney fees provision.

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§16.59 3. Drafting Attorney Fees Provisions

Counsel should consider the following when drafting an attorney fees provision:

- The provision could allow a party to make a settlement offer that, if rejected and not bettered at trial, shifts the risk of attorney fees. See form in §16.61.
- The provision should specify whether contract, tort, or all actions give rise to payment of attorney fees. See *Xuereb v Marcus & Millichap, Inc.* (1992) 3 CA4th 1338, 1342, 5 CR2d 154 (provision for attorney fees in litigation to which "this Agreement gives rise" held to provide fees in tort and contract actions). See form in §16.60.
- The provision should cover both future litigation of the claim as well as any cost of enforcing the judgment. See form in §16.60.
- The provision can also limit the availability of attorney fees depending on the procedure. *Kalai v Gray* (2003) 109 CA4th 768, 777, 135 CR2d 449 (provision awarding fees to prevailing party in arbitration does not allow for fees to party that had case dismissed from litigation, unless that party later prevails in arbitration). Conditioning attorney fees on participation in mediation before litigation or arbitration is commenced allows the parties to enforce the mediation clause. See form in §16.61A.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/16 Dispute Resolution Procedures/§16.60 4. Form: Attorney Fees Provision

§16.60 4. Form: Attorney Fees Provision

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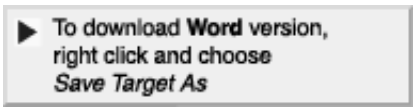
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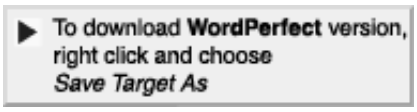
16.60-1 Attorney fees

___. *Attorney Fees.* In any litigation, arbitration, or other proceeding by which one party either seeks to enforce its rights under this Agreement (whether in contract, tort, or both) or seeks a declaration of any rights or obligations under this Agreement, the prevailing party will be awarded reasonable attorney fees, together with any costs and expenses, to resolve the dispute and to enforce the final judgment.

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§16.61 5. Form: Definition of "Prevailing Party"





16.61-1 "Prevailing party" defined

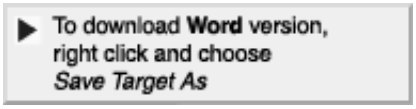
___. *Definition of Prevailing Party.* If either party commences arbitration or litigation arising from the interpretation or performance of this Agreement, then at least _ _[*e.g., 30 calendar days*]_ _ before commencement of the arbitration or trial, each party shall submit to the other a confidential settlement offer (the "Offer"). This Offer is not admissible in evidence in any arbitration or at trial with respect to the liability of a party; each Offer must be kept confidential by the parties until the tribunal or court makes a final award. If the parties do not reach a settlement, the tribunal or court in the arbitration or litigation will award to the prevailing party reasonable costs and expenses incurred in the arbitration or litigation, including expert witness fees and attorney fees.

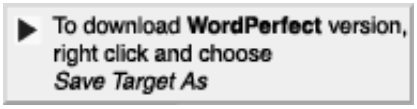
If the final award by the tribunal or court is less than the defendant's Offer, then the defendant is the prevailing party. If the final award by the tribunal or court is more than the plaintiff's Offer, then the plaintiff is the prevailing party. If the final award by the tribunal or court is between the two Offers, neither party is a prevailing party and each party pays for its own costs and expenses. A party that has not made an Offer cannot be a prevailing party; that party's Offer will be deemed to be zero if it is the defendant, or the claimed amount if it is the plaintiff.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/16 Dispute Resolution Procedures/§16.61A 6. Form: Forfeiture of Attorney Fees for Failure to Mediate

§16.61A 6. Form: Forfeiture of Attorney Fees for Failure to Mediate





16.61A-1 Forfeiture of attorney fees for failure to mediate

___. *Forfeiture of Attorney Fees for Failure to Mediate.* If either party commences an action without first participating in mediation, or refuses a request to mediate, that party is not entitled to any award of attorney fees, even if that party would otherwise be entitled to such an award.

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VI. MISCELLANEOUS PROVISIONS

A. Insurance

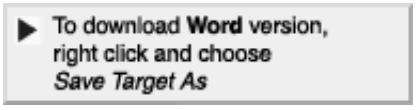
§16.62 1. General Principles

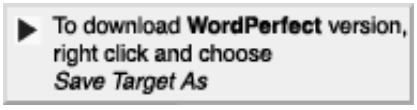
Before completing the design of the dispute resolution procedure, counsel should consider what role insurance may play in any future dispute. It may be in the parties' interest to require that the performing party under the agreement have a particular type of insurance with certain levels of coverage. If an insurer will be a participant in any future dispute, then each party should consider how the insurer's presence will affect the dispute resolution process. For example: Would anything in the insurance agreement preclude arbitrating the dispute? How will an insurer's payment of defense costs affect a party's decision on whether to arbitrate or litigate?

If insurance is required, the agreement should provide that the party carrying insurance provide a document from the insurance company stating that a policy has been placed. It may be advantageous to have the insurance company include the other party as an additional insured. This additional insurance is usually a low-cost endorsement that could be beneficial because certain exclusions (*e.g.,* work by the insured) may apply to the party that buys the insurance but not to the other party.

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§16.63 2. Form: Requiring Commercial General Liability Insurance





16.63-1 Requiring commercial general liability insurance

___. *Commercial General Liability Insurance.* **_ _**[*Name of first party*]**_ _ shall obtain and maintain a broad form Commercial General Liability Insurance policy providing for coverage of at least $_ _**[*amount*]**_ _ for each occurrence. Before commencing any work, _ _**[*name of first party*]**_ _ will provide _ _**[*name of other party*]**_ _ with proof of this insurance and with proof that _ _**[*name of other party*]**_ _ has been made an additional insured under this policy.**

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§16.64 B. Indemnity

The parties may want to provide for indemnity if a dispute arises, especially one involving third parties. Two key issues must be considered:

- **When is the party required to begin making payment?** If the indemnity provision provides for indemnity from "claims, demands, damages, or costs," then the duty to pay arises only after the party has paid the claim. But if the provision provides for indemnity against "liability" only, the duty to pay arises once the party is found liable. CC §2778(1)-(2).
- **Does the indemnity cover claims that arise from alleged negligent conduct?** A "general" indemnity does not cover active negligence, despite its label; to cover active negligence, the provision must explicitly refer to coverage for negligent acts. *Rossmoor Sanitation, Inc. v Pylon, Inc.* (1975) 13 C3d 622, 628, 119 CR 449. One cannot provide indemnity for future *wrongful* acts (CC §2773), but one can provide indemnity for future *negligent* acts (*Goldman v Ecco-Phoenix Elec. Corp.* (1964) 62 C2d 40, 41 CR 73).

An attorney fee provision in an indemnity agreement generally covers only disputes with third parties and not disputes between the parties to the agreement. *Myers Bldg. Indus. v Interface Technol., Inc.* (1993) 13 CA4th 949, 17 CR2d 242. Accordingly, if the parties want to provide for attorney fees in disputes between themselves, they should do so in a separate provision.

For further discussions of indemnification, see §§11.13-11.39.

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17

General Provisions

George S. Cabot

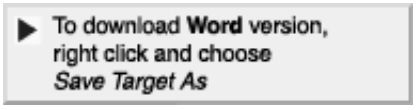
I. CHECKLIST: GENERAL PROVISIONS §17.1

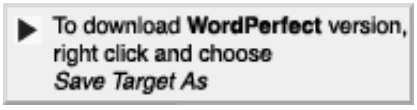
II. SCOPE OF CHAPTER §17.2

III. EFFECT OF GENERAL PROVISIONS AND FORMS
- A. Notice §17.3
- B. Form: Notice §17.4
- C. Modification §17.5
- D. Form: Modification of Agreement §17.6
- E. Word Usage §17.7
- F. Form: Word Usage §17.8
- G. Printed Versus Written Words §17.9
- H. Form: Printed Versus Written Words §17.10
- I. Entire Agreement §17.11
- J. Form: Entire Agreement §17.12
- K. Severability §17.13
- L. Form: Severability of Agreement §17.14
- M. Separate Writings and Exhibits §17.15
- N. Form: Separate Writings and Exhibits §17.16
- O. Time of the Essence §17.17
- P. Form: Time of the Essence §17.18
- Q. Counting Days §17.19
- R. Form: Counting Days §17.20
- S. Survival §17.21
- T. Form: Survival §17.22
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- W. Joint and Several Liability §17.25
- X. Form: Joint and Several Liability §17.26
- Y. Waiver §17.27
- Z. Form: Waiver §17.28
- AA. Section Headings §17.29
- BB. Form: Headings §17.30
- CC. Necessary Acts, Further Assurances §17.31
- DD. Form: Necessary Acts, Further Assurances §17.32

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§17.1 I. CHECKLIST: GENERAL PROVISIONS





- Dispute resolution procedures (see chap 16)
- Assignment (see chap 13)
- Attorney fees (see §§15.18, 16.57-16.61)
- Authority of signer (see §§18.3, 18.10, 18.14)
- Construction against drafter (see §§17.23-17.24)
- Counterparts (see §§18.47-18.48)
- Counting days (see §§17.19-17.20)
- Date of agreement (see §6.2)
- Entire agreement (integration or merger clause) (see §§17.11-17.12)
- Exhibits (see §§17.15-17.16)
- Gender and number (see §§17.7-17.8)
- Governing law (see §§16.55-16.56)
- Headings (captions) (see §§17.29-17.30)
- Joint and several liability (see §§17.25-17.26)
- Jurisdiction and venue (see §§16.55-16.56)
- Modification (see §§17.5-17.6)
- Necessary acts, further assurances (see §§17.31-17.32)
- Notice (see §§17.3-17.4)
- Printed versus written words (see §§17.9-17.10)
- Severability (partial invalidity) (see §§17.13-17.14)
- Survival (see §§17.21-17.22)
- Third party beneficiaries (see §§13.42-13.44)
- Time of the essence (see §§17.17-17.18)
- Waivers (see §§17.27-17.28)

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§17.2 II. SCOPE OF CHAPTER

This chapter discusses the clauses commonly referred to as "boilerplate"—the assortment of provisions, typically found at the end of the agreement, that relate generally to its interpretation and legal effect. Often, they are included in an agreement without much deliberation or discussion by either party. As with any other provision in an agreement, however, the careful drafter will consider:

- Whether the boilerplate provision meets the client's needs; and
- How the boilerplate provision relates to the other provisions in the agreement.

This chapter provides the drafter with sample boilerplate provisions and commentary about case law, statutes, and practical issues that should be considered when using these provisions.

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III. EFFECT OF GENERAL PROVISIONS AND FORMS

§17.3 A. Notice

An agreement that contemplates any interaction between the parties or requires performances by certain dates should contain a detailed notice provision. Subjects generally addressed in a notice provision are (1) means of providing notice (*e.g.,* regular mail versus certified mail); (2) addresses of the parties for this purpose; (3) rules for determining when notice is deemed to have been received; and (4) procedures for changing a party's address for notice purposes.

If an agreement does not specify what is meant by "notice," certain statutes provide guidance on the issue, which may produce results that the parties never intended. For example:

- Constructive notice of a fact exists when the person has "actual notice of circumstances sufficient to put a prudent [person] upon inquiry as to a particular fact" (CC §§18-19);
- Notice of a fact exists when the recipient has actual knowledge, has received notice of the fact, or from all facts and circumstances known to it the recipient has reason to know it exists (Com C §1202(a);
- Notice is "given" when the giver of notice takes "such steps as may be reasonably required to inform the other person in ordinary course, whether or not the other person actually comes to know of it" (Com C §1202(d));
- Notice is received when it comes to a person's attention (Com C §1202(e)(1)) or it is duly delivered in a form reasonable under the circumstances at the place of business through which the contract was made or at another location held out by that person as the place for receipt of such communications (Com C §1202(e)(2)); and
- A correctly addressed letter is presumed to have been received in the ordinary course of the mail (Evid C §641).

Notice provisions commonly require that a copy of any notice be sent to the attorney representing a party. While some attorneys use a "copy to" notice provision almost as a matter of course, this is a bad practice. First, if notice is provided to the party, but not to the party's attorney, the notice may be ineffective even though the party received it. Second, this provision arguably imposes obligations on the attorney. For example, what if a notice is received for a client the attorney no longer represents, or for a client with whom the attorney has not had contact for a long time? Is the attorney under an obligation to try to make contact with the client? If the attorney changes his or her office address, must the attorney send a change of address to all parties affected by a "copy to" notice clause? The attorney may want to consider providing for a "courtesy copy" of notice, as an alternative.

Many notice provisions allow notice by registered or certified mail. Registered mail is normally used for items of negotiable value, such as stock certificates or promissory notes. Postal insurance of registered mail is available. Certified mail, on the other hand, is appropriate for notices and other communications not involving items of negotiable value. A return receipt signed by the recipient on delivery of the item is available for an extra fee with certified mail, but a return receipt is not available with registered mail. Accordingly, if notice by first-class mail is considered inadequate because of the lack of confirmation of receipt, the notice provision should require notice by certified mail, return receipt requested, and not by registered mail.

PRACTICE TIP: Special care may be required when identifying recipients for notices sent to large organizations. If the agreement involves repeated notices, such as royalty reports, payments, or trademark samples as in royalty-bearing licenses or trademark licenses, the drafter is often required to provide separate notice provisions to accommodate the organization's internal structure. The drafter should also consider specifying the individual to whom notice should be sent, either by name or, preferably, position (*e.g.*, "Attn. Chief Financial Officer"). Specific names of individuals should ordinarily be avoided if the agreement is long term, or if the individual named to receive notice may not be with the organization for the duration of the agreement.

When the agreement is between parties with different native languages, the drafter should consider specifying the language to be used for the notice.

A standard boilerplate provision for "deemed receipt" of a notice on mailing, or within a specified number of days

after mailing, could operate as effective notice even if the notice is never received. The attorney should consider whether particularly important notices should be deemed effective only on actual receipt. See *Jenkins v Tuneup Masters* (1987) 190 CA3d 1, 235 CR 214. In *Jenkins,* a lessee had the option to extend the lease if it gave notice at least 6 months before the lease expired. The lease stated that notice must be in writing and "sent by registered or certified United States mail, return receipt requested." However, the lease did not require that the notice be received to be effective. It stated that "any notice so mailed shall be deemed to have been given as of the time said notice is deposited in the United States mail." The lessee complied with this provision, but postal authorities lost the notice. The court held that notice was properly given and the lessee's option effectively exercised, even though the lessor never received the notice.

The form in §17.4 requires that notice be given in English, and provides for "deemed delivery" when the recipient refuses delivery or fails to claim an item. This situation usually arises when postal authorities notify a recipient that an item of certified mail is being held at the post office. The form also allows notice to be sent by fax transmission, but notice is not deemed given unless receipt is confirmed. Most fax machines produce written confirmation slips indicating the recipient's fax machine, the date and time of transmission and the number of pages transmitted. In a dispute over the propriety of notice transmitted in this fashion, the noticing party would presumably be expected to produce the fax cover sheet, if any, and the confirmation slip or other evidence of confirmation, together with a copy of the notice itself. The attorney should also consider providing for a notice that arrives after business hours (as fax transmissions may).

The form in §17.4 also provides for notice by e-mail transmission. E-mailed notices are now generally enforceable under the federal Electronic Signatures in Global and National Commerce Act (E-SIGN) (15 USC §§7001-7031) and the California Uniform Electronic Transactions Act (UETA) (CC §§1633.1-1633.17), discussed more fully in chap 18A. Formal notices by e-mail can be sent using, for example, the RPost system. See http://www.rpost.com. A registered e-mail sent using the RPost system should be legally equivalent to registered or certified mail delivery, with return receipt, by the United States Postal Service and has the added feature of a verifiable, unalterable record of the content of the message. With respect to electronic transactions generally, see chap 18A.

Other confirmation methods are also possible, *e.g.,* telephoning the recipient or providing notice by courier service.

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§17.4 B. Form: Notice

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17.4-1 Notice

__. *Notice*.

(a) *Types of Notice.* Any notice, approval, or other communication required or permitted under this Agreement _ _[*, except for the payment or reporting of royalties as set forth in Section _ _, or for trademark quality control purposes as set forth in Section _ _,*]_ _ will be given in the English language and will be deemed received as follows:

(1) *Personal delivery.* When personally delivered to the recipient. Notice is effective on delivery.

(2) *First-class mail.* When mailed first class to the last address of the recipient known to the party giving notice. Notice is effective _ _[*e.g., 3*]_ _ mail delivery days after deposit in a United States Postal Service office or mailbox.

(3) *Certified mail.* When mailed certified mail, return receipt requested. Notice is effective on receipt, if delivery is confirmed by a return receipt.

(4) *Overnight delivery.* When delivered by _ _[*overnight delivery Federal Express/Airborne/United Parcel Service/DHL Worldwide Express*]_ _, charges prepaid or charged to the sender's account. Notice is effective on delivery, if delivery is confirmed by the delivery service.

(5) *Telex or facsimile transmission.* When sent by telex or fax to the last telex or fax number of the recipient known to the party giving notice. Notice is effective on receipt, provided that (a) a duplicate copy of the notice is promptly given by first-class or certified mail or by overnight delivery, or (b) the receiving party delivers a written confirmation of receipt. Any notice given by telex or fax will be deemed received on the next business day if it is received after 5:00 p.m. (recipient's time) or on a nonbusiness day.

(6) *E-mail transmission*. When sent by e-mail using software that provides unmodifiable proof (a) that the message was sent, (b) that the message was delivered to the recipient's information processing system, and (c) of the time and date the message was delivered to the recipient along with a verifiable electronic record of the exact content of the message sent.

(b) *Addresses for Notice.* Addresses for purpose of giving notice are as follows:

_ _[*Name of party*]_ _
Address: _ _[*address*]_ _
E-mail address: _ _[*e-mail address*]_ _

_ _[*Name of party*]_ _
Address: _ _[*address*]_ _
E-mail address: _ _[*e-mail address*]_ _

_ _[*Name of party*]_ _
Address: _ _[*address*]_ _
E-mail address: _ _[*e-mail address*]_ _

[*If appropriate, add*]

Courtesy copy to: _ _[*Name, address, and telephone number of recipient party's attorney*]_ _

[*Continue*]

(c) *Refused or Undeliverable Notice*. Any correctly addressed notice that is refused, unclaimed, or undeliverable because of an act or omission of the party to be notified will be deemed effective as of the first date that said notice was refused, unclaimed, or deemed undeliverable by the postal authorities, messenger, or overnight delivery service.

(d) *Change of Address.* Any party may change its address, telex, fax number, or e-mail address by giving the other party notice of the change in any manner permitted by this Agreement.

(e) *Writing Requirement*. All notices, requests, demands, amendments, modifications or other communications under this Agreement must be in writing. Notice is sufficient for all such purposes if personally delivered, sent by first class, registered or certified mail, return receipt requested, delivery by courier with receipt of delivery, facsimile transmission with written confirmation of receipt by recipient, or e-mail delivery with verifiable and unmodifiable proof of content and time and date of sending by sender and delivery to recipient. Notice is effective on confirmed receipt by recipient or _ _[*number*]_ _ days after sending, whichever is sooner.

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§17.5 C. Modification

Generally, a written contract may be modified by a contract in writing or by an executed oral agreement. CC §1698(a)-(b). Unless the contract expressly provides otherwise, a written contract may also be modified by an oral agreement supported by new consideration. CC §1698(c). (Note, however, that a contract for the sale of goods may be modified by an oral agreement without new consideration, unless the contract requires a signed writing. Com C §2209(2).) Thus, if the parties wish to preclude later oral modifications of their written agreement, the agreement should include a provision requiring a writing.

Even if the parties' agreement contains a provision prohibiting oral modification, however, that provision would not apply to a modification that was fully executed. Cal L Rev'n Comm'n Comment to CC §1698. See, *e.g., MacIsaac & Menke Co. v Cardox* (1961) 193 CA2d 661, 14 CR 523 (oral agreement between contractor and subcontractor to do extra work was enforceable by subcontractor after work was done, even though contract required agreement for extra work to be in writing). Nor would the provision apply to:

- An oral novation of the contract;
- An oral rescission of the contract;
- An oral waiver
- An oral independent collateral contract; or
- A situation in which the party attempting to enforce the prohibition was estopped from doing so.

See Cal L Rev'n Comm'n Comment to CC §1698 and cases cited there.

If the transaction is a sale of goods using a merchant's preprinted contract, a provision prohibiting oral modification of the contract must be separately initialed by the buyer when the buyer is not also a merchant. Com C §2209(2). See generally California UCC Sales and Leases, chap 6 (Cal CEB 2002).

A provision allowing modification of the contract by the parties' mutual agreement does not give rise to a duty to bargain for a new or amended contract in good faith; the contract must specifically require the parties to negotiate modifications in good faith for that duty to arise. *Racine & Laramie, Ltd. v Department of Parks & Recreation* (1992) 11 CA4th 1026, 14 CR2d 335.

An agreement that includes the sale of goods is susceptible to acquiring additional terms through the boilerplate language included in many preprinted purchase order forms and order acknowledgments. Com C §2207(1). Prior notification of objection to the additional terms may be sufficient in most cases to avoid unintended additions to the agreement. The drafter should consider providing for such notice of objections when the agreement involves the sale of goods. Com C §2207(2).

For further discussion of subsequent modifications and amendments to an agreement, see chap 19.

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§17.6 D. Form: Modification of Agreement

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17.6-1 Modification of agreement

Modification of Agreement. **This Agreement may be supplemented, amended, or modified only by the mutual agreement of the parties. No supplement, amendment, or modification of this Agreement will be binding unless it is in writing and signed by _ _[*both parties/the party to be charged*]_ _. No provisions in either party's correspondence or other business forms used by either party will supersede or add to the terms and conditions of this Agreement.**

Comment: The alternative language is provided for whether the amendment must be signed by both parties or merely the party to be charged. To satisfy the statute of frauds, only the signature of the party to be charged is required. See, *e.g.,* CC §1624; Com C §2201.

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§17.7 E. Word Usage

The "word usage" clause is used to avoid ambiguities that might otherwise be created by standard contract provisions containing incorrect gender and number references. For example, a printed form contract clause might use masculine pronouns in referring to a party that happens to be female. The Civil Code has no rule of interpretation when this occurs in a contract.

A similar cause of potential confusion is the word "or." For example, in *Kelly v William Morrow & Co.* (1986) 186 CA3d 1625, 231 CR 497, the plaintiff agreed to allow defendants to write a book about him "either factually or fictionally." Defendants wrote a book that arguably included fact and fiction. The plaintiff sued for breach of contract, arguing that defendants had no right to write a book containing *both* fact and fiction. The court held that the contract covered factual material, fictional material, or any combination of the two. It stated that although the word "or" is ordinarily used to create mutually exclusive options, in any given instance it is necessary to review the contract to determine what the parties intended. Based on its review of the relevant documents, the court concluded that in this case, the word "or" could be given the additional meaning of "and."

PRACTICE TIP: Most often, parties using the word "or" intend it to mean "and/or," so that exercising a remedy or a right under a contract does not preclude resort to other specified remedies or rights. Using additional contract language may help to clarify the parties' intent.

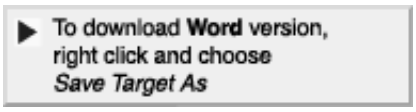
Another word that can cause problems is "including." Although "including," as used in the phrase "including but not limited to," is clear in meaning, it is sometimes argued that when "including" is used alone, it limits whatever is being described to the examples given. California law is clear that the word "including" is not limiting, but expansive. See, *e.g., People v Horner* (1970) 9 CA3d 23, 27, 87 CR 917. A short and easy drafting solution—if this is the parties' intent—is to use language like that in §102 of the Bankruptcy Code (11 USC §102), which states that "'or' is not exclusive" and "'including' [is] not limiting."

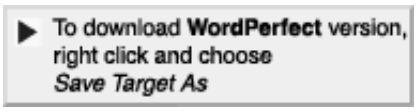
See generally *Poseidon Dev., Inc. v Woodland Lane Estates, LLC* (2007) 152 CA4th 1106, 62 CR3d 59 (goal of contract interpretation is to give effect to mutual intent of parties at time of contracting; terms are to be understood in their ordinary and popular sense).

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§17.8 F. Form: Word Usage





17.8-1 Word usage

Word Usage. **Unless the context clearly requires otherwise, (a) the plural and singular numbers are each deemed to include the other; (b) the masculine, feminine, and neuter genders are each deemed to include the others; (c) "shall," "will," or "agrees" are mandatory, and "may" is permissive; (d) "or" is not exclusive; and (e) "includes" and "including" are not limiting.**

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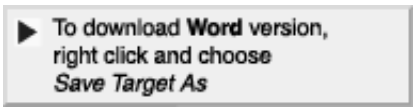
§17.9 G. Printed Versus Written Words

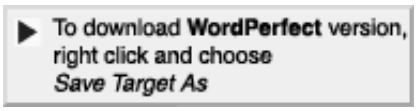
In construing a contract, handwritten words control inconsistent typed words and both generally control inconsistent printed words. CC §1651. See also CCP §1862. If the parties wish to avoid the application of this rule of construction, a printed contract (such as a standard form lease) should include a provision indicating that the parties intend both written or typed and printed words to be of equal importance.

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§17.10 H. Form: Printed Versus Written Words





17.10-1 Printed versus written words

Handwritten or Typed Words. **Handwritten or typed words have no greater weight than printed words in the interpretation or construction of this Agreement.**

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§17.11 I. Entire Agreement

The purpose of an "entire agreement" clause, also known as an "integration" or a "merger" clause, is to invoke the parol evidence rule. This is a rule of substantive law (as opposed to a rule of evidence), which prohibits the introduction of any extrinsic evidence (oral or written) to vary or add to the terms of an integrated writing. CCP §1856; Com C §2202. See *Bionghi v Metropolitan Water Dist.* (1999) 70 CA4th 1358, 83 CR2d 388. It distinguishes between writings embodying the "final" expression from writings embodying the "complete and exclusive" statement of the provisions of the agreement. See California UCC Sales and Leases, chap 7 (Cal CEB 2002).

The terms of a "final" expression of agreement may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement but may be explained or supplemented by evidence of consistent additional terms. CCP §1856(a)-(b); Com C §2202.

Even when the terms of a writing are final, the writing may not be "complete and exclusive" if it does not contain *all* terms of the agreement. A writing intended as a "complete and exclusive" statement of the terms of the agreement may not be explained or supplemented even by evidence of consistent additional terms. CCP §1856(b); Com C §2202(b).

PRACTICE TIP: An "entire agreement" provision should include the phrase "complete and exclusive statement" because it duplicates the language of the parol evidence rule set forth in CCP §1856 and Com C §2202.

The presence of an "entire agreement" clause is *conclusive* proof that the writing was intended as an integrated agreement, and parol evidence to show that the writing was *not* intended as an integrated agreement will be excluded. If a written contract lacks an "entire agreement" clause, a court may still find that the parties intended it to be an integrated agreement, based on such factors as:

- Its completeness and comprehensiveness;
- Whether the alleged oral understanding might naturally be made separately and not included in the written agreement;
- Whether the alleged oral understanding contradicts any provision of the written agreement or merely supplements it; and
- The relative sophistication of the parties.

See *A. Kemp Fisheries, Inc. v Castle & Cooke, Inc.* (9th Cir 1988) 852 F2d 493. See generally UCC Sales & Leases, chap 7.

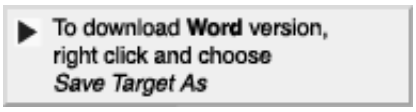
Points for the practitioner to remember are:

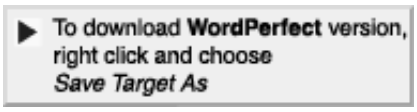
- Define the subject matter of the contract (see chap 7 on recitals);
- "Integrate" an agreement when the writing is a part of a multi-document transaction, such as purchase and sale of a business; and
- Incorporate supporting documents, such as schedules, riders, and exhibits so that they become part of the "entire agreement" (see §§17.15-17.16).

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§17.12 J. Form: Entire Agreement





17.12-1 Entire agreement

Entire Agreement. **This Agreement _ _**[*and all other agreements, exhibits, and schedules referred to in this Agreement*]**_ _ constitute(s) the final, complete, and exclusive statement of the terms of the agreement between the parties pertaining to _ _**[*the subject matter of this Agreement/describe general nature of transaction, e.g., the purchase and sale of the Product*]**_ _ and supersedes all prior and contemporaneous understandings or agreements of the parties. No party has been induced to enter into this Agreement by, nor is any party relying on, any representation or warranty outside those expressly set forth in this Agreement.**

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§17.13 K. Severability

A "severability" or a "partial invalidity" clause prevents a court from declaring an entire contract invalid or unenforceable because of invalidity or unenforceability of a single provision in the contract.

Civil Code §1599 provides that "[w]here a contract has several distinct objects, of which one at least is lawful, and one at least is unlawful, in whole or in part, the contract is void as to the latter and valid as to the rest."

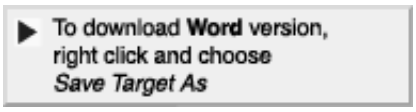
A contract may be construed as severable or entire. A severable or divisible contract is one in which two or more separate partial performances on each side are agreed to be exchanged for partial performances on the other side. The failure to perform one part does not bar recovery for performance of another part. See, *e.g., Lowry v United Pac. Ins. Co.* (1967) 67 C2d 87, 60 CR 225 (construction contract, work in two phases, consideration apportioned; held severable, and nonperformance under second phase did not preclude recovery for performance under first). An entire contract is one in which all performances are common and interdependent, and any material breach justifies termination by the other party. Whether a contract is severable or entire depends on the parties' intention, as revealed in the language of the contract itself and the surrounding circumstances. *Keene v Harling* (1964) 61 C2d 318, 38 CR 513. A severability provision like the one in §17.14 helps to clarify the parties' intention. For related discussions, see chaps 9 and 10 on covenants and conditions, respectively.

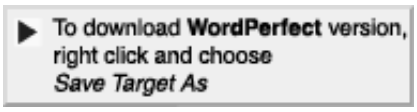
Even a divisible contract will be voided, however, if the contract itself was induced by fraud. *Filet Menu, Inc. v CCL. & G., Inc.* (2000) 79 CA4th 852, 94 CR2d 438.

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§17.14 L. Form: Severability of Agreement





17.14-1 Severability

Severability of Agreement. **If a court or an arbitrator of competent jurisdiction holds any provision of this Agreement to be illegal, unenforceable, or invalid in whole or in part for any reason, the validity and enforceability of the remaining provisions, or portions of them, will not be affected,** _ _[*unless an essential purpose of this Agreement would be defeated by the loss of the illegal, unenforceable, or invalid provision*]_ _**.**

Comment: The optional language can be used when the entire agreement would fail if the provision that is struck down is so central to the transaction that its purpose cannot be carried out. The drafter may want to specify the provisions that, if struck down, would nullify the agreement. See California Law of Contracts §§5.70-5.71 (Cal CEB 2007).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/17 General Provisions/§17.15 M. Separate Writings and Exhibits

§17.15 M. Separate Writings and Exhibits

Frequently, crucial provisions are set forth on attached exhibits or schedules. For example, in the sale of a business, a description of the equipment and other tangible property being sold is often set forth on an attached schedule. To carry out the parties' intent, the drafter should clearly indicate that the separate writings are part of the contract. When key contract provisions are set forth separately, it may be necessary to incorporate them into the main agreement in order to satisfy the statute of frauds.

PRACTICE TIP: A written contract may incorporate other written agreements, plans, specifications, and other documents. The separate writings need not always be attached. Nor is explicit incorporation by reference necessary; it is sometimes sufficient if the contract refers to the writings by implication. See CC §1642 (several contracts relating to the same subject matter, between the same parties, and made as parts of substantially the same transaction are to be construed together). However, to avoid any uncertainty over what terms are part of the contract, the better practice is to have the contract incorporate the other writings. See form in §17.16.

When an agreement consists of multiple writings, the drafter should take care that their provisions are consistent with each other, to avoid uncertainty in their construction and application. To illustrate, suppose a company borrows money, which is reflected in a promissory note. The debt is secured by the company's inventory, and this arrangement is reflected in a security agreement. The security agreement provides that a default in payment of the note also constitutes a default under the security agreement. The security agreement, however, gives the debtor a 14-day grace period to cure any default, while the note does not. What rights would the secured party have if the debtor failed to make a payment when due? Would a court, construing the agreements together, infer that the grace period applies to the note as well as to the security agreement? What if a provision in the note allowed acceleration of the whole obligation on default, but the security agreement did not? Consistency is especially important in provisions relating to default, cure, and giving notice. The drafter may want to use a single definition for default in one writing, with cross-references to that definition in the other writings. Alternatively, the drafter may wish to set forth a hierarchy of application among several writings in the event of inconsistencies among them.

An exhibit or other separate writing is sometimes incorporated into a contract by including a specific reference to the separate writing, followed by the words "incorporated into this document by reference." For example, equipment to be sold in the sale of a business could be described as: "The equipment listed on Schedule 1.1, which is attached to this document and incorporated by this reference." Alternatively, when numerous schedules, exhibits, or other separate writings are involved, a more elegant approach might be to include a provision like that in §17.16, indicating that all writings referred to are incorporated by reference. If such a provision is used, the equipment would simply be described as: "The equipment listed on Schedule 1.1."

PRACTICE TIP: To minimize the possibility that attachments or exhibits may be modified by one of the parties without the consent of the other party, each page of the attachment and any amendments should be dated and initialed by both parties. In referring to the attachment, the agreement should indicate "as executed contemporaneous herewith or as mutually modified in the future."

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§17.16 N. Form: Separate Writings and Exhibits

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17.16-1 Separate writings and exhibits

Separate Writings and Exhibits. **The following _ _**[*e.g., agreements, exhibits, schedules, or other separate writings*]**_ _ constitute a part of this Agreement and are incorporated into this Agreement by this reference:**

[*List separate writings by name and date*]

Should any inconsistency exist or arise between a provision of this Agreement and a provision of any exhibit, schedule, or other incorporated writing, the provision of this Agreement will prevail.

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§17.17 O. Time of the Essence

Generally, a delay in performance of a contractual obligation is not considered a material breach that excuses the nonbreaching party from its required performance unless the parties have declared time to be of the essence of the obligation. See CC §1492.

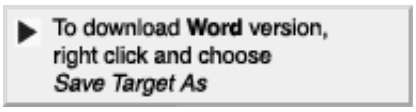
Even when the contract states that time is of the essence, the courts may not enforce the provision strictly. *Katemis v Westerlind* (1953) 120 CA2d 537, 261 P2d 553. The court considers the seriousness of the breach, *i.e.,* the seriousness of the loss to the defaulting party from the forfeiture of its contract rights versus the seriousness of the harm to the other party from having to accept delayed performance. Except in unusual circumstances, delayed performance by one party does not cause such harm to the other party that it cannot be compensated by the payment of money. See 1 Miller & Starr, California Real Estate §2:24 (3d ed 2000).

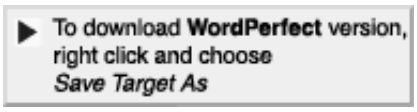
Despite the inclusion of a "time is of the essence" provision, if the time for performance of an act falls on a Sunday or a holiday, the obligor has until the next business day to perform the act, unless the parties specify otherwise. CC §§7, 11. Civil Code §11 is discussed at greater detail in §17.19.

A "time is of the essence" clause should not be included in every agreement, but only when it is appropriate for the nonbreaching party's performance to be excused for the breaching party's failure to perform in a timely fashion. A "time is of the essence" clause can backfire by releasing *all* parties from their obligations when concurrent performances are required. See *Pittman v Canham* (1992) 2 CA4th 556, 3 CR2d 340. See also chap 9.

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§17.18 P. Form: Time of the Essence





17.18-1 Time of the essence

Time of the Essence. **Time is of the essence in respect to all provisions of this Agreement that specify a time for performance; provided, however, that the foregoing may not be construed to limit or deprive a party of the benefits of any grace or use period allowed in this Agreement.**

Comment: See California Law of Contracts §8.10 (Cal CEB 2007).

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§17.19 Q. Counting Days

To compute the time for performance of an act under the agreement, the first day is excluded and the last day is included. CC §10. If the last day is a holiday, however, it is also excluded, and the act may be performed on the next day. Generally, "holidays" are Sundays and other holidays designated in Govt C §§6700-6716. CC §7. Saturdays are optional bank holidays. Part or all of each Saturday is a holiday as regards public offices. See Govt C §§6702, 6704. However, some statutes defining "holidays" are inconsistent. See CCP §§10, 13.

Code of Civil Procedure §12a does not apply to extend a period of performance for acts governed solely by contractual provisions by considering Saturday a "holiday." *Gans v Smull* (2003) 111 CA4th 985, 990, 4 CR3d 353. For maximum certainty, counsel can specify which statute defining holidays controls. Days other than "holidays" are "business days." CC §9. Performance is timely if it is completed before midnight on the day of performance. See *Alfinito v Sater* (1966) 246 CA2d 362, 54 CR 636.

EXAMPLE 1: A party is required to cure a default within 30 days after receiving notice. Notice is given on June 4. The defaulting party has until July 5 to cure the default.

EXAMPLE 2: A party is required to make payment on the first day of each month. April 1 falls on a Sunday. The party has until Monday, April 2, to make the payment required on April 1.

EXAMPLE 3: A party is required by contract to make a payment on the first day of each month. February 1 falls on a Saturday. The party has until midnight on Saturday, February 1, to make the required payment.

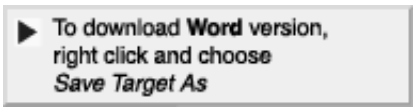
Without an express provision otherwise, a court would apply the Civil Code rules for counting days and ascertaining the day of performance. See *Reichardt v Reichardt* (1960) 186 CA2d 808, 9 CR 225. The Civil Code may not carry out the parties' intent, however, and it may not be entirely predictable, especially concerning Saturdays. Thus, counsel who wants intended, predictable results should include a day-counting provision in the contract.

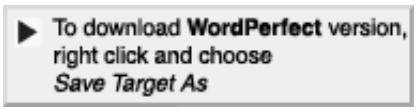
If no time is expressed to perform an act, a reasonable time is the presumed intent of the parties. CC §1657; Com C §2309(1).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/17 General Provisions/§17.20 R. Form: Counting Days

§17.20 R. Form: Counting Days





17.20-1 Counting days

Counting Days. **Days are to be counted by excluding the first day and including the last day, unless the last day is a Saturday, a Sunday, or a legal holiday, and then it is to be excluded. Any act required by this Agreement to be performed by a certain day is timely performed if completed before 5:00 p.m. local time on that date. If the day for performance of any obligation under this Agreement is a Saturday, a Sunday, or a legal holiday, then the time for performance of that obligation is extended to 5:00 p.m. local time on the first following day that is not a Saturday, Sunday, or legal holiday.**

[*If appropriate, add*]

As used in this section, "legal holiday" means those days designated as "holidays" in _ _[*e.g., Government Code §§6700-6716*]**_ _.**

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§17.21 S. Survival

In some situations, the parties intend certain rights and obligations to continue despite termination of the contract. For example, on termination of an employment contract, the parties' principal rights and obligations expire (the employee is no longer obligated to perform services, and the employer is no longer obligated to employ the employee). However, the contract may prohibit the employee from improperly using confidential information, or it may restrict the employee's right to solicit customers of the former employer, after termination. In this situation, the drafter may provide in the confidentiality clause or noncompetition clause that its terms will survive termination of the agreement. Alternatively, all rights and obligations that will survive termination could be addressed in a separate provision. See form in §17.22. Note that a confidentiality and nondisclosure clause may be enforceable only for a reasonable period of time after the employment relationship terminates. *Monogram Indus. v Sar Indus.* (1976) 64 CA3d 692, 134 CR 714. See §9.12 for further discussion of post-termination covenants.

A time limitation on the survival of rights and obligations sets forth only the time period for which a breach may occur or be discovered; it does not serve as a contractual limitation on the applicable statute of limitations. *Western Filter Corp. v Argan, Inc.* (9th Cir 2008) 540 F3d 947. Any contractual period of limitation shorter than that fixed by the statute of limitations must be "clear and explicit." 540 F3d at 953. The period fixed may not be "so unreasonable as to show imposition or undue advantage in some way." 540 F3d at 952, quoting *Moreno v Sanchez* (2003) 106 CA4th 1415, 1430, 131 CR2d 684.

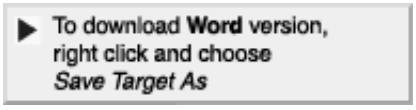
The parties should consider an express provision with respect to the survival of representations and warranties (see chap 7), because when an agreement contemplates the delivery of money, instruments, or property in connection with the closing of the transaction, failure to object to the tender of such items as nonconforming may result in a waiver of those objections. CCP §2076. For example, in the real estate context, the delivery and acceptance of the deed may result in a waiver of any objections based on breaches of representations. See *Burnand v Nowell* (1948) 84 CA2d 1, 189 P2d 796. There are, however, various warranties that statutorily or judicially survive the closing. See *Pollard v Saxe & Yolles Dev. Co.* (1974) 12 C3d 374, 115 CR 648 (fitness for use of newly constructed real property); CC §§1113, 3304 (implied covenants in real estate deeds); Com C §§2312-2315 (implied warranties of title, authority, noninfringement, merchantability, fitness for particular use); CC §§1791-1792 (fitness for ordinary use of consumer goods and specified second-hand goods).

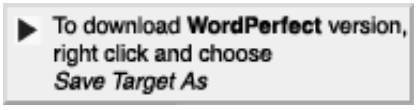
For agreements that provide indemnities, duties of confidentiality, and similar covenants that the parties contemplate performing after the agreement terminates or expires, the drafter should consider specifically noting that these obligations survive, along with any supporting provisions such as limitation of liabilities, definitions, and general provisions.

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§17.22 T. Form: Survival





17.22-1 Survival

[*Add one of the following alternatives*]

[*Alternative 1: Survival of all obligations*]

Survival. _ _[*Except as otherwise expressly provided in this Agreement,*]_ _ _ _[*All/all*]_ _ **representations, warranties, and covenants contained in this Agreement, or in any instrument, certificate, exhibit, or other writing intended by the parties to be a part of their Agreement, will survive the** _ _[*Closing/termination of this Agreement*]_ _ _ _[*for/until*]_ _ _ _[*specify period of time or event on which obligations terminate*]_ _**.**

[*Alternative 2: Survival of specific obligations*]

Survival. **The rights and obligations created by** _ _[*specify section or clause*]_ _ **with respect to** _ _[*describe nature of rights and obligations*]_ _ **will survive termination of this Agreement** _ _[*, except as otherwise expressly provided,*]_ _ _ _[*for/until*]_ _ _ _[*specify period of time or event on which obligations terminate*]_ _**.**

[*Alternative 3: Survival of specific articles and sections*]

Survival. **Articles** _ _[*article numbers*]_ _ **and Sections** _ _[*section numbers*]_ _ **will survive the termination or expiration of this Agreement.**

Comment: The first alternative creates a presumption in favor of survival of all obligations of the parties, as well as all representations and warranties. The drafter should make sure that any exceptions to this presumption are clearly specified. The second alternative specifies the obligations that continue after termination. The obligation can survive indefinitely, for a specified time, or until the occurrence of a specified event. The third alternative is the preferred method for clearly defining the survival of obligations, representations, warranties and their associated limitations, definitions, and general provisions. Care must be taken, however, to draft the respective articles and sections so that they contain only the provisions intended to survive.

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§17.23 U. Ambiguities

When an ambiguity in a contract is not resolved by other rules of construction, it is construed against the party who prepared the instrument (or the party whose attorney prepared the instrument). CC §1654. See, *e.g., Coutin v Nessanbaum* (1971) 17 CA3d 156, 94 CR 453 (language of guaranty drafted by creditor's attorney construed against creditor).

To avoid application of this rule, the drafter may include a provision that the rule not apply in the interpretation of their agreement. The attorney with primary drafting responsibility (who represents the party against whom CC §1654 may be invoked) will favor a neutral interpretation of the contract, while the attorney representing the other party (who would benefit by application of CC §1654) may resist any attempt to vary this rule of interpretation.

PRACTICE TIP: A blank in a form contract creates an ambiguity that is construed against the preparing party. *Lacey v Westside Print Works, Inc. (In re Westside Print Works, Inc.)* (BAP 9th Cir 1995) 180 BR 557.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/17 General Provisions/§17.24 V. Form: Ambiguities

§17.24 V. Form: Ambiguities

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17.24-1 Ambiguities

Ambiguities. **Each party and its counsel have participated fully in the review and revision of this Agreement. Any rule of construction to the effect that ambiguities are to be resolved against the drafting party do not apply in interpreting this Agreement.**

Comment: This provision is designed for situations in which both parties have been involved in negotiating and drafting the agreement. The first sentence should be deleted or modified if one party has not in fact fully participated in the drafting process.

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§17.25 W. Joint and Several Liability

When more than one party agrees to meet an obligation under a contract, their obligations may be (1) joint, (2) joint and several, or (3) several. CC §1430.

If liability is joint or joint and several, an injured party may maintain an action and seek full recovery from one or all of the jointly and severally liable parties. If liability is several, each party is liable only for his or her predetermined individual share. Under the common-law rule formerly in effect in California, if liability was merely joint, the plaintiff had to join all obligors in one action. The requirement of compulsory joinder was eliminated in 1971. In practice, joint (as opposed to joint and several) contractual liability is quite unusual.

Civil Code §1431 creates a statutory presumption that an obligation imposed on more than one person is a *joint* obligation. However, an obligation is presumed to be *joint and several* when all parties receive some benefit from the consideration, whether past or present, or when the promise is made in the singular number but is executed by each party (so that each says in effect, "I agree"). CC §1659. These presumptions are rebuttable and may be varied by agreement.

PRACTICE TIP: Even when one of these presumptions seems to apply, the prudent practitioner should include an express provision stating whether the parties intend the obligations to be several or joint and several. This may be particularly relevant when different parties have an obligation to perform different tasks or one contracted-for task must be performed before a second party will be able to perform his or her obligations and it is not intended that the second party be held liable if the first party fails to perform. See §17.26.

An example of obligations intended to be *several* are those of limited partners, who sign a limited partnership agreement in which they agree to make specified contributions of capital. An individual limited partner's liability is generally limited to the amount of his or her contribution and any distributions received from the partnership at a time when the partnership's assets are insufficient to satisfy its liabilities. Corp C §§15632, 15666. In contrast, the partners of a general partnership (other than partners in a registered limited liability partnership, Corp C §15015(b)) are jointly and severally liable for the wrongful acts or omissions of any partner acting in the ordinary course of partnership business or with the partners' authority, and all partners are jointly liable for all other debts and obligations of the partnership. Corp C §§15013-15015.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/17 General Provisions/§17.26 X. Form: Joint and Several Liability

§17.26 X. Form: Joint and Several Liability

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17.26-1 Joint and several liability

[*Add one of the following alternatives*]

[*Alternative 1: Several liability only*]

Several Liability. **The obligations of _ _[*e.g., Lenders*]_ _ are several, and no _ _[*e.g., Lender*]_ _ shall be responsible for the obligations or commitments of any other _ _[*e.g., Lender*]_ _. Nothing in this Agreement and no action taken by _ _[*e.g., Lenders*]_ _ under this Agreement will be deemed to constitute _ _[*e.g., Lenders*]_ _ as a partnership.**

[*Alternative 2: Joint and several liability*]

Joint and Several Liability. **If _ _[*e.g., Buyer*]_ _ consists of more than one person or entity, the liability of each such person or entity signing this Agreement as _ _[*e.g., Buyer*]_ _ is joint and several.**

Comment: The drafter may also wish to provide that each person becomes liable on their execution of the agreement, in order to avoid the argument that the liability of each was conditioned on execution by all. See chap 10 on conditions, and see form in §18.51.

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§17.27 Y. Waiver

Strict performance of a contractual obligation may be waived by the party in whose favor the obligation runs. One party may unilaterally seek a waiver of certain terms if it can be shown that the parties placed the provision in question in the agreement solely for the benefit of the waiving party, even though both parties may benefit by the provision.

PRACTICE TIP: If the parties intend that the provision be waivable unilaterally by one party, the contract should so state to avoid later litigating the issue.

Waivers may be written, oral, or implied from the circumstances. See California UCC Sales and Leases, chap 6 (Cal CEB 2002). The burden is on the party claiming the waiver to prove it by clear and convincing evidence. *Cathay Bank v Lee* (1993) 14 CA4th 1533, 1539, 18 CR2d 420.

The purpose of a waiver clause is to avoid the difficult proof issues that may arise in connection with alleged oral waivers and to prevent unintended waivers arising from the parties' conduct, by requiring that any waiver, to be binding, must be in writing. It is also customary to provide that, if an effective waiver is made, the scope of the waiver should be limited both in effect and in time. See form in §17.28. Waivers of legal defenses should be explicit. *Cathay Bank v Lee* (1993) 14 CA4th 1533, 18 CR2d 420; but see *River Bank Am. v Diller* (1995) 38 CA4th 1400, 45 CR2d 790. See also *WRI Opportunity Loans II, LLC v Cooper* (2007) 154 CA4th 525, 544, 65 CR3d 205 (rule against enforcement of unlawful transactions rendered waiver of statutory usury defense ineffective).

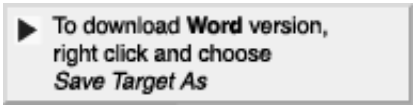
If the contract is governed by the Commercial Code, the party who has made a waiver affecting an executory portion of the contract may retract the waiver by notifying the other party that strict performance will be required in the future of the portion waived, unless the retraction would be unjust in view of a material change of position in reliance on the waiver. Com C §2209(5); *Noyes v Habitation Resources, Inc.* (1975) 49 CA3d 910, 123 CR 261. See generally UCC Sales & Leases §§6.19-6.22.

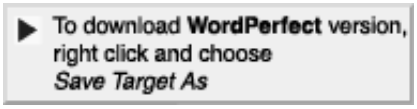
The operation of a "waiver" clause can be illustrated by a contract calling for installment payments. The payor may argue that the payee's acceptance of late payments in the past constitutes a waiver of the payee's right to declare a default or impose contractual late penalties. The first sentence of the form in §17.28 requires that any such "waiver" be in writing to be binding. An oral statement by the payee that a late payment will be accepted is thus not binding on the payee, who could later insist on strict performance. When the payee has executed a binding waiver of timely payment with respect to an installment, the second sentence of the form in §17.28 makes it clear that such a waiver is not a waiver of the right to insist on timely payment of future installments.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/17 General Provisions/§17.28 Z. Form: Waiver

§17.28 Z. Form: Waiver





17.28-1 Waiver

Waiver. **No waiver of a breach, failure of any condition, or any right or remedy contained in or granted by the provisions of this Agreement will be effective unless it is in writing and signed by the party waiving the breach, failure, right, or remedy. No waiver of any breach, failure, right, or remedy will be deemed a waiver of any other breach, failure, right, or remedy, whether or not similar, nor will any waiver constitute a continuing waiver unless the writing so specifies.**

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§17.29 AA. Section Headings

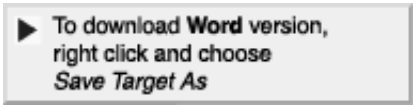
Most agreements include titles and captions. Usually, such titles and captions are included simply for the convenience of the reader, as a way to quickly draw attention to the general subject matter of the provision. However, courts have used headings to interpret the parties' intent when a provision is ambiguous or misleading. See *Wise v Westchester Fire Ins. Co.* (10th Cir 1972) 463 F2d 386; *Orchard v Agricultural Ins. Co.* (D Or 1964) 228 F Supp 564, aff'd (9th Cir 1965) 340 F2d 948. The drafter should consider whether headings *should* aid in interpreting an agreement. A common rationale for negating their interpretive significance, as alternative 1 of the form in §17.30 does, is that a heading might not adequately summarize the provision that follows. In particular, during negotiations, a section might be modified in a way that was not contemplated when the provision was originally drafted.

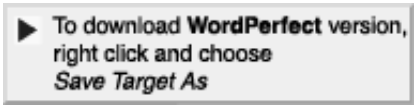
For additional discussion of section headings, see §5.6.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/17 General Provisions/§17.30 BB. Form: Headings

§17.30 BB. Form: Headings





17.30-1 Headings

[*Add one of the following alternatives*]

[*Alternative 1: Headings with no legal effect*]

Headings. **The headings in this Agreement are included for convenience only and neither affect the construction or interpretation of any provision in this Agreement nor affect any of the rights or obligations of the parties to this Agreement.**

[*Alternative 2: Headings with limited legal effect*]

Headings. **The headings in this Agreement are included principally for convenience and do not by themselves affect the construction or interpretation of any provision in this Agreement, nor affect any of the rights or obligations of the parties to this Agreement.**

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§17.31 CC. Necessary Acts, Further Assurances

The "necessary acts" provision is a catch-all that can be invoked to require a party to perform some act or sign an instrument even when the party is not specifically required to do so elsewhere in the agreement. This provision is useful in two respects: (1) It relieves the drafter of the need to describe a party's performance down to the smallest detail; and (2) it can be invoked to require a future act not anticipated at the time of execution in order to effectuate the agreement or to confirm or evidence the agreement. See form in §17.32.

EXAMPLE: (1) An agreement for the sale of a business requires the seller to transfer the assets of the business to the buyer by means of appropriate instruments of transfer. Rather than specifying that the equipment is to be transferred by a bill of sale, the vehicles by forms supplied by the Department of Motor Vehicles, etc., the drafter could simply rely on the "necessary acts" provision. As a matter of caution, however, the drafter should be as specific as possible for any material performance.

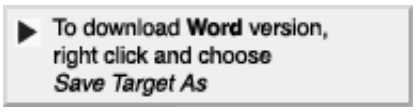
(2) An agreement for the sale of a business requires the seller to transfer title to assets, free and clear of any encumbrance. After the closing, the parties discover that a UCC filing is still in effect on some of the assets even though the underlying debt has been satisfied. This clause requires the seller to obtain the creditor's signature on a termination statement, to file it with the Secretary of State, and to pay any required filing fee.

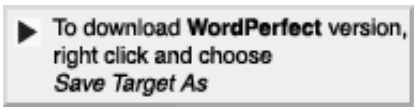
A "necessary acts" provision may be coupled with an irrevocable power of attorney that authorizes, *e.g.,* the execution and filing of documents relating to the agreement. See chap 23.

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§17.32 DD. Form: Necessary Acts, Further Assurances





17.32-1 Necessary acts, further assurances

Necessary Acts and Further Assurances. **The parties shall at their own cost and expense execute and deliver such further documents and instruments and shall take such other actions as may be reasonably required or appropriate to evidence or carry out the intent and purposes of this Agreement.**

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18

Execution and Signatures

Carolyn Owens Vogt

I. CHECKLIST: INFORMATION NECESSARY TO PREPARE FOR EXECUTION §18.1

II. METHOD OF EXECUTION §18.2
- A. Corporate Parties
  - 1. Effect of Signature Block Form on Personal and Corporate Liability §18.3
  - 2. Formalities for Corporate Parties
    - a. Seals as Ineffective §18.4
    - b. Attestations §18.5
    - c. Officer's Certificate §18.6
      - (1) Form: Certificate of Incumbency §18.7
      - (2) Form: Certified Corporate Records §18.8
  - 3. Form: Execution by Corporation §18.9
- B. Limited Liability Company Parties
  - 1. Effect of Signature Block Form §18.10
  - 2. Form: Members' Certificate for Member-Managed Limited Liability Company §18.11
  - 3. Form: Managers' Certificate for Manager-Managed Limited Liability Company §18.12
  - 4. Form: Execution by Limited Liability Company §18.13
- C. General Partnership Parties
  - 1. Effect of Signature Block Form on Personal and General Partnership Liability §18.14
  - 2. Form: Certificate of Managing Partner §18.15
  - 3. Form: Execution by General Partnership With Corporate Partner Authorized to Sign §18.16
  - 4. Form: Execution by General Partnership With Individual Partner Authorized to Sign §18.17
- D. Limited Partnership Parties
  - 1. Effect of Signature Block Form on Personal and Limited Partnership Liability §18.18
  - 2. Form: Execution by Limited Partnership With Corporate General Partner Authorized to Sign §18.19
  - 3. Form: Execution by Limited Partnership With Individual Partner Authorized to Sign §18.20
- E. Limited Liability Partnership
  - 1. Effect of Signature Block Form §18.21
  - 2. Form: Certificate of Managing Partner §18.22
  - 3. Form: Execution by Limited Liability Partnership §18.23
- F. Individual Parties
  - 1. Signature Block §18.24
  - 2. Form: Execution by Individual §18.25
  - 3. Need for Spouse or Registered Domestic Partner to Sign or Consent §18.26
  - 4. Signing Versus Consenting to Agreement §18.27
  - 5. Form: Consent When Spouse or Registered Domestic Partner Represented by Counsel §18.28
  - 6. Form: Consent When Spouse or Registered Domestic Partner Not Represented by Counsel §18.29
- G. Attorney-in-Fact
  - 1. When Used §18.30
  - 2. Form: Execution by Attorney-in-Fact Authorized to Sign on Behalf of Individual §18.31
- H. Guarantors and Sureties §18.32
- I. Form: Example of Signature Block for Agreement Including All Forms of Entities §18.33

III. ACKNOWLEDGMENTS (NOTARIZATION)
- A. When Required §18.34
- B. Acknowledgment Signed in California §18.35
- C. Form: Civil Code §1189 General Form of Certificate of Acknowledgment §18.36
- D. Acknowledgment Signed Outside California §18.37

IV. CERTIFICATIONS AND DECLARATIONS UNDER PENALTY OF PERJURY §18.38
- A. Form: Certification or Declaration Under Penalty of Perjury Executed in California §18.39
- B. Form: Certification or Declaration Under Penalty of Perjury Executed Within or Outside California §18.40

V. PRACTICAL CONSIDERATIONS AND FORMALITIES
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B. Facsimiles of Signatures; Electronic Signatures
1. Use of Facsimiles §18.42
2. Form: Facsimile Signature §18.43
3. Electronic Signatures §18.44
4. Form: Electronic Signatures §18.45
C. Location of Signature §18.46
D. Counterparts
1. Purpose and Use §18.47
2. Form: Execution in Counterparts §18.48
E. Execution Copy and Duplicate Originals §18.49
F. Who Should Sign First?
1. General Rules §18.50
2. Form: Effective After All Parties Sign §18.51
G. Alterations
1. Methods of Including Changes §18.52
2. Form: Sample Alteration of Agreement Provision §18.53

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/18 Execution and Signatures/ §18.1 I. CHECKLIST: INFORMATION NECESSARY TO PREPARE FOR EXECUTION

§18.1 I. CHECKLIST: INFORMATION NECESSARY TO PREPARE FOR EXECUTION

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- Parties
- Guarantors
- For corporations (see §§18.3-18.9)
- Name and title of individual signing on behalf of corporation (see §§18.6-18.7)
- Officer's certificate (see §§18.6-18.8)
- Effect of corporate seal or attestation (see §§18.4-18.5)
- For limited liability companies (see §§18.10-18.13)
- Name and title of members signing on behalf of limited liability company (see §18.10)
- For partnerships (see §§18.14-18.17)
- Name and title of partners signing on behalf of partnership (see §18.14)
- Certified partnership agreement (see §18.15)
- For individuals (see §§18.24-18.29)
- Full name
- Need for consent of spouse or registered domestic partner (see §§18.26-18.29)
- For attorneys-in-fact (see §§18.30-18.31)
- Need for acknowledgment, certification, or declaration (see §§18.35-18.40)
- Alternative means of execution
- By mark (see §18.41)
- By facsimile or other electronic means (see §§18.42-18.45)
- Number of copies executed (see §§18.47-18.49)

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§18.2 II. METHOD OF EXECUTION

This chapter discusses the practical aspects of signing and executing a business agreement. In everyday practice, the terms "signing" and "execution" have no difference in meaning. From a technical standpoint, however, signing an agreement is the act of signing one's name to an instrument, while execution of an agreement is both the signing of the agreement by all parties and the delivery of the agreement. CCP §1933. On execution, an enforceable agreement is created among the parties.

Real property transactions sometimes have different execution requirements from business transactions; they are generally not discussed in this chapter. For a discussion of the requirements for executing and signing agreements for the disposition of real property, see California Real Property Sales Transactions, chap 4 (4th ed Cal CEB 2007).

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A. Corporate Parties

§18.3 1. Effect of Signature Block Form on Personal and Corporate Liability

A corporation has the power to enter into contracts. Corp C §207(g). Officers of the corporation derive their power to enter into contracts on behalf of the corporation from the bylaws and resolutions of the corporation's board of directors, which provide whether one officer acting alone, or more than one officer, is required to bind the corporation with respect to a particular matter. Corp C §§211, 300.

NOTE: Shareholder approval is generally necessary for an acquisition, merger, or sale of all or a significant portion of a corporation's assets. Corp C §§1001(a), 1101, 1103, 1201.

The signature block for a corporation should state the name of the corporation and indicate by name and title the person executing the document on behalf of the corporation. See §18.9. If the corporation's name is not mentioned, the officer's signature, even if followed by the officer's title (*e.g.,* "Vice President"), does not create a corporate obligation; instead, a personal obligation of the signer is created. *Hobson v Hassett* (1888) 76 C 203, 18 P 320; *Sebastian Int'l v Peck* (1987) 195 CA3d 803, 240 CR 911. See also Com C §3402; Prob C §18000.

An agreement signed by the corporation's "chairman of the board, the president or any vice president and the secretary, any assistant secretary, the chief financial officer or any assistant treasurer" can be a valid agreement enforceable against the corporation, even if the signing officer did not have the authority to sign on behalf of the corporation, unless the other party to the agreement had actual knowledge that the signing officer had no authority to execute the agreement. Corp C §313. Putting it another way, if the agreement is signed by two individuals, one from each of the listed groups, a safe harbor is created and the agreement is binding on the corporation. This does not mean that an agreement signed by only one corporate officer is not enforceable.

> [W]hen applicable, Corp C §313 provides a conclusive, rather than a merely rebuttable, evidentiary presumption of authority on the part of the specified corporate officers to execute the document in question on behalf of the corporation. The statute also limits the burden of proof, insofar as the third party's knowledge is concerned, to a showing that he or she did not have actual knowledge of any lack of authority on the part of the signing officers. In so providing, the statute's purpose is to permit the third party to rely upon the assertive authority of the officers designated by the statute. At the same time, the third party whose agreement has been executed by a person who is not one of the specified officers is not prevented from utilizing common law theories to prove that a corporation is bound by the agreement.

Snukal v Flightways Mfg., Inc. (2000) 23 C4th 754, 783, 98 CR2d 1. In *Snukal*, the California Supreme Court concluded that under Corp C §313, a contract is binding on a corporation when an individual who in fact occupies the office of president, chief financial officer, and secretary of a corporation executes a contract on behalf of the corporation, even when the contract expressly identifies the individual solely as its president.

PRACTICE TIP: Counsel should review certified copies of the bylaws of the corporation and the resolutions of the board of directors and shareholders, if applicable, which authorize the officers signing the agreement on behalf of the corporation to do so. See §18.8. Such certified copies of the bylaws and resolutions are prima facie evidence of the matters stated in the bylaws or resolutions. Corp C §314. The best course of action is to obtain the signatures of two corporate officers, the first being the CEO, President, or any VP and the second being the secretary, assistant secretary, CFO, or assistant treasurer.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/18 Execution and Signatures/ 2. Formalities for Corporate Parties/§18.4 a. Seals as Ineffective

2. Formalities for Corporate Parties

§18.4 a. Seals as Ineffective

California law does not distinguish between an agreement that has the corporate seal embossed on it and an unsealed document. CC §1629. Therefore, an agreement to which a seal has been affixed may be amended by an unsealed agreement. CCP §1932.

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§18.5 b. Attestations

An agreement contains an attestation if someone other than the signer witnesses the signing and signs the agreement as a witness. A business agreement need not contain an attestation to be enforceable in California. In practice, however, certain documents (*e.g.,* indentures) routinely call for an attestation by the corporate secretary of the signing corporate party.

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§18.6 c. Officer's Certificate

Certificates of signing authority and the incumbency of the corporate parties' officers are routinely part of the closing documents. A corporate officer, usually the corporate secretary, might certify that the person signing the agreement on behalf of the corporation is a duly elected officer and that the signature of the party signing the agreement is his or her genuine signature.

In connection with the closing of a transaction, the corporate secretary also routinely certifies that the articles of incorporation, bylaws, and resolutions attached to the certificate are true and correct copies of such documents and that there have been no changes in the matters set forth in the documents since the date of the documents. The bylaws and resolutions state which officers are permitted to sign agreements on behalf of the corporation. Such certificates, when used in connection with the signing of a business agreement, generally are *not* made under "penalty of perjury." See §§18.38-18.40.

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§18.7 (1) Form: Certificate of Incumbency

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18.7-1 Certificate of incumbency

CERTIFICATE OF INCUMBENCY

The undersigned, _ _[*name of chief executive officer*]_ _ and _ _[*name of secretary*]_ _, do hereby certify that:

1. They are the duly elected and acting Chief Executive Officer and Secretary, respectively, of _ _[*name of corporation*]_ _, a _ _[*e.g., California*]_ _ corporation, and

2. The following persons are now, and have been since the date following their names, duly elected and qualified officers of _ _[*name of corporation*]_ _, holding the office indicated opposite their respective names, and

3. The signature appearing opposite their respective names are genuine signatures of such persons:

Name *Office* *Date* *Signatures*

IN WITNESS WHEREOF, we have executed this Certificate and affixed the corporate seal of _ _[*name of corporation*]_ _ this _ _[*date*]_ _.

__[*Signature*]__

Name: _ _[*Typed name*]_ _
Title: Chief Executive Officer

__[*Signature*]__
Name: _ _[*Typed name*]_ _
[Seal] **Title: Secretary**

Comment: This certificate can be combined with the secretary's certificate relating to articles of incorporation, bylaws, and resolutions (see §18.8).

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§18.8 (2) Form: Certified Corporate Records

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18.8-1 Certified corporate records

SECRETARY'S CERTIFICATE

I, _ _[*name of secretary*]_ _, hereby certify that:

1. I am the duly elected and acting Secretary of _ _[*name of corporation*]_ _, a _ _[*e.g., California*]_ _ corporation (the "Corporation"), and as such I have charge and custody of the corporate seal and the books and records of the Corporation.

2. The articles of incorporation attached to this certificate as Exhibit A are the true, correct, and complete articles of incorporation of the Corporation, and they have not been amended or repealed, and are in full force and effect, as of the date of this certificate.

3. The bylaws attached to this certificate as Exhibit B are the true, correct, and complete bylaws of the Corporation, and they have not been amended or repealed, and are in full force and effect, as of the date of this certificate.

4. The corporate resolutions attached to this certificate as Exhibit C are the true resolutions duly and legally adopted by the Board of Directors of the Corporation on _ _[*date*]_ _, and they have not been amended or revoked, and remain in full force and effect, as of the date of this certificate.

Date: _ _ _ _ _ _ __[*Signature*]__

Name: _ _[*Typed name*]_ _

[Seal] **Title: Secretary**

Comment: This certificate can be combined with the certificate of incumbency (see §18.7).

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§18.9 3. Form: Execution by Corporation

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18.9-1 Execution by corporation

Date: _ _ _ _ _ _

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*State of incorporation*]_ _ **corporation**

By: __[*Signature of officer*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: The name of the corporation, as it appears in the signature block and the beginning of the agreement, should be that name specified in its articles of incorporation. An alternative form would be to use the word "Title" in place of "Its."

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B. Limited Liability Company Parties

§18.10 1. Effect of Signature Block Form

A limited liability company (LLC) is a business organization that is treated like a corporation for liability purposes and like a partnership for income tax purposes. In California, LLCs are governed by the Beverly-Killea Limited Liability Company Act (Corp C §§17000-17705). The Act contemplates management by the LLC's owners, who are called "members." Corp C §§17001(x), 17150. The LLC also can be "manager-managed" by either members or nonmembers. Corp C §17150.

A member is not personally liable for any contract, tort, or other obligation of the LLC simply by being a member of the LLC. Corp C §17101. Similarly, neither managers nor officers of the LLC have any personal liability for contract, tort, or other obligations of the LLC by virtue of being managers or officers. Corp C §17158.

Unless provided otherwise in the LLC's articles of organization or operating agreement, the act of any member for the apparent purpose of carrying on in the usual way the business or affairs of the LLC binds the LLC, unless the member in fact has no authority to act and the person with whom the member is dealing has actual knowledge that the member has no such authority. Corp C §17157(a). For manager-managed LLCs, in the absence of language to the contrary in the operating agreement, the act of any manager for the apparent purpose of carrying on in the usual way the business or affairs of the LLC binds the LLC, unless the manager in fact has no authority to act and the person with whom the manager is dealing has actual knowledge that the manager has no such authority. Corp C §17157(b)(2).

An agreement signed by at least two managers of an LLC (or by one manager if the articles of organization provide for only one manager) can be a valid agreement enforceable against the LLC, even if the signing manager or managers did not have the authority to sign on behalf of the LLC, unless the other party to the agreement had actual knowledge that the signing officer had no authority to execute the agreement. Corp C §17157(d). If the LLC's operating agreement provides for the appointment of officers, an agreement signed by the LLC's chairperson of the board, the president or any vice president, and any secretary, any assistant secretary, the chief financial officer, or any assistant treasurer of the LLC, can be a valid agreement enforceable against the LLC, even if the signing officer did not have the authority to sign on behalf of the LLC, unless the other party to the agreement had actual knowledge that the signing officer had no authority to execute the agreement. Corp C §17154(c). See discussion in §18.3 of *Snukal v Flightways Mfg., Inc.* (2000) 23 C4th 754, 98 CR2d 1.

PRACTICE TIP: There is no "established practice" as to what documents will be required to confirm the status of a limited liability company. However, the prudent attorney may follow the general practice for corporate entities and require a certified copy of the articles of organization and operating agreement of the LLC.

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§18.11 2. Form: Members' Certificate for Member-Managed Limited Liability Company

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18.11-1 Members' certificate for member-managed limited liability company

MEMBERS' CERTIFICATE

The undersigned, the members of _ _[*name of limited liability company*]_ _ (the "LLC"), hereby certify that:

1. The articles of organization attached to this certificate as Exhibit A are the true, correct, and complete articles of organization of the LLC, _ _[*as amended,*]_ _ and that they have not been _ _[*further*]_ _ amended or repealed, and are in full force and effect, as of the date of this certificate.

2. The Operating Agreement attached to this certificate as Exhibit B is the true, correct, and complete Operating Agreement of the LLC, _ _[*as amended,*]_ _ and that it has not been _ _[*further*]_ _ amended or repealed, and is in full force and effect, as of the date of this certificate.

Date: _ _ _ _ _ _

__[*Signature*]__
Name: _ _[*Typed name*]_ _
Title: Member

Comment: The signature line should be repeated for each member signing the certificate.

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§18.12 3. Form: Managers' Certificate for Manager-Managed Limited Liability Company

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18.12-1 Managers' certificate for manager-managed limited liability company

MANAGERS' CERTIFICATE

The undersigned, the managers of _ _[*name of limited liability company*]_ _ (the "LLC"), hereby certify that:

1. The articles of organization attached to this certificate as Exhibit A are the true, correct, and complete articles of organization of the LLC, _ _[*as amended,*]_ _ and that they have not been _ _[*further*]_ _ amended or repealed, and are in full force and effect, as of the date of this certificate.

2. The Operating Agreement attached to this certificate as Exhibit B is the true, correct, and complete Operating Agreement of the LLC, _ _[*as amended,*]_ _ and that it has not been _ _[*further*]_ _ amended or repealed, and is in full force and effect, as of the date of this certificate.

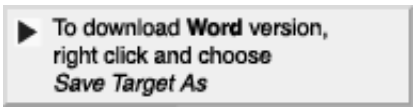
Date: _ _ _ _ _ _

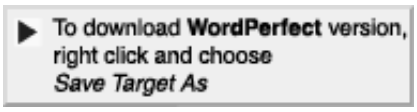
__[*Signature*]__
Name: _ _[*Typed name*]_ _
Title: Manager

Comment: The signature line should be repeated for each manager of the LLC.

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§18.13 4. Form: Execution by Limited Liability Company





18.13-1 Execution by limited liability company

Date: _ _ _ _ _ _

_ _[*NAME OF LIMITED LIABILITY COMPANY*]_ _,
a _ _[*State of organization*]_ _ **limited liability company**

By: __[*Signature of member/manager*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: The name of the limited liability company, as it appears in the signature block and at the beginning of the agreement, should be the name specified in its articles of organization. The signature block should be repeated for each member or manager required to sign on behalf of the limited liability company.

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C. General Partnership Parties

§18.14 1. Effect of Signature Block Form on Personal and General Partnership Liability

Most general partnerships formed on or after January 1, 1997, are governed by the Revised Uniform Partnership Act of 1994 (RUPA) (Corp C §§16100-16962), enacted in 1996. Partnerships formed before that date are governed by the Uniform Partnership Act (UPA) (Corp C §§15001-15058) until January 1, 1999, when RUPA applies to all partnerships. Thus, references in the following discussion to the provisions of UPA without reference to corresponding provisions in RUPA are valid only with respect to issues of authority for partnership actions taking place before that date.

Every partner of a general partnership is an agent of the partnership for the purpose of its business. Therefore, each partner can bind the partnership by executing in the partnership name an agreement for apparently carrying on the business of the partnership in the usual way, unless the other party has knowledge that the signing partner has no authority to bind the partnership. Corp C §§15009(1), 16301(1). A partner does not bind the partnership by executing an agreement that is not apparently for carrying out the business of the partnership in the usual way, unless the agreement is authorized by the other partners. Corp C §§15009(2), 16301(2). Similarly, under UPA, a partner cannot bind the partnership if to do so would violate restrictions on authority contained in the partnership agreement and the other party to the agreement has knowledge of the restrictions. Corp C §15009(4).

The signature block for a general partnership should state the name of the partnership and the name of the person or persons who have the authority to execute the document on behalf of the partnership. Often, the party with authority to enter into agreements on behalf of the partnership is the managing partner. However, other partners and officers also may have such authority. Every partner in a general partnership is personally liable for the debts and obligations of the partnership. Corp C §§15015, 16306. Nevertheless, for clarity, the person signing an agreement on behalf of a general partnership should indicate that he or she is signing on behalf of the partnership.

If the partner signs only in his or her name, without mentioning the partnership, the partnership is not liable under the agreement. If a liability is created by the agreement, the parties will look to the assets of the individual and not to the assets of the partnership, because the partnership is not a party to the agreement unless it is identified in the signature block. See *Sebastian Int'l v Peck* (1987) 195 CA3d 803, 808, 240 CR 911.

RUPA establishes a statewide filing system to assist partnerships and third parties in verifying who has authority to act for a general partnership. Unlike filings by corporations, limited partnerships, and limited liability companies, this filing system is purely voluntary. Under RUPA, a partnership may file a statement of partnership with the Secretary of State for the purpose of establishing the authority of partners. Corp C §16303(a). The statement may specify the authority, or limitations on authority, of some or all of the partners to enter into transactions on behalf of the partnership. Corp C §16303(a)(2). Any partner can file a statement of denial, for the purpose of contradicting a filed statement of authority, including a denial of a person's authority or status as a partner. Corp C §16304. A dissociated partner or the partnership can file a statement of dissociation indicating that a given partner has dissociated from the partnership and therefore no longer has authority to act for the partnership. Corp C §16704.

A filed statement of authority can generally be used by a third party to establish partnership authority, but the existence of a filed statement does not create constructive notice of its terms. Corp C §16303(d), (f). There are some important exceptions to this rule: (1) nonpartners are deemed to know of limitations on authority specified in a statement recorded in the office for recording transfers of real property (Corp C §16303(e)); and (2) third parties have constructive notice of filed statements of dissociation and statements of dissolution 90 days after the filing (Corp C §16704(c)).

PRACTICE TIP: Counsel should review a certified copy of the partnership agreement to verify that (a) those persons executing the agreement have the authority to do so, (b) those persons are all the persons necessary to bind the partnership, and (c) all proper partnership procedures with respect to the agreement (such as partnership meetings, if necessary) have been followed. Counsel should also ascertain who is authorized to certify the partnership agreement. Counsel should check with the Secretary of State's office for filed statements of authority,

statements of denial, and statements of dissociation for RUPA partnerships.

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§18.15 2. Form: Certificate of Managing Partner

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18.15-1 Certificate of managing partner

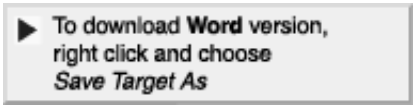
CERTIFICATE OF MANAGING PARTNER

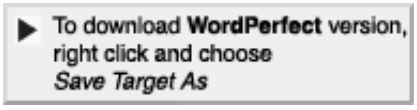
I, _ _[*name of managing partner*]_ _, Managing Partner of _ _[*name of partnership*]_ _ (the "Partnership"), hereby certify that the Partnership Agreement attached to this certificate as Exhibit A is the true, correct, and complete Partnership Agreement of the Partnership, _ _[*as amended,*]_ _ and that it has not been _ _[*further*]_ _ amended or repealed, and is in full force and effect, as of the date of this certificate.

Date: _ _ _ _ _ _ __[*Signature*]__
Name: _ _[*Typed name*]_ _
Title: Managing Partner

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§18.16 3. Form: Execution by General Partnership With Corporate Partner Authorized to Sign





18.16-1 Execution by general partnership with corporate partner authorized to sign

Date: _ _ _ _ _ _

_ _[*NAME OF PARTNERSHIP*]_ _,
a _ _[*State of organization*]_ _ **partnership**

By: _ _[*Name of corporate partner*]_ _,
_ _[*State of incorporation*]_ _ **corporation**

By: __[*Signature of corporate officer*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Corporate title*]_ _
Its: _ _[*Partnership title*]_ _

Comment: The name of the partnership, as it appears in the signature block and at the beginning of the agreement, should be that name specified in the partnership agreement. The name of the corporate partner authorized to sign on behalf of the partnership, as it appears in the signature block, should be that name specified on its articles of incorporation.

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§18.17 4. Form: Execution by General Partnership With Individual Partner Authorized to Sign

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18.17-1 Execution by general partnership with individual partner authorized to sign

Date: _ _ _ _ _ _

_ _[*NAME OF PARTNERSHIP*]_ _,
a _ _[*State of organization*]_ _ **partnership**

By: __[*Signature of individual*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: The name of the partnership, as it appears in the signature block and at the beginning of the agreement, should be that name specified in the partnership agreement.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/18 Execution and Signatures/ D. Limited Partnership Parties/§18.18 1. Effect of Signature Block Form on Personal and Limited Partnership Liability

D. Limited Partnership Parties

§18.18 1. Effect of Signature Block Form on Personal and Limited Partnership Liability

A limited partner may not enter into an agreement on behalf of the limited partnership; the management of a limited partnership resides with its general partners. Corp C §§15024, 16401(f), 15643 (Corp C §15904.06, operative Jan. 1, 2008, for new or electing limited partnerships). Limited partners who do not take control of the business have no right to execute agreements entered into by the partnership, have no liability for partnership liabilities or obligations, and are not personally bound by the obligations of the partnership. Corp C §§15501, 15507, 15632, (Corp C §15903.03(a), operative Jan. 1, 2008, for new or electing limited partnerships).

The authority of the general partner to bind the limited partnership is stated in the limited partnership agreement. Counsel must ascertain who is the general partner and who has the authority to sign agreements on behalf of the limited partnership.

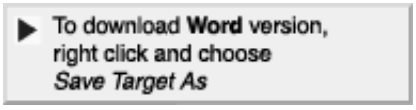
The signature block for a limited partnership should state the name of the partnership and indicate the name and title of the person who is executing the document on behalf of the partnership. See §§18.19-18.20.

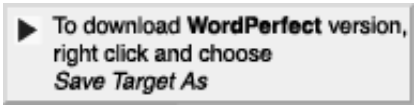
PRACTICE TIP: Counsel should review a certified copy of the limited partnership agreement to verify the authority of the general partner to bind the limited partnership, to confirm that no limited partner consent is required (or if required, that it was granted), and to ascertain who is authorized to certify the limited partnership agreement.

For rules governing transfer of real property, see Corp C §§15010, 16302, 16303.

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§18.19 2. Form: Execution by Limited Partnership With Corporate General Partner Authorized to Sign





18.19-1 Execution by limited partnership with corporate general partner authorized to sign

Date: _ _ _ _ _ _

_ _[*NAME OF PARTNERSHIP*]_ _,
a _ _[*State of organization*]_ _ **limited partnership**

By: _ _[*Name of corporate general partner*]_ _,
a _ _[*State of incorporation*]_ _ **corporation**

By: __[*Signature of corporate officer*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Corporate title*]_ _
Its: General Partner

Comment: The name of the limited partnership, as it appears in the signature block and at the beginning of the agreement, should be that name specified in the limited partnership agreement. The name of the corporate general partner authorized to sign on behalf of the limited partnership, as it appears in the signature block, should be the name specified in the corporation's articles of incorporation.

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§18.20 3. Form: Execution by Limited Partnership With Individual Partner Authorized to Sign

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18.20-1 Execution by limited partnership with individual partner authorized to sign

Date: _ _ _ _ _ _

_ _[*NAME OF PARTNERSHIP*]_ _,
a _ _[*State of organization*]_ _ **limited partnership**

By: __[*Signature of individual*]__
Name: _ _[*Typed name*]_ _
Its: General Partner

Comment: The name of the limited partnership, as it appears in the signature block and at the beginning of the agreement, should be the name specified in the limited partnership agreement.

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E. Limited Liability Partnership

§18.21 1. Effect of Signature Block Form

A registered limited liability partnership (LLP) is, in general, a partnership that practices public accountancy or law and complies with the requirements of Corp C §§15047-15058, 16951-16962. A partner in an LLP is not personally liable for the contracts, torts, or other obligations of the LLP or the other partners of the LLP by virtue of being a partner of the LLP. Corp C §§15015, 16306(c).

Every partner of the LLP is its agent, and the act of every partner for the apparent purpose of carrying on in the usual way the business or affairs of the LLP binds the LLP, unless the partner in fact has no authority to act and the person with whom the partner is dealing has actual knowledge that the partner has no such authority. Corp C §15009.

PRACTICE TIP: As with other partnerships, counsel should review a certified copy of the partnership agreement to verify that (1) those persons executing the agreement have the authority to do so, (2) those persons are all the persons necessary to bind the partnership, and (3) all proper partnership procedures with respect to the agreement (such as partnership meetings, if necessary) have been followed. Counsel should also ascertain who is authorized to certify the partnership agreement. Counsel should check with the Secretary of State's office for filed statements of authority, statements of denial, and statements of dissociation for all LLPs governed by RUPA.

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§18.22 2. Form: Certificate of Managing Partner

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18.22-1 Certificate of managing partner

CERTIFICATE OF MANAGING PARTNER

I, _ _[*name of managing partner*]_ _, Managing Partner of _ _[*name of limited liability partnership*]_ _ (the "Partnership"), hereby certify that the Partnership Agreement attached to this certificate as Exhibit A is the true, correct, and complete Partnership Agreement of the Partnership, _ _[*as amended,*]_ _ and that it has not been _ _[*further*]_ _ amended or repealed, and is in full force and effect, as of the date of this certificate.

Date: _ _ _ _ _ _

__[*Signature*]__
Name: _ _[*Typed name*]_ _
Title: Managing Partner

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§18.23 3. Form: Execution by Limited Liability Partnership

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18.23-1 Execution by limited liability partnership

Date: _ _ _ _ _ _

_ _[*NAME OF LIMITED LIABILITY PARTNERSHIP*]_ _,
a _ _[*State of organization*]_ _ **limited liability partnership**

By: __[*Signature of partner*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: The name of the limited liability partnership, as it appears in the signature block and at the beginning of the agreement, should be that name specified in the partnership agreement. The signature block should be repeated for each partner required to sign on behalf of the limited liability partnership.

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F. Individual Parties

§18.24 1. Signature Block

An agreement that imposes obligations on an individual, in his or her individual capacity only, should be executed by that individual as his or her name appears in the heading of the agreement. For clarity, the person's name should be typed under the signature. While a signature can consist of a party's abbreviated name, initials, or nickname, parties usually sign their formal name or the name by which they are known. *Marks v Walter G. McCarty Corp.* (1949) 33 C2d 814, 820, 205 P2d 1025. For form of signature block for an individual, see §18.25.

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§18.25 2. Form: Execution by Individual

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18.25-1 Execution by individual

Date: _ _ _ _ _ _ __[*Signature*]__
Name: _ _[*Typed name*]_ _

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§18.26 3. Need for Spouse or Domestic Partner to Sign or Consent

If a business agreement is to be entered into by an individual, should the individual's spouse or registered domestic partner (see Fam C §§297-299.6) sign or consent to the agreement? Under California law, each spouse has a fiduciary duty with respect to the other spouse in the management and control of their community property. Fam C §1100(e). The provisions of Fam C §§1100 and 1102 are equally applicable to registered domestic partners by operation of Fam C §297.5.

A spouse who is operating or managing a business that is all or substantially all community personal property may act alone in all transactions but must give prior written notice to the other spouse of any sale, lease, or other disposition of the property, regardless of how it is titled. Fam C §1100(d). A spouse is also prohibited from conveying community personal property without the other spouse's written consent (Fam C §1100(c)), and both spouses must join in executing any instrument by which community real property is leased for 1 year or longer, or is sold, conveyed, or encumbered (Fam C §1102(a)). However, conveyances by one spouse only to a lessee, purchaser, or encumbrancer acting in good faith without knowledge of the marriage relationship are presumed valid. Fam C §1102(c)(2).

If an individual is a party to a transaction, the individual's spouse or registered domestic partner should sign the agreement; this will avoid questions concerning whether the individual properly exercised his or her fiduciary duty to the spouse or registered domestic partner. See §§18.27-18.29.

The spouse who has primary management responsibility and who controls the community asset may act alone regarding that asset, subject to an obligation to give prior written notice to the other spouse. Failure to do so, however, will not adversely affect the validity of the transaction nor of any interest transferred. Fam C §1100. The only recourse of the other spouse if proper notice was not given is a claim against the managing or controlling spouse for breach of fiduciary duty and impairment to that spouse's undivided one-half interest in the community estate.

For more discussion of contractual obligations with respect to the spouse or registered domestic partner of the person entering into the contract, see California Law of Contracts §4.43 (Cal CEB 2007).

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§18.27 4. Signing Versus Consenting to Agreement

Both spouses or registered domestic partners should sign an agreement if the parties intend that both be bound by the agreement. Are both spouses or registered domestic partners making the representations? Should both agree to the covenants? If the spouse or registered domestic partner is not to be bound by all the provisions of the agreement but community property is involved, a consent by the spouse or registered domestic partner is appropriate. For example, a consent might be appropriate if the agreement provides for the sale of a business operated principally by one spouse or registered domestic partner.

PRACTICE TIP: It is strongly recommended that the consenting spouse or registered domestic partner consult with separate counsel. If the consenting spouse or registered domestic partner decides not to be represented by counsel, he or she should sign a statement that he or she has had the opportunity to have representation.

For form of consent for a spouse or registered domestic partner not signing the agreement, see §§18.28-18.29.

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§18.28 5. Form: Consent When Spouse or Registered Domestic Partner Represented by Counsel

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18.28-1 Consent when spouse or registered domestic partner represented

I have had an opportunity to be, and have been, represented in the above Agreement by counsel of my own choosing. I have read the Agreement, my counsel has fully explained its contents to me, and I am aware of its legal effect. I understand that, under the terms of the Agreement, my _ _[*spouse/registered domestic partner*]_ _ agrees to _ _[*describe action to be taken, e.g., sell the entire interest of each of us in _ _[identify property*]_ _]_ _, including my community interest in it, on the terms stated in the Agreement.

I consent to the Agreement and I agree to be bound by it.

Date: _ _ _ _ _ _ __[*Signature*]__
Name: _ _[*Typed name*]_ _

Approved:
By: __[*Signature of counsel*]__
Name: _ _[*Typed name*]_ _
Attorney for _ _[*Name of spouse or registered domestic partner*]_ _

Date: _ _ _ _ _ _

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§18.29 6. Form: Consent When Spouse or Registered Domestic Partner Not Represented by Counsel

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18.29-1 Consent when spouse or registered domestic partner not represented

I have had an opportunity to be represented in the above Agreement by counsel of my own choosing but have declined the opportunity. I have read the Agreement and fully understand its contents, and I am aware of its legal effect. I understand that, under the terms of the Agreement, my _ _[*spouse/registered domestic partner*]_ _ agrees to _ _[*describe action to be taken, e.g., sell the entire interest of each of us in _ _[identify property*]_ _]_ _, including my community interest in it, on the terms stated in the Agreement.

I consent to the Agreement and I agree to be bound by it.

Date: _ _ _ _ _ _ __[*Signature*]__
Name: _ _[*Typed name*]_ _

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G. Attorney-in-Fact

§18.30 1. When Used

An individual party to an agreement, or an individual signing on behalf of a corporation or partnership, may be unavailable to execute the agreement at the time and place of closing. In such instances, the signatory can arrange to have an attorney-in-fact sign the agreement on his or her behalf by executing and, if necessary, recording a power of attorney. See chap 23. In the corporate or partnership context, a power of attorney is seldom necessary because there is usually more than one officer authorized to sign an agreement.

The attorney-in-fact should sign the principal's name on the line where the principal would sign if he or she were signing, then sign his or her own name and identify the power of attorney. For form of signature block for an attorney-in-fact, see §18.31.

PRACTICE TIP: Counsel should review a copy of the power of attorney to assure that the person signing the agreement has the authority to do so.

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§18.31 2. Form: Execution by Attorney-in-Fact Authorized to Sign on Behalf of Individual

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18.31-1 Execution by attorney-in-fact authorized to sign

Date: _ _ _ _ _ _

__[*Attorney-in-fact signs principal's name*]__
Name: _ _[*Typed name of principal*]_ _

By: __[*Signature of attorney-in-fact*]__
Name: _ _[*Typed name*]_ _
Under Power of Attorney dated _ _[*date*]_ _

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§18.32 H. Guarantors and Sureties

If an obligation in the agreement is to be guaranteed by a third party, the guaranty must be signed by the third party; otherwise, the guaranty will not be effective. CC §2793. See also CCP §§995.310-995.380 (relating to bonds); Com C §3401(a) (no person liable on instrument unless person signed instrument). Usually, the guaranty will be set forth in a separate document, but it can be included in the main agreement if it is clear when and how the guarantor's obligations arise.

NOTE: California has abolished any distinction between guarantors and sureties. Both terms refer to one who promises to answer for the debt or default of another. CC §2787.

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§18.33 I. Form: Example of Signature Block for Agreement Including All Forms of Entities

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This form provides an example demonstrating how to incorporate signature blocks when different types of entities execute the same agreement. There are four parties in the example:

(1) Party 1 (ABC Corporation) is a California corporation. Allen Smith is the President of ABC.

(2) Party 2 (DEF Partnership) is a California general partnership with three partners:

- A California limited partnership (GHI Limited Partnership). Jane Doe is the General Partner of GHI.
- A California corporation (JKL, Inc.). Clay Carter is the President of JKL.
- An individual (Sue Peterson).

(3) Party 3 (XYZ Limited Liability Company) is a member-managed California limited liability company with members Nancy Brown and Sally Johnson.

(4) Party 4 (UVW Limited Liability Partnership) is a California limited liability partnership with partners Melissa Stern and Rod Bows. Melissa Stern is an unmarried individual whose attorney-in-fact (Harvey Jones) is executing the agreement for her. See §18.30. Rod Bows is a married individual. Frieda Bows is his wife and is signing a spousal consent. Barbara Fine is Frieda's attorney.

18.33-1 Example of signature block for agreement including all forms of entities

Date: July 1, 2006 **ABC CORPORATION,**
a California corporation

By: *Allen Smith*
Name: Allen Smith
Its: President

DEF PARTNERSHIP,
a California partnership

Date: July 1, 2006 **By: GHI LIMITED PARTNERSHIP,**
a California limited partnership

By: *Jane Doe*
Name: Jane Doe
Its: General Partner
Its: Partner

Date: July 1, 2006 **By: JKL, INC.,**
a California corporation

By: *Clay Carter*
Name: Clay Carter
Its: President
Its: Partner

Date: July 1, 2006 **By:** *Sue Peterson*
Name: Sue Peterson
Its: Partner

XYZ LIMITED LIABILITY COMPANY,

a California limited liability company

Date: July 1, 2006 **By:** *Nancy Brown*
Name: Nancy Brown
Its: Member

Date: July 1, 2006 **By:** *Sally Johnson*
Name: Sally Johnson
Its: Member

UVW LIMITED LIABILITY PARTNERSHIP,
a California limited liability partnership

Date: July 1, 2006 **By:** *Melissa Stern*
Name: Melissa Stern
Its: Partner

By: *Harvey Jones*
Name: Harvey Jones
Under Power of Attorney
dated January 1, 2005

Date: July 1, 2006 **By:** *Rod Bows*
Name: Rod Bows
Its: Partner

I have had an opportunity to be, and have been, represented in the above Agreement by counsel of my own choosing. I have read the Agreement, my counsel has fully explained its contents to me, and I am aware of its legal effect. I understand that, under the Agreement, my spouse, Rod Bows, agrees to sell the entire interest of each of us in property located at 123 Main Street, Anytown, California, including my community interest in it, on the terms stated in the Agreement.

I consent to the Agreement and I agree to be bound by it.

Date: July 1, 2006 *Frieda Bows*
Name: Frieda Bows

Dated: July 1, 2006 **Approved:**
By: *Barbara Fine*
Name: Barbara Fine
Attorney for Frieda Bows

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III. ACKNOWLEDGMENTS (NOTARIZATION)

§18.34 A. When Required

An acknowledgment is a person's declaration that:

- An agreement has been executed by a person (the signer) in the signer's authorized capacity, and
- The agreement was executed by the signer's signature.

The acknowledgment can be made before a notary public or before certain other officers. CC §§1181-1183. A certificate of acknowledgment executed on behalf of a corporation or unincorporated entity by duly authorized persons, *e.g.,* the president, vice president, secretary, or assistant secretary, is prima facie evidence that the instrument is the duly authorized act of the entity named in the instrument. CC §1190.

Most business agreements need not be notarized unless they provide for the conveyance of real property or an interest in real property. See, *e.g.,* Govt C §§27287-27288. In the absence of notarization, the parties' authority to execute is ascertained by examining certified documents, such as certified copies of articles of incorporation and bylaws or partnership agreements. See §18.8.

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§18.35 B. Acknowledgment Signed in California

Any certificate of acknowledgment in California must be in the form set forth in CC §1189(a). See §18.36. The statutory form is used for corporate, partnership, and individual acknowledgments.

Certain judges, clerks, and attorneys are permitted to sign this form of acknowledgment. CC §1181. In most business transactions, however, the acknowledgment is signed by a notary authorized to act in California.

NOTE: An attorney who signs an acknowledgment takes on the responsibility of ascertaining the facts in the acknowledgment.

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§18.36 C. Form: Civil Code §1189 General Form of Certificate of Acknowledgment

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18.36-1 Civil Code §1189 general form of certificate of acknowledgment

State of California)
County of _____)
)

On _____ before me, (here insert name and title of the officer) personally appeared _____, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument, and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies) and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

__[*Signature of officer*]__ [*Officer's seal*]

Comment: On the requirements for a thumbprint when notarizing a deed, quit claim deed, deed of trust affecting real property, or a power of attorney document, see Govt C §8206(a)(2)(G). A certificate of acknowledgment taken within California must be in the form set forth in CC §1189(a).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/18 Execution and Signatures/ §18.37 D. Acknowledgment Signed Outside California

§18.37 D. Acknowledgment Signed Outside California

An agreement can be acknowledged outside California and treated as if acknowledged in California if it is acknowledged in accordance with the laws of the place where the acknowledgment is made. CC §1189(b). The notary or other officer taking the acknowledgment must sign it, state the name of his or her office, and affix his or her seal, if required by the other state or country. CC §1193.

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§18.38 IV. CERTIFICATIONS AND DECLARATIONS UNDER PENALTY OF PERJURY

An unsworn certification or declaration of a person can be used in place of a sworn statement or declaration of that person if (CCP §2015.5):

- It is in writing;
- It recites that the matter in question is certified or declared to be true under penalty of perjury;
- It is signed by the person making the certification or declaration;
- If executed in California, it states the date and place of execution; and
- If executed outside California, it states the date of execution and that it is certified or declared under California law.

NOTE: Certificates regarding corporate formalities used in business agreements (see §§18.7-18.8) are not usually made "under penalty of perjury."

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§18.39 A. Form: Certification or Declaration Under Penalty of Perjury Executed in California

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18.39-1 Certification or declaration under penalty of perjury executed in California

[*Add one of the following alternatives*]

[*Alternative 1: Certified at the end of document*]

I certify (or declare) under penalty of perjury that the foregoing is true and correct.

Date: _ _ _ _ _ _ __[*Signature*]__
Place: _ _ _ _ _ _ **Name:** _ _[*Typed name*]_ _

[*Alternative 2: Information contained in certification*]

I certify (or declare) under penalty of perjury that the following is true and correct:

[*Insert information being certified*]

Date: _ _ _ _ _ _ __[*Signature*]__
Place: _ _ _ _ _ _ **Name:** _ _[*Typed name*]_ _

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§18.40 B. Form: Certification or Declaration Under Penalty of Perjury Executed Within or Outside California

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18.40-1 Certification or declaration under penalty of perjury executed within or outside California

[*Add one of the following alternatives*]

[*Alternative 1: Certified at the end of document*]

I certify (or declare) under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date: _ _ _ _ _ _ __[*Signature*]__
Name: _ _[*Typed name*]_ _

[*Alternative 2: Information contained in certification*]

I certify (or declare) under penalty of perjury under the laws of the State of California that the following is true and correct:

[*Insert information being certified*]

Date: _ _ _ _ _ _ __[*Signature*]__
Name: _ _[*Typed name*]_ _

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V. PRACTICAL CONSIDERATIONS AND FORMALITIES

§18.41 A. Signature by Thumbprint, Mark, or Other Means

Signatures in pencil, by mark, or by thumbprint, and stamped, printed, or typewritten signatures are the equivalent of a "signature" by a person signing his or her name in ink. See, *e.g., Marks v Walter G. McCarty Corp.* (1949) 33 C2d 814, 820, 205 P2d 1025; *Walsh v Hunt* (1898) 120 C 46, 51; *Skirball v RKO Radio Pictures, Inc.* (1955) 134 CA2d 843, 863, 286 P2d 954. See Com C §§1201(b)(37), 1201(b)(43), 3401; CC §14. These methods of signing are unusual in the business context, however, and are not recommended. See California Law of Contracts §4.40 (Cal CEB 2007).

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B. Facsimiles of Signatures; Electronic Signatures

§18.42 1. Use of Facsimiles

California courts have not ruled squarely on the validity of facsimile signatures to business agreements. However, some courts appear to presume their validity. See, *e.g.*, *Ellefson v Megadeth, Inc.* (SD NY, Jan. 13, 2005, No. 04 Civ 5395 (NRB)) 2005 US Dist Lexis 545 (applying California law; by faxing signed signature page to undisputed execution version of agreement, plaintiff indicated willingness to be bound by its terms, rather than mere desire to continue negotiations), and, in practice, most attorneys accept facsimile signatures to agreements at closing.

If the parties plan to sign the agreement, ancillary agreements, or subsequent documents under the agreement by facsimile or other electronic means, the agreement should provide that such signatures are permissible. See §18.43. On the E-Sign Act and electronic signatures, see §§18A.6-18A.9. On what constitutes a signature, see California Law of Contracts §§4.40, 4.54-4.62 (Cal CEB 2007).

NOTE: Facsimile signatures are acceptable as originals in other contexts, *e.g.,* under Cal Rules of Ct 2.305(d) (filing documents with trial court by facsimile transmission).

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§18.43 2. Form: Facsimile Signature

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18.43-1 Facsimile signature

***Acceptance of Facsimile Signatures*. The parties agree that this Agreement, agreements ancillary to this Agreement, and related documents to be entered into in connection with this Agreement will be considered signed when the signature of a party is delivered by facsimile transmission. Such facsimile signature must be treated in all respects as having the same effect as an original signature.**

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§18.44 3. Electronic Signatures

Electronic signatures are valid and enforceable under the federal Electronic Signatures in Global and National Commerce Act (E-SIGN) (15 USC §§7001-7031) and the California Uniform Electronic Transactions Act (UETA) (CC §§1633.1-1633.17). E-SIGN provides that, notwithstanding any other rule of law, "a signature, contract, or other record relating to [a] transaction may not be denied legal effect, validity, or enforceability solely because it is in electronic form." 15 USC §7001(a)(1). UETA includes similar language (see CC §1633.7(a), (b)) and further provides that "if a law requires a record to be in writing, an electronic record satisfies the law" (CC §1633.7(c)) and "if the law requires a signature, an electronic signature satisfies the law" (CC §1633.7(d)).

UETA also provides that an intended recipient is considered to have received an electronic record when the e-mail enters an information processing system that the recipient has designated for such purposes and from which the recipient can retrieve the electronic record. CC §1633.15(b). It is considered received even if no individual is aware of its delivery. CC §1633.15(e). The electronic document is considered to have been sent either when it "(1) enters an information processing system outside the control of the sender… or (2) enters a region of an information processing system that is under the control of the recipient." CC §1633.15(a).

On electronic contracting principles, see chap 18A.

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§18.45 4. Form: Electronic Signatures

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18.45-1 Electronic signatures

***Electronic Signatures*. Each party shall adopt as its signature an electronic identification consisting of a symbol or code which must be affixed to or contained in each document transmitted by such party ("Signature"). Each party agrees that any Signature of such party affixed to or contained in any transmitted document will be sufficient to verify that such party executed such document.**

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§18.46 C. Location of Signature

There is no legal requirement that signatures be located at any specific place on the business agreement, but parties customarily sign at the end of an agreement. *Marks v Walter G. McCarty Corp.* (1949) 33 C2d 814, 820, 205 P2d 1025. If the signature is not at the end of an agreement, the court determines whether the signature represents an execution of the agreement and whether any terms found after the signature are part of the agreement. See CCP §1933; *Rubino v Pray* (1960) 187 CA2d 495, 500, 9 CR 651 (whether terms after signature are part of agreement is question of fact); *In re Kossack* (1953) 113 F Supp 884, 888.

PRACTICE TIP: While there is no requirement to do so, it is recommended that all parties initial each page of the agreement, acknowledging by their initials that they have at a minimum viewed each page of the document. This also avoids arguments at a later date that the page or document was changed after execution by the parties.

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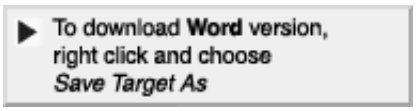
D. Counterparts

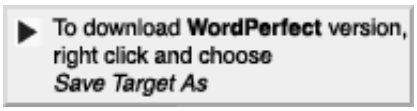
§18.47 1. Purpose and Use

Business agreements are often signed in counterparts, *i.e.,* each party to the agreement signs on a separate signature page. This procedure is commonly used if parties do not attend the closing in person. Separate signature pages allow parties to sign in different locations and send their signature pages to their attorney to be presented at the closing. If the agreement is signed in counterparts, all original signature pages taken together constitute a fully signed agreement. Counsel should include a paragraph in the agreement providing for counterpart signatures if they are to be used in the agreement. See form in §18.48.

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§18.48 2. Form: Execution in Counterparts





18.48-1 Execution in counterparts

***Counterparts*. This Agreement may be executed in any number of counterparts, each of which will be an original, but all of which together will constitute one instrument.**

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§18.49 E. Execution Copy and Duplicate Originals

Counsel often type the words "Execution Copy" on the top right hand corner of the first page of the final copy of an agreement to distinguish the final version from draft copies. Generally, each party to an agreement should have a fully executed copy of the agreement with original signatures. Customarily, the attorney for each party and each other party, such as accountants, who advises a party receive an originally executed copy. Thus, there may be numerous "original" copies of the agreement.

There should only be one "original" of an agreement for transactions under Com C §§9101-9508. Similarly, there should be only one "original" copy of a promissory note. The original should be clearly marked as such with the notation "Original." All other copies should be marked "Copy," even if the copies contain original signatures.

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F. Who Should Sign First?

§18.50 1. General Rules

If the parties to an agreement are signing the agreement by mail, can there be an enforceable agreement before all parties have signed? Certain contracts are invalid unless they are in writing and signed by the party to be charged or its agent. CC §1624. However, in certain circumstances, a party who signs an agreement can be bound by the agreement even if other parties to the agreement have not signed it. CC §3388. See *Kaneko v Okuda* (1961) 195 CA2d 217, 224, 15 CR 792. To avoid problems determining when an enforceable agreement has been made, the agreement should state whether it is effective only when all parties have signed it.

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§18.51 2. Form: Effective After All Parties Sign

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18.51-1 Effective after all parties sign

***Effectiveness*. This Agreement will be effective only when signed by all parties.**

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G. Alterations

§18.52 1. Methods of Including Changes

All provisions of the agreement should be printed or typed into the agreement. If omitted provisions need to be added at the last minute, however, they can be handwritten or typed on all copies of the agreement. The handwritten or typed changes to the execution copies of an agreement should be initialed by the authorized signer for each party to the agreement, as close as possible to the place in the agreement where the change is made. If both parties do not initial each change, questions may arise as to whether the change was part of the agreement.

Alternatively, the parties can change the agreement after execution by describing the change after the signatures of the parties and having all parties sign this change. See §18.53.

The third, and best, approach is to execute an amendment. See chap 19.

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§18.53 2. Form: Sample Alteration of Agreement Provision

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18.53-1 Sample alteration of agreement

The parties agree that all references to the guarantor in the above agreement are deleted.

Date: July 1, 2006 *John Doe/*
Name: John Doe

Date: July 1, 2006 *Jane Roe*
Name: Jane Roe

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18A

Electronic Contracting

Clara Ruyan Martin

I. CHECKLIST: ELECTRONIC CONTRACTING §18A.1

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IV. E-SIGN
- A. Introduction §18A.6
- B. Electronic Signatures §18A.7
- C. Consumer Protection Features §18A.8
- D. Electronic Record Retention §18A.9

V. UNIFORM ELECTRONIC TRANSACTIONS ACT (UETA)
- A. Introduction §18A.10
- B. Consent Under UETA §18A.11

VI. UNIFORM COMPUTER INFORMATION TRANSACTIONS ACT (UCITA) §18A.12

VII. AMERICAN LAW INSTITUTE (ALI) PRINCIPLES OF THE LAW OF SOFTWARE CONTRACTS §18A.12A

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- A. Access to Terms §18A.14
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X. ONLINE SOFTWARE USER "CLICK-WRAP" AGREEMENT
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- B. Form: Recitals §18A.17
- C. Form: Nature of Agreement; License Grant §18A.18
- D. Terms
  1. Form: Ownership and Restrictions §18A.19
  2. Form: Obligations of Licensee §18A.20
  3. Form: Term and Termination §18A.21
  4. Form: Confidentiality §18A.22
  5. Form: Liability §18A.23
  6. Form: Warranty §18A.24
- E. Form: General Provisions §18A.25
- F. Form: Acknowledgment and Exclusivity §18A.26

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§18A.1 I. CHECKLIST: ELECTRONIC CONTRACTING

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

- Form of license (see §§18A.2-18A.5)
- E-Sign (see §18A.6)
- Electronic signature (see §18A.7)
- Statement of consumer rights (see §18A.8)
- Retaining contract (see §18A.9)
- California UETA
- Preemption (see §18A.10)
- Consent of parties (see §18A.11)
- UCITA (see §18A.12)
- ALI Software Principles (see §18A.12A)
- EU Directives (see §18A.13)
- Agreement structure
- Access to terms (see §18A.14)
- Conspicuous display of terms (see §18A.15)
- Affirmative consent mechanism (see §18A.15)
- Option to reject terms and consequences (see §18A.15)
- Printable (see §18A.15)
- Software license agreement
- Recitals (see §18A.17)
- Nature of agreement (see §18A.18)
- Terms (see §§18A.19-18A.22)
- General provisions (see §18A.25)
- Acknowledgment (see §18A.26)

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§18A.2 II. INTRODUCTION

Advances in technology and mass-market distribution of computer software have challenged the traditional process of contract formation. It is not feasible to require a consumer to sign and return a software license before purchasing a word processing or other software package at a retail outlet. Similarly, any requirement that an end user physically sign and return a written agreement before entering and using an Internet website would be completely impractical to implement.

These challenges have given rise to alternative forms of contracting based on the user's acts rather than the user's signature for rights to use software and Internet-based functions. For example:

- A "shrink-wrap" license agreement refers to a contract formed when a user opens the software's packaging (often plastic shrink wrap) and begins using the software. See §18A.3.
- A "click-wrap" agreement is a contract formed by a user's action of clicking on a button or icon on a web page or screen launched as part of the installation of the program on the user's computer to indicate acceptance of contract terms. See §18A.4. For a form of click-wrap agreement, see §§18A.16-18A.26.
- A "browse-wrap" or "click-free" agreement is a contract formed by a user's action of simply visiting or viewing an Internet website. See §18A.5.

Click-wrap and browse-wrap formats are used for many types of agreements and consents relating to the Internet, including software license agreements, linking agreements, website terms of use, and privacy policies. On drafting software license agreements, see chap 24. For general discussion, see Internet Law and Practice in California (Cal CEB 2004).

This chapter provides an overview of the issues concerning the enforceability of agreements in these formats, as well as statutory provisions governing enforcement of electronic contracts generally, including the federal Electronic Signatures in Global and National Commerce Act (E-Sign) (15 USC §§7001-7031) (see §§18A.6-18A.9); the California Uniform Electronic Transactions Act (UETA) (CC §§1633.1-1633.17) (see §§18A.10-18A.11); the apparently ill-fated Uniform Computer Information Transactions Act (UCITA) (see §18A.12); and applicable European Union directives (see §18A.13). Tips for drafting enforceable online agreements are included in §§18A.14-18A.15.

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III. ENFORCEABILITY OF SHRINK-WRAP, CLICK-WRAP, AND BROWSE-WRAP AGREEMENTS

§18A.3 A. Shrink-Wrap Software Licenses

The modern view on the enforceability of shrink-wrap licenses is reflected in the leading case of *ProCD, Inc. v Zeidenberg* (7th Cir 1996) 86 F3d 1447. In *ProCD*, the Seventh Circuit held that a shrink-wrap license will be enforceable if (1) customers have an opportunity to review the terms of the license before making a final decision regarding use of the software, and (2) the license contains no contract terms that are unconscionable. In so holding, the Seventh Circuit relied on former UCC §2-204(1), which provides as follows:

> A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract.

The court also cited UCC §2-606(1)(b), which provides that a buyer is deemed to have accepted goods when, after an opportunity to inspect, he or she fails to make an effective rejection. 86 F3d at 1452. The court found that a customer may signal agreement to the terms of the license by installing and using the software, regardless of whether he or she actually took the time to read the license. Only an opportunity to review is needed. Significantly, the Seventh Circuit also held that the issue of enforceability of the license was a matter of state law, not preempted by the Copyright Act. See also *Hill v Gateway 2000, Inc.* (7th Cir 1997) 105 F3d 1147 (plaintiffs accepted terms of unread license agreement shipped with computer by using computer).

Courts originally viewed the enforceability of shrink-wrap mass market software license agreements with skepticism, holding that contract terms hidden "inside the box" would not be enforceable because any contract was formed at the time of purchase and delivery of the box, not later when the box was opened. See, *e.g., Step-Saver Data Sys. v Wyse Technol.* (3d Cir 1991) 939 F2d 91 (shrink-wrap license that purchaser saw for first time on opening software was ineffective under former UCC §2-207 to subsequently modify the terms of contract formed on acceptance of offer).

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§18A.4 B. Click-Wrap Agreements

Specific terms of online click-wrap agreements between users and software or service providers have been upheld in many cases. *CompuServe, Inc. v Patterson* (6th Cir 1996) 89 F3d 1257 was one of the first cases holding that a contract could be formed when a user indicates acceptance by interacting with a website. In that case, the Sixth Circuit upheld a forum selection clause in an online click-wrap agreement, which required the user to type "AGREE" at several points in the online document to indicate consent to its terms. The forum selection clause at issue was in a separate agreement incorporated by reference into the main registration agreement. The court found that the user's online conduct manifested assent to the terms of the main agreement as well as to the agreement incorporated by reference. See also *Caspi v Microsoft Network, LLC* (NJ Super 1999) 732 A2d 528 (upholding forum selection clause in Microsoft Network's click-wrap membership agreement; subscribers were prompted to click either "I Agree" or "I Don't Agree" icons after scrolling through online agreement). But see *Williams v America Online, Inc*. (Mass Super, Feb. 8, 2001, No. 00-0962) 2001 Mass Super Lexis 11 (forum selection clause in AOL's service agreement not enforceable because users did not have reasonable notice of contract terms before AOL's software reconfigured their computers and because of complexity in accessing contract terms).

In *American Eyewear v Peeper's Sunglasses* (ND Tex 2000) 106 F Supp 2d 895, the court recommended the use of click-wrap agreements to avoid venue disputes, recognizing that operating a business on the Internet may potentially subject the website owner to the laws of multiple jurisdictions. For further discussion of jurisdictional issues in doing business online, see Internet Law and Practice in California, chap 19 (Cal CEB 2004).

The federal district court in *Hotmail Corp. v Van$ Money Pie, Inc.* (ND Cal, Apr. 16, 1998, No. C98-20064-JW) 1998 US Dist Lexis 10729, enforced a click-wrap agreement that prohibited users of Hotmail's e-mail service from distributing spam through their Hotmail accounts. The court found that the defendant had agreed to the restriction by clicking an acceptance button indicating consent to Hotmail's online click-wrap agreement.

For a form of click-wrap agreement, see §§18A.16-18A.26.

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§18A.5 C. Browse-Wrap Agreements

Browse-wrap (or click-free) agreements are documents—such as terms of use, privacy policy statements, or software license modifications—posted on a website that do not require users to affirmatively interact with the site to show their consent to the document terms. Users are expected to find and review the text of the documents on their own. Typically, the website or the document itself includes a statement that a user's continued use of the website or the software downloaded from the site evidences the user's agreement to all of the terms and conditions of the document. The few courts that have considered browse-wrap agreements have been reluctant to enforce them because of their noninteractive nature.

In *Ticketmaster Corp. v Tickets.com, Inc*. (CD Cal, Mar. 7, 2003) 2003 US Dist Lexis 6483, the court acknowledged that a binding contract on the Internet could be formed without requiring a user to separately click "I agree." It ruled that "a contract can be formed by proceeding into the interior web pages after knowledge (or, in some cases, presumptive knowledge) of the conditions accepted when doing so." 2003 US Dist Lexis 6483 at *9.

The *Ticketmaster* decision highlights the importance of placing terms of use or other browse-wrap agreements in a conspicuous and readily accessible part of the website. The case indicates that courts will require both *notice* (*i.e.,* making online agreements conspicuous to site users) and *proof* that a user actually accessed the online agreement before enforcing the agreement. The more action required on the part of the website user, the more likely a court will hold that a contract has been formed. Compare the *Ticketmaster* decision with *Pollstar v Gigmania* (ED Cal 2000) 170 F Supp 2d 974, in which the court refused to enforce the terms of an online license agreement because the link to it was not sufficiently obvious. The *Pollstar* court did not rule that the license agreement was per se unenforceable, only that the website did not give users adequate notice of it.

In *Specht v Netscape Communications Corp.* (2d Cir 2002) 306 F3d 17, the Second Circuit refused to enforce an arbitration clause contained in a browse-wrap software license agreement because end users were able to download the free software without reviewing the license agreement: To view the license terms, users were required to scroll down below the "download" button and click on a hyperlink. At no time were users required to indicate their agreement to those terms.

PRACTICE TIP: Both *Pollstar* and *Specht* serve as cautions to website operators who might prefer not to require their users to confront click-wrap agreements before accessing website content. If users are not required to review and affirmatively accept the terms of use, a court may refuse to enforce those terms if it finds that users do not have sufficient notice of them. The same concerns apply to amendments of online agreements. Further, when amendments are intended to apply retroactively, the FTC has concluded in at least one case that opt-in consent of affected end users is required. *In re Gateway Learning Corp.* (Sept. 10, 2004) FTC File No. 042-3047, available at http://www.ftc.gov/os/caselist/0423047/040917do0423047.pdf. However, in a commercial context, courts have been more inclined to find terms of use binding on the end user of an Internet site. See, *e.g., Register.com, Inc. v Verio, Inc*. (2d Cir 2004) 356 F3d 393 (Verio's repeated use of Register.com's WHOIS database was evidence of consent to terms of use).

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IV. E-SIGN

§18A.6 A. Introduction

The Electronic Signatures in Global and National Commerce Act (E-Sign) (15 USC §§7001-7031) confirms the ability of parties to contract electronically, defining an "electronic signature" broadly as "an electronic sound, symbol or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record." 15 USC §7006(5). See §18A.7. This definition encompasses click-wrap agreements (see §18A.4), thus assuring their enforceability. E-Sign provides that any signature, contract, or other record cannot be denied legal effect, validity, or enforceability solely because it is in electronic form (15 USC §7001(a)(1)), and any contract cannot be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation (15 USC §7001(a)(2)). E-Sign, however, does not require any person to agree to use or accept electronic records or electronic signatures. 15 USC §7001(b)(2).

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§18A.7 B. Electronic Signatures

At common law, any symbol made with the intent to sign a document could qualify as a legally valid signature. The definition of "signed" in the Uniform Commercial Code includes "any symbol," as long as it is "executed or adopted with present intention to adopt or accept a writing." UCC §1-201(37). See also Comment 37 to Com C §1201. E-Sign extends this approach to electronic signatures by requiring that an electronic signature possess three elements (15 USC §7006(5)):

- A sound, symbol, or process,
- Attached to or logically associated with an electronic record, and
- Made with the intent to sign the electronic record.

An electronic signature can take many forms, and can be created by many different technologies. Examples of electronic signatures that should qualify under E-Sign include:

- Typing the sender's name at the end of an e-mail message sent by him or her;
- Including a digitized image of a handwritten signature attached to an electronic document;
- A mouse click (*e.g.,* on an "I accept" or "I agree" button); and
- A "digital signature" (*e.g.,* a signature created through public key cryptography).

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§18A.8 C. Consumer Protection Features

In addition to granting legal effect to electronic documents generally, E-Sign includes several provisions intended to protect the rights of consumers in electronic transactions. E-Sign's consumer protection provisions are triggered only when a statute, regulation, or other rule of law requires that information relating to a transaction be provided or made available to a consumer in writing. 15 USC §7001(c). Providing information electronically in these circumstances is acceptable only if the consumer affirmatively consents to receive the information in electronic form, gives his or her consent electronically, and does so in a manner that reasonably demonstrates that he or she can access the information in the electronic format that will be used to provide it. 15 USC §7001(c)(1)(A), (C)(ii).

Before giving consent, the consumer must receive a clear and conspicuous statement of his or her rights, the scope of the consent given, and how to withdraw the consent. 15 USC §7001(c). In particular, businesses are required to take the following actions:

- Inform the consumer of (1) any right to have an electronic record made available in nonelectronic (paper) form, (2) the right of a consumer to withdraw his or her consent to have the record provided in an electronic form, and (3) any conditions, consequences (such as termination of the parties' relationship), or fees if the consumer's consent is withdrawn (15 USC §7001(c)(1)(B)(i));
- Inform the consumer whether his or her consent applies (1) only to the specific transaction that gave rise to the obligation to provide the record, or (2) to identified categories of records that may be provided over the course of the parties' relationship (15 USC §7001(c)(1)(B)(ii));
- Describe the procedures the consumer is required to use to withdraw consent and to update information needed to contact the consumer electronically (15 USC §7001(c)(1)(B)(iii));
- Inform the consumer of (1) how, after consenting to the electronic record, the consumer may obtain a paper copy of the electronic record on request, and (2) the fee, if any, to be charged for such copy (15 USC §7001(c)(1)(B)(iv));
- Provide the consumer (before consent) with a description of the hardware and software requirements for access to and retention of the electronic records (15 USC §7001(c)(1)(C)(i)); and
- If the software or hardware requirements necessary to access the electronic record change, advise the consumer of (1) the new hardware and software requirements, and (2) the consumer's right to withdraw consent without the imposition of any fees or any condition or consequence not previously disclosed (15 USC §7001(c)(1)(D)(i)).

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§18A.9 D. Electronic Record Retention

Under E-Sign, if the law requires that a record of a contract be retained, an electronic record is adequate for the purpose, provided that it "accurately reflects the information" in the contract and the record remains accessible for later reference in a form that can be accurately reproduced. 15 USC §7001(d)(1). E-Sign provides that the legal effect, validity, or enforceability of an electronic record "may be denied if such electronic record is not in a form that is capable of being retained and accurately reproduced for later reference by all parties or persons who are entitled to retain the contract or other record." 15 USC §7001(e). Even if a contract is not required by law to be retained, it is always advisable to keep a record of an electronic contract for evidentiary purposes. Thus, a website operator should include online functionalities for printing and saving electronic agreements to better assure their enforceability.

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V. UNIFORM ELECTRONIC TRANSACTIONS ACT (UETA)

§18A.10 A. Introduction

Before E-Sign, California adopted a version of the Uniform Electronic Transactions Act (UETA) (see CC §§1633.1-1633.17), which applies to transactions between parties who have each agreed to conduct a transaction electronically. UETA provides for the enforceability of electronic contracts, as well as for records retention and the evidentiary use of electronic records. As of this writing, almost all of the states have adopted a version of UETA. See http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-ueta.asp. Although broader than E-Sign, UETA covers many of the same issues as E-Sign and is therefore subject to federal preemption. E-Sign, however, has an exemption from federal preemption applicable in states where UETA has been enacted in the form recommended by the National Conference of Commissioners on Uniform State Laws (NCCUSL). The California version of UETA is nonconforming; it substantially altered many of UETA's provisions. Under E-Sign, however, only provisions that would create an exception to the scope of UETA (as recommended by NCCUSL) and are otherwise inconsistent with E-Sign are subject to federal preemption by E-Sign. See 15 USC §7002. Thus, the scope of E-Sign's potential preemption of California's version of UETA is unclear. It is therefore advisable to assume that E-Sign's restrictions and exclusions will apply in California and any other state that has not enacted UETA in the form recommended by NCCUSL.

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§18A.11 B. Consent Under UETA

Both E-Sign and UETA authorize parties to enter into electronic transactions, but do not require parties to do so. See 15 USC §7001(b)(2); CC §1633.5(a). Unlike E-Sign, UETA is premised on consent by the parties; the statute does not apply unless the parties have "agreed to conduct transactions by electronic means." CC §1633.5(b). The consent requirement applies to both business and consumer transactions. Whether the parties have consented to conduct a transaction by electronic means is determined from the context and circumstances surrounding the transaction, and consent may be either express or implied. CC §1633.5(b). Under the California version of UETA, consent must be given by electronic means. CC §1633.5(b). If a company's website is capable of receiving electronic communications from customers, and a customer enters into a transaction with the company using the company's website, it can be inferred that both parties have impliedly agreed to conduct their transaction electronically.

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§18A.12 VI. UNIFORM COMPUTER INFORMATION TRANSACTIONS ACT (UCITA)

The Uniform Computer Information Transactions Act (UCITA) has been an effort spearheaded by the software industry to develop uniform state legislation with default rules for the creation and enforcement of contracts (including shrink-wrap and click-wrap licenses) relating to electronic information. For example, it would cover agreements for the development, distribution, licensing, and transfer of computer software, multimedia products, computer databases, and Internet websites. The full text of the model uniform law is posted at http://www.law.upenn.edu/bll/ulc/ucita/2002final.htm. UCITA was patterned in part after Article 2 of the Uniform Commercial Code and was intended to fill the gap in coverage of the UCC that exists because Article 2 ostensibly applies only to tangible goods and not to intangible property, such as software. For the most part, UCITA attempted to codify practices already in use with respect to computer information and supported freedom of contract. Among other things, UCITA set uniform guidelines for shrink-wrap, click-wrap, and browse-wrap agreements, making it clear that such agreements would be legally binding as long as the user has an opportunity to review the terms before assenting.

To date, only two states, Virginia and Maryland, have adopted UCITA. See Va Code Ann §59.1-501.1—59.1-509.2; Md Comm'l Law Code Ann §22-101—22-816. UCITA, however, provides that companies based in a state that has not adopted UCITA may elect to have their contracts governed by the laws of a state that has adopted it. For example, a consumer in Alaska could purchase software issued by a California company and discover that the shrink-wrap license inside the package purports to be governed by Virginia law—and therefore UCITA.

UCITA has proved to be extremely controversial and has been opposed by various interest groups because of its perceived unfairness to consumers, alleged conflicts with federal copyright law, and other reasons. See, *e.g.,* http://www.ucita.com. Four states to date—Iowa, North Carolina, Vermont, and West Virginia—have adopted so-called bomb shelter (anti-UCITA) legislation that protects software licensees from choice-of-law provisions making UCITA the governing law of the contract or from choice-of-forum provisions that select a state unrelated to either the licensee or the vendor as the forum for settling legal disputes under the contract.

California has not yet adopted UCITA, and UCITA's future is presently uncertain. In the summer of 2003, citing widespread opposition from consumers, libraries, and other interest groups, the National Conference of Commissioners on Uniform State Laws pulled its support for the legislation, announcing that it would not seek its adoption in any other state. Because UCITA is the law in Maryland and Virginia, however, and because it has served as a resource for judges in cases relating to electronic information, the controversy will likely continue.

PRACTICE TIP: California practitioners should be generally familiar with the scope of UCITA, even though it has not been adopted in this state. If the parties to a contract for software or other electronic information do not wish UCITA to apply in interpretation or enforcement of the agreement, the parties should affirmatively disclaim its applicability in the text of the agreement. An example of such a disclaimer is as follows:

> ***UCITA Not Applicable.*** **The parties hereby acknowledge and agree that any provisions of any state law adopting exactly or in modified form the Uniform Computer Information Transactions Act (UCITA) do not apply to this Agreement. Furthermore, both parties waive any and all rights arising from any such law.**

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§18A.12A VII. AMERICAN LAW INSTITUTE (ALI) PRINCIPLES OF THE LAW OF SOFTWARE CONTRACTS

On May 19, 2009, the American Law Institute (ALI) approved, subject to certain discussion, the proposed final draft of the Principles of the Law of Software Contracts (ALI Software Principles), a copy of which is available for purchase at the ALI website, http://www.ali.org. The ALI Software Principles constitute an effort to fill the legal vacuum still existing with respect to software contracts because of the failure of UCITA (see §18A.12) to gain widespread acceptance. The Principles are generally intended to establish a series of best practices in software licensing transactions. Although the Principles do not have the force of law, California lawyers addressing technology transactions should be familiar with them because they may influence judicial decision making. They were developed over a 3-year period by a group of law professors, judges, and practicing attorneys from around the United States.

Following are some important features of the Principles:

- The Principles apply to agreements to sell, lease, license, access, or otherwise transfer or share software for consideration, including open-source software licenses. See Principles §1.06. Unlike UCITA, they are not intended to cover contracts relating to digital media content in the entertainment industry.
- The Principles include special rules applicable to the formation of contracts for standard-form transfers of generally available software, including, *e.g.,* a requirement that the transferee have reasonable notice and access to the form before payment or completion of the transaction. See Principles §2.02. The rules cover transfers of both electronic and prepackaged software and are not limited to consumer transactions.
- The Principles restrict the ability of a transferor of generally available software under a standard-form contract to disclaim the implied warranty against intellectual property infringement (see Principles §3.01) or to disable the software automatically in the event of a breach by the transferee (see Principles §4.03). The Principles also limit the enforceability of choice-of-law provisions in contracts for standard-form transfers of generally available software. See Principles §1.13.
- The Principles generally rewrite the UCC rules concerning express warranties and implied warranties of merchantability and fitness. See Principles §§3.02-3.04. In addition, the Principles create a new, *nonwaivable* implied warranty that the software contains "no material hidden defects of which the transferor was aware at the time of the transfer." Principles §3.05.
- The Principles restrict a transferor's right to disable software automatically both in the context of transferee breach and otherwise if doing so results in a loss of the transferee's rights under the contract or the loss of use of the transferee's other software or digital content. Principles §4.03.
- The Principles include limitations on the transferor's right to cancel the contract in the event of breach. See Principles §4.04. Other provisions address damages and specific performance (see Principles §§4.05-4.06).
- Finally, the Principles limit the enforceability of forum selection clauses if unfair or unreasonable. See Principles §1.14.

Practitioners should consult the text of the Principles and review the accompanying commentary for further information on their content and scope.

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§18A.13 VIII. EUROPEAN UNION DIRECTIVES

In the European Union, the enforceability of electronic transactions is governed by both the Electronic Signatures Directive (ES Directive) adopted in 1999 (Directive 1999/93/EC of 13 December 1999), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2000:013:0012:0020:EN:PDF, and the Electronic Commerce Directive (EC Directive), adopted in 2000 (Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2000:178:0001:0016:EN:PDF. The European Union ES Directive requires member states to "ensure that an electronic signature is not denied legal effectiveness … solely on the grounds that it is in electronic form." ES Directive, Art 5(2).

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IX. CREATING ENFORCEABLE ELECTRONIC AGREEMENTS

§18A.14 A. Access to Terms

Although E-Sign, UETA, and recent case decisions make it probable that click-wrap agreements will be enforced, counsel should take steps to assure that click-wrap (see §§18A.16-18A.26) and other electronic agreements conform with applicable statutes and case law. See also the American Law Institute's Principles of the Law of Software Contracts (ALI Software Principles), approved May 19, 2009, and reviewed briefly in §18A.12A. In the wake of the lower court's decision in *Specht v Netscape Communications Corp.* (SD NY 2001) 150 F Supp 2d 585, aff'd (2d Cir 2002) 306 F3d 17 (see §7.4), an American Bar Association working group convened to assess strategies for creating enforceable click-wrap agreements, ultimately recommending the following six principles as guidance for structuring and implementing online agreements (see Kunz, *Click-Through Agreements: Strategies for Avoiding Disputes on Validity of Assent,* 57 Bus Law 401 (2001)):

- Users should have easy, automatic access to the terms of the agreement, as well as a subsequent opportunity to review the terms;
- Contract terms should be displayed in a way that complies with applicable laws on format and content, such as laws governing notice, disclosure, and conspicuousness;
- Users should be required to take affirmative action to indicate their assent to the contract terms and should be informed of the consequences of clicking on the "I Agree" button;
- Users should be given a clear means by which they can reject the proposed terms, and should be informed of the consequences of rejecting the agreement terms;
- The agreement process should include a method for users to avoid, or to detect and correct, errors likely to be made by the user; and
- Users should be able to print out a version of the agreement terms, and software vendors should have a method for preserving records of the agreed-to terms and of the manner in which users indicated assent to those terms.

The ALI Software Principles embody most of these guidelines, along with other rules for software contracts. See §18A.12A.

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§18A.15 B. Special Online Considerations

In drafting click-wrap agreements that will appear online, practitioners should take heed of these practical considerations:

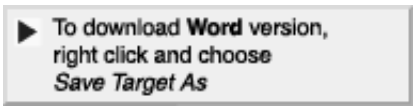
- The contract should include a representation or warranty covering the identity and authority of the user accepting the contract, specifying that the user is the person he or she claims to be and, if the user is entering the contract on behalf of another person or entity, that the user has the authority to bind that other person or entity.
- It may be appropriate to include a representation and warranty that the contracting party is an adult (over a specified age), capable of entering into a binding agreement, and not a minor.
- The contract will be interpreted under traditional contract law principles. Accordingly, it is important to observe the same rules that would apply to a "paper" contract. If a term or condition would not be enforceable offline, it will not be enforceable online. Courts will reject any terms that they deem unreasonable or unconscionable, based on the facts and circumstances of each case.
- The click-wrap agreement should not contain terms that might be considered unreasonable or unfair or that might surprise an average software consumer. Terms that might be viewed as overly harsh or one sided include arbitration clauses, forum selection clauses, and limitations on liability for damages.
- Online software purchasers should be notified that use of the software is subject to the terms of the vendor's license agreement and that the vendor will not enter into the transaction unless that purchaser agrees to its terms.
- The user should be required to review and accept the license agreement before payment and delivery of the software, so that the license agreement forms an integral part of the transaction. Software distributors should thereby avoid the problems faced by the vendor in *Step-Saver Data Sys. v Wyse Technol.* (3d Cir 1991) 939 F2d 91 (relying on former UCC §2-207(2)(b), court found that disclaimer of warranty and limitation of remedies in box-top software license delivered after purchase contract was formed had never been accepted by purchaser).
- The purchaser should be required to review the entire agreement before accepting it and to expressly assent to the terms by taking some affirmative action, such as clicking on an "Accept" or "I Agree" button before the software can be downloaded.
- Buttons or icons for "I Agree" and "I Do Not Agree" should be placed at the end of the terms of an online contract, along with statements indicating (1) the effect of clicking on "I Agree" (*e.g.,* "These terms will form a binding legal contract between us as soon as you click the 'I Agree' button."), and (2) the effect of clicking on "I Do Not Agree" (*e.g.*, "If you do not agree to accept these terms, click 'I Do Not Agree' below, and you will not be permitted to install or use this software.").

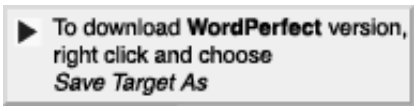
When users are presented with choices or are asked to furnish information in connection with their agreement to an online contract, users should also be asked to review those choices (or information furnished) on a confirmation screen and be given a chance to correct any errors before assenting to the contract.

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X. ONLINE SOFTWARE "CLICK-WRAP" USER AGREEMENT

§18A.16 A. Form: Warning to Software User





18A.16-1 Warning to user

ONLINE SOFTWARE END-USER LICENSE AGREEMENT

IMPORTANT! The _ _[*identify/describe software*]_ _ software (the "Software") you seek to download from the _ _[*vendor's name*]_ _ website is licensed only on the condition that you agree to the terms and conditions set forth below. PLEASE READ THE TERMS OF THIS SOFTWARE LICENSE AGREEMENT CAREFULLY.

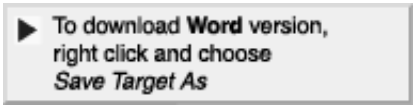
IF YOU AGREE TO BE BOUND BY THE TERMS OF THIS AGREEMENT, PLEASE CLICK ON THE BOX ON THIS PAGE LABELED "I ACCEPT," AT WHICH TIME THE SOFTWARE WILL BE DOWNLOADED TO YOUR COMPUTER.

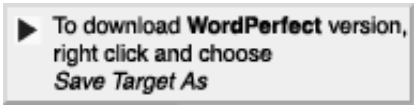
IF YOU DO NOT AGREE TO THE TERMS OF THIS AGREEMENT, PLEASE CLICK ON THE BOX ON THIS PAGE LABELED "I DO NOT ACCEPT," WHICH WILL RETURN YOU TO THE PREVIOUS WEB PAGE WITHOUT DOWNLOADING THE SOFTWARE.

Comment: This clause and the clauses in §§18A.17-18A.26 comprise a generic end-user software license agreement to accompany the download of a software program. This form of agreement likely qualifies as a "standard-form transfer of generally available software" under §§1.01(*l*) and 2.02 of the ALI Software Principles (see §18A.12A). It is sometimes known as a "click-wrap" agreement. For a review of basic software license terms and a long-form software license agreement with alternative clauses, see chap 24.

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§18A.17 B. Form: Recitals





18A.17-1 Recitals

The Software that you are about to access was developed by _ _[*name of vendor*]_ _, a _ _[*state of incorporation*]_ _ corporation ("Vendor") to _ _[*state purpose of software, e.g., help companies manage their inbound and outbound freight shipping processes*]_ _. This End-User License Agreement (this "Agreement") sets forth the terms under which you, as an individual or entity authorized by Vendor (or, for entities, any employee you authorize to use the Software) ("you"), may use the Software.

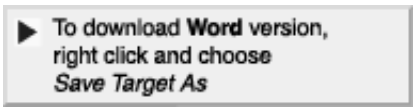
[*If appropriate, add*]

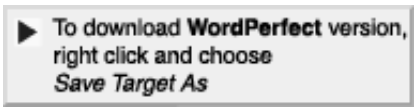
Access to and use of the Software is by permission of Vendor only, and only for applicants who accept this Agreement. Vendor may grant or withhold approval in its sole discretion. If Vendor approves you for use of the Software, Vendor will issue a user identification (the "User ID") and a password (the "Password") that will authorize your access to the Software for the term of this Agreement.

Comment: The optional provision in this form can be used if the vendor wants to retain control over who has access to the software when it is being hosted and run remotely.

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§18A.18 C. Form: Nature of Agreement; License Grant





18A.18-1 Nature of agreement

Based on the foregoing and for other good and valuable consideration, you and Vendor agree as follows:

1. *Nature of Agreement*. This Agreement is a legal contract made between you and Vendor. This Agreement contains the terms and conditions that you must comply with if you wish to access and use the Software.

18A.18-2 License grant

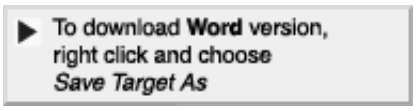
2. *License Grant*. Under this Agreement, Vendor grants to you a nonexclusive, nonassignable, nonsublicensable license, for your internal use only, for the term of this Agreement, to access and use the Software and any user's guides, specifications, and other related documentation available online (the "Documentation"), subject to the terms and conditions of this Agreement. The licenses granted in this Agreement are conditioned on payment in full for the Software in advance of your download or receipt of the Software.

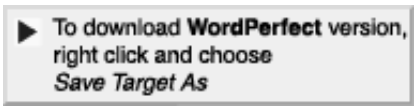
Comment: Note that this agreement does not include terms regarding payment of the purchase price for the software. The process for purchasing downloadable software can vary, but typically companies walk the user through several steps, as follows: First, the user selects the desired software by placing it in a "shopping cart;" then the user enters shipping, billing, and credit card information, with the actual purchase conditional on the user's acceptance of the end user license terms. These terms will appear on the screen along with "I Accept" and "I Do Not Accept" buttons. Once the license is accepted, the purchase can be completed and the download commenced.

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D. Terms

§18A.19 1. Form: Ownership and Restrictions





18A.19-1 Ownership

3. *Ownership of Software*. Vendor retains all rights to the Software and the Documentation not specifically granted in this Agreement. Vendor owns the Software and the Documentation and all copyright and other intellectual property rights contained within them, and this Agreement does not transfer to you any title to or any proprietary or intellectual property rights in or to the Software, any updates or derivative works to them, or the Documentation, or any copyrights, patent rights, or trademarks embodied or used in connection with them, except for the rights expressly granted in this Agreement. The Software and the Documentation are protected by United States laws and international treaty provisions.

YOU MAY NOT USE, COPY, OR MODIFY THE SOFTWARE, IN WHOLE OR IN PART, EXCEPT AS EXPRESSLY PROVIDED FOR IN THIS AGREEMENT.

18A.19-2 Restrictions

4. *Restrictions*. To the maximum extent permitted by law, you shall not (a) modify, reverse engineer, decompile, disassemble, or attempt to derive the source code of the Software; (b) rent, lease, loan, sell, sublicense, distribute, transmit, or otherwise transfer the Software access to any third party; (c) make any copy of or otherwise reproduce the Software (or any of the browser screens comprising the Software user interface) except for copies necessarily made by the personal computer and Internet browser that are running the Software; or (d) use the Software to provide service bureau or time-sharing services.

[*If appropriate, add*]

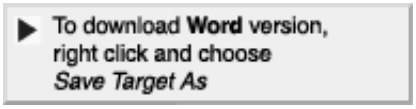
; or (e) disclose your User ID or Password to any third party.

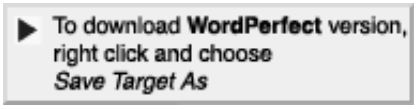
You agree to take all reasonable steps to safeguard your User ID and Password for the Software to ensure that no unauthorized person will have access to it, and that no persons authorized to have access will make any unauthorized use. You shall promptly report to Vendor any unauthorized use of the Software of which you become aware and shall take such further steps as may reasonably be requested by Vendor to prevent unauthorized use of the Software.

Comment: The attorney should consider using the optional provisions in this form if the vendor is requiring use of a password to access the software, as provided in the optional provisions of form 18A.17-1.

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§18A.20 2. Form: Obligations of Licensee



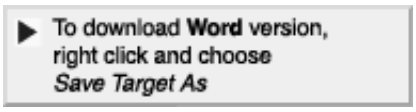


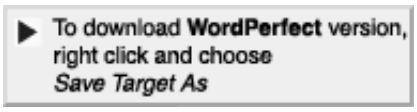
18A.20-1 Obligations of licensee

5. *Your Obligations*. You are solely responsible for the following: (a) providing all hardware, software, and communications capabilities required for use of the Software, including personal computers with Pentium _ _[*specify minimum CPU speed, e.g., III*]_ _ processors or higher that contain at least _ _[*number, e.g., 64*]_ _ MB of RAM and _ _[*number, e.g., 50*]_ _ MB of available hard disk space, and are equipped with Internet access and a Java-enabled browser such as Netscape Navigator _ _[*specify minimum level, e.g., 4.06*]_ _ or higher; (b) generating, providing, and loading your data into the Software, including freight rates and historical freight data to permit you to use the Software; and (c) providing and maintaining, at all times during the term of this Agreement, the Internet access necessary for your use of the Software.

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§18A.21 3. Form: Term and Termination





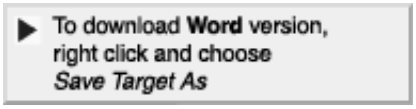
18A.21-1 Term and termination

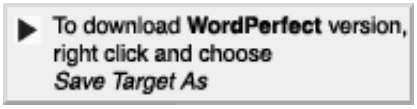
6. *Term And Termination.* The license granted in this Agreement is effective until terminated. The term of this Agreement and the license grant under it will commence on the date you agree to this Agreement and download the Software. You may terminate the license and this Agreement at any time on 30 days' prior written notice to Vendor. Vendor may terminate the license and this Agreement at any time on written notice to you that you or your agent has failed to pay any amount due to Vendor under this Agreement. This license also terminates automatically on your failure to comply with any of the other terms of this Agreement. On termination of this Agreement, you agree to promptly destroy all printed copies and delete all electronic copies of any documentation that you have downloaded, printed, or created relating to the Software, and to ensure that no copies of any of the Software screens, data, or other content remain archived or otherwise stored on your computers. Notwithstanding termination, the provisions of Sections 3, 6, 7, 8, 9, and 10 of this Agreement will survive and continue to apply.

Comment: Section 4.04 of the ALI Software Principles (see §18A.12A) includes restrictions on the ability of a vendor to cancel or terminate a software contract in the event of breach. If counsel wishes the foregoing termination provision to conform with the ALI Software Principles, the provision should be revised accordingly.

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§18A.22 4. Form: Confidentiality





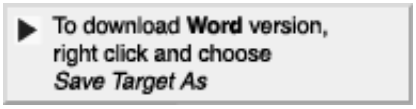
18A.22-1 Confidentiality

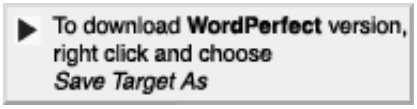
7. *Confidentiality.* You agree that you shall not disclose to any third party the Software or any portion of it, any technical, product, or business information, or any information that Vendor identifies as confidential (collectively, "Confidential Information") related to the Software without the prior written consent of Vendor. You shall maintain the confidentiality of all Confidential Information and shall not use it for any purpose other than the performance of this Agreement.

Notwithstanding the foregoing, Confidential Information does not include information that you can demonstrate was (a) publicly available at the time of disclosure, or later became publicly available through no act or omission by you; (b) in your possession before disclosure by Vendor; or (c) disclosed to you by a third party not in violation of any obligations of confidentiality to Vendor or to any third party.

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§18A.23 5. Form: Liability





18A.23-1 Liability

8. *Limitation of Liability.* You are not entitled to receive damages from Vendor for any cause relating to this Agreement, to your use of the Software, to any services provided by Vendor under this Agreement, or to any services provided by any third party in connection with your use of the Software. In addition, in no event will you be entitled to obtain any injunctive relief or enjoin, restrain, or otherwise interfere with Vendor or with the distribution, operation, development, or performance of the Software or any related products.

IN NO EVENT WILL VENDOR BE LIABLE TO YOU FOR ANY DAMAGES WHATSOEVER ARISING OUT OF YOUR USE OF, OR INABILITY TO USE, THE SOFTWARE. IN NO EVENT WILL VENDOR BE LIABLE FOR ANY SPECIAL, INDIRECT, INCIDENTAL, OR CONSEQUENTIAL DAMAGES, OR DAMAGES FOR LOSS OF DATA, LOST PROFITS, OR LOST BUSINESS OPPORTUNITIES, REGARDLESS OF THE LEGAL THEORY UNDER WHICH SUCH DAMAGES ARE SOUGHT, AND EVEN IF ADVISED IN ADVANCE OF THE POSSIBILITY OF SUCH DAMAGES. AS SOME STATES DO NOT ALLOW THE LIMITATION OR EXCLUSION OF LIABILITY FOR INCIDENTAL OR CONSEQUENTIAL DAMAGES, THE ABOVE LIMITATION OR EXCLUSION MAY NOT APPLY TO YOU.

Comment: Sections 4.01-4.02 of the ALI Software Principles include restrictions on the ability of the parties to a software contract to liquidate or limit damages or other relief. If counsel wishes the foregoing provision to conform with the ALI Software Principles, the provision should be revised accordingly.

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§18A.24 6. Form: Warranty

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

18A-24-1 Warranty

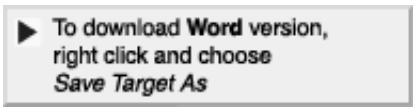
9. *Limited Warranty And Disclaimer.* Vendor represents and warrants that the Software will, at the time you purchase the Software and for a period of 60 days thereafter, substantially conform to the Documentation in effect on the date of purchase of the Software when given normal, proper, and intended usage in compliance with Vendor's instructions. If there is a nonconformance during that period, you agree to promptly report it, along with all information required by Vendor. Vendor shall investigate any reported nonconformance and shall use commercially reasonable efforts to remedy it. If Vendor is unable to remedy the nonconformance within 90 days after the date Vendor has received all relevant information from you, your sole remedy under this Agreement is to return the Software, delete all copies and all Documentation from your systems, and receive a refund of the price you paid.

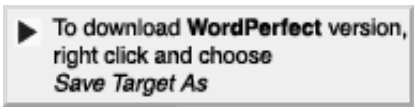
TO THE MAXIMUM EXTENT PERMITTED BY LAW, VENDOR EXPRESSLY DISCLAIMS ANY AND ALL WARRANTIES, EXPRESS OR IMPLIED, INCLUDING THE IMPLIED WARRANTIES OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE, AS WELL AS ANY WARRANTIES ALLEGED TO HAVE ARISEN FROM CUSTOM, USAGE, OR THE COURSE OF DEALING BETWEEN THE PARTIES. VENDOR DOES NOT WARRANT THAT THE FUNCTIONS CONTAINED IN THE SOFTWARE WILL MEET YOUR REQUIREMENTS OR THAT THE OPERATION OF THE SOFTWARE WILL BE UNINTERRUPTED OR ERROR-FREE. IN ADDITION, VENDOR DOES NOT WARRANT OR GUARANTEE THAT YOU WILL BE ABLE TO ACCESS THE SOFTWARE AT ALL TIMES. YOU UNDERSTAND AND ACKNOWLEDGE THAT INTERNET CONGESTION AND OUTAGES, AS WELL AS MAINTENANCE, DOWNTIME, AND OTHER INTERRUPTIONS, MAY INTERFERE AT TIMES WITH YOUR ABILITY TO ACCESS THE SOFTWARE.

Comment: Sections 3.01-3.07 of the ALI Software Principles set forth a series of express and implied warranties applicable in software transactions and include restrictions on the ability of the transferor to disclaim express and implied warranties. If counsel wishes the foregoing provision to conform with the ALI Software Principles, the provision should be revised accordingly.

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§18A.25 E. Form: General Provisions





18A.25-1 Governing law

10. *Governing Law.* This Agreement is governed by and construed in accordance with the laws of the State of California, without regard to its conflict of laws provisions.

18A.25-2 Force majeure

11. *Force Majeure.* If the performance of Vendor under this Agreement is prevented, hindered, or otherwise made impractical because of flood, strike, war, acts of government, or any other casualty or cause beyond the control of Vendor, then Vendor will be excused from its performance to the extent and as long as it is prevented, hindered, or delayed by any of these events.

18A.25-3 Severability

12. *Severability*. If any one or more of the provisions contained in this Agreement is, for any reason, held to be invalid, illegal, or unenforceable in any respect, then to the maximum extent permitted by law, the invalidity, illegality, or unenforceability will not affect any other provision of this Agreement.

18A.25-4 Assignment

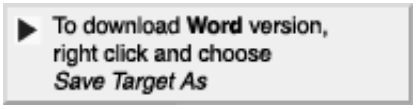
13. *No Assignment*. You may not assign this Agreement or any of the rights granted by Vendor under it, in whole or in part, without the prior written consent of Vendor, and any attempt to do so is. This Agreement is binding on and inures to the benefit of the parties and their respective successors and permitted assigns.

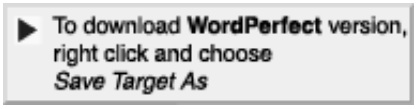
18A.25-5 Compliance with law

14. *Export Control*. You agree to obey and comply with all applicable United States laws, rules, and regulations governing the export of software.

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§18A.26 F. Form: Acknowledgment and Exclusivity





18A.26-1 Acknowledgment

15. *Acknowledgment And Exclusivity*. YOU ACKNOWLEDGE THAT YOU HAVE READ THIS AGREEMENT, UNDERSTAND IT, AND AGREE TO BE BOUND BY ITS TERMS AND CONDITIONS. YOU FURTHER AGREE THAT IT IS THE COMPLETE AND EXCLUSIVE STATEMENT OF THE AGREEMENT BETWEEN YOU AND VENDOR, AND THAT IT SUPERSEDES ANY PROPOSAL, PRIOR AGREEMENT, OR UNDERSTANDING, ORAL OR WRITTEN, AND ANY OTHER COMMUNICATION BETWEEN YOU AND VENDOR RELATING TO THE SUBJECT MATTER OF THIS AGREEMENT. THIS AGREEMENT MAY NOT BE CHANGED, ALTERED, OR MODIFIED EXCEPT BY A WRITING SIGNED BY THE PARTIES.

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19

Amendments and Modifications to Executory Contracts

Alan S. Gutterman

I. CHECKLIST: INFORMATION NECESSARY FOR AMENDMENTS §19.1

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- A. Amendments and Modifications §19.3
- B. Supplemental Agreements §19.4
- C. Rescissions §19.5
- D. Novation §19.6

III. BUSINESS CONSIDERATIONS §19.7
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  - 1. Form: Effectiveness as of Specific Date §19.28
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  - 3. Form: Modifying Provision of Original Agreement §19.38
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- F. Changing Exhibits and Ancillary Agreements §19.40
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2. Form: Representations and Warranties §19.44
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§19.1 I. CHECKLIST: INFORMATION NECESSARY FOR AMENDMENTS

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- Name and date of original contract (see §§19.24-19.26)
- Parties to original contract (see §§19.24-19.26)
- Purpose of original contract (see §§19.24-19.26)
- Parties to amendment (see §§19.24-19.26)
- Purpose of amendment (see §§19.24-19.26)
- Effective date for amendment (see §§19.27-19.29)
- Consideration for amendment (see §§19.15, 19.30-19.31)
- Definitions (see §§19.32-19.34)
- Provisions to be added, modified, or deleted (see §§19.35-19.38)
- Exhibits and ancillary agreements to be added, modified, or deleted (see §§19.40-19.41)
- Representations and warranties to be added, modified, or deleted (see §§19.11, 19.43-19.44)
- Need for spousal, guarantor, or other consents (see §§19.14, 19.20-19.21)
- Formalities (see §§19.45-19.50)

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/19 Amendments and Modifications to Executory Contracts/§19.2 II. DISTINCTIONS BETWEEN TYPES OF CHANGES TO AGREEMENTS

§19.2 II. DISTINCTIONS BETWEEN TYPES OF CHANGES TO AGREEMENTS

Many contracts are fully performed at the time of execution; the parties' duties and obligations under other contracts often extend over a period of time. Because circumstances may change during the term of a contract, the parties may seek to amend or modify certain aspects of their relationship. Some contractual changes may result from changes in the law, but most amendments follow from changes in the basic business relationship among the parties.

EXAMPLE: If a change in law permits a corporation to indemnify its officers and key employees against certain liabilities arising from performance of their duties, the parties may amend existing employment agreements to include the indemnification.

The possible scope of changes to a contractual arrangement is virtually unlimited. The basic types of changes are amendments and modifications (see §19.3), supplemental agreements (see §19.4), rescissions (see §19.5), and novations (see §19.6). Amendments are the most common form of changes to agreements. This chapter focuses on amendments, and briefly defines the other types of changes.

NOTE: The amendment, because it creates the new, operative agreement for the parties, is just as important as the original agreement and must be as carefully and effectively drafted. The forms in this chapter address basic provisions, but as with any forms, counsel should thoroughly review them to ensure that they completely address the needs of the parties.

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§19.3 A. Amendments and Modifications

An amendment or a modification of a contract introduces new terms into the contract, changes part of the contract, or cancels part of the contract. The enforceability and validity of amendments or modifications are subject to the same rules that apply to contracts generally. *American Bldg. Maintenance Co. v Indemnity Ins. Co.* (1932) 214 C 608, 615, 7 P2d 305; *Carlson, Collins, Gordon & Bold v Banducci* (1967) 257 CA2d 212, 223, 64 CR 915. A modification typically requires a formal amendment or modification agreement to the original contract. The amendment must satisfy any statutory requirements for enforceability of a contract as well as any specific conditions stated in the contract.

The observance of a duty or an obligation under a contract may be excused or waived by the parties to the contract. A waiver of this type is, in effect, an amendment of the contract, but the formalities usually take the form of a "consent" or a "waiver." For discussion of waivers, see §§11.57-11.60.

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§19.4 B. Supplemental Agreements

A supplemental agreement clarifies or explains how a contract is to be used and interpreted by the parties; it does not materially change the provisions of the original contract.

EXAMPLE: Landlord and Tenant enter into a lease for commercial real property. The lease agreement states that the commencement date for the lease is the first business day after Landlord's completion of tenant improvements to Tenant's satisfaction. After the tenant improvements are completed, the parties execute a supplemental agreement that identifies the actual commencement date of the lease.

A supplemental agreement need not be supported by additional consideration. *Cutter Labs. v Twining* (1963) 221 CA2d 302, 34 CR 317 (discussing distinction between supplementary and modification agreements in terms of new consideration required). In most transactions, a supplemental agreement does not require a formal amendment to the original contract. A supplement may take the form of a letter or memorandum of understanding between the parties, or it may be appended as an exhibit to the contract.

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§19.5 C. Rescissions

An agreement that changes the general purpose or effect, or deletes essential elements, of the contract is a "rescission" rather than a modification. *Travelers Ins. Co. v WCAB* (1967) 68 C2d 7, 64 CR 440; *Grant v Aerodraulics Co.* (1949) 91 CA2d 68, 204 P2d 683. Parties who rescind a contract enter into a new contractual arrangement rather than amending or modifying the original contract. All mutual duties and obligations of the parties under the contract terminate and are superseded if the parties satisfy all formalities for creation of a new contract.

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§19.6 D. Novation

A novation cancels the original agreement and substitutes a new agreement rather than changing the original one. CC §1531; *Davies Mach. Co. v Pine Mountain Club, Inc.* (1974) 39 CA3d 18, 24, 113 CR 784. It has the effect of a rescission for the party that is being completely released from its obligations under the contract. The intent to create a novation must clearly appear for it to be effective. See California UCC Sales and Leases §11.3 (Cal CEB 2002).

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§19.7 III. BUSINESS CONSIDERATIONS

The first step in amending a contract is to identify the scope of the modification intended by the parties. Often, counsel is presented with only a summary description of the parties' reason for amending their relationship; sometimes the parties say they wish to change only one provision in the contract. However, the desired change or changes may trigger modification of numerous other provisions. Counsel should draft the amendment so that the parties can easily update, clarify, and improve their basic business relationship without making further amendments.

To fully anticipate the scope of an amendment, counsel must investigate the existing relationship and the desired new relationship between the parties. See §§19.8-19.12.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/19 Amendments and Modifications to Executory Contracts/§19.8 A. Circumstances Causing Amendment

§19.8 A. Circumstances Causing Amendment

Counsel must identify the general circumstances that caused the parties to consider the amendment or modification. By understanding why the parties want to change the agreement, counsel can identify all areas of the business relationship that need examination.

PRACTICE TIP: Counsel must review the recitals of the original agreement, as well as the operative provisions, to see whether they need to be amended. In some leases, for example, the leased space is defined in the recitals and this section must therefore be amended if the parties change the leased space. Counsel should also review any background materials that elucidate the original intent of the parties.

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§19.9 B. Effect of Amendment or Modification on Rights of Parties and Others

Consideration is required for a valid amendment of most written contracts. See §19.15. Understanding the effect of the amendment helps identify the consideration. In addition, customers, suppliers, employees, creditors, or lenders may have an interest in the contract, such that an amendment of the contract may affect their relationships with the parties. Without understanding the implications of the modification, counsel may generate unexpected problems for the client.

EXAMPLE: A change in payment terms with one lender could result in the borrower's default under a loan agreement with another lender or could impair a credit reserves requirement.

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§19.10 C. Other Changes Required by Amendment

Even if the parties change only one element of the agreement, additional definitions and procedures may be required to implement the amendment or modification. Moreover, an apparently minor amendment may result in inconsistencies in the amended agreement. Counsel must read the entire contract as amended to ensure that there are no conflicting rights or obligations and no contradictory provisions.

PRACTICE TIP: Counsel should review the client's other contractual arrangements to see whether the proposed change will affect any other contracts.

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§19.11 D. Requirement for New Representations, Warranties, Guaranties, or Third Party Consents or Approvals

An amendment generally includes new duties, obligations, and promises from each party. Counsel should therefore consider the need for any new representations and warranties as to factual matters, any new guaranties as to performance under the contract as amended, and any consents or approvals from third parties (including guarantors).

WARNING: In the absence of a waiver of consent in a guaranty agreement, the guarantor may be exonerated by any alteration of the original agreement. CC §2819. Similarly, for debt obligations secured by real property, a substantial modification to a senior lien may adversely affect junior lienholders and result in a loss of the senior lienholder's priority. See 3 Miller & Starr, California Real Estate §11:96 (3d ed 2000).

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§19.12 E. Use of Amendment to Clarify Uncertainties

An amendment or a modification presents an opportunity for the parties to incorporate additional information into the contract and modify the manner in which the parties relate to each other. Counsel should draft provisions defining procedures necessary to resolve any uncertainties or contingencies under the contract so as to avoid the need for later amendments.

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§19.13 IV. LEGAL CONSIDERATIONS

Parties to a contract can amend or modify its provisions. CC §§1697-1698; *Main St. & Agric. Park R.R. v Los Angeles Traction Co.* (1900) 129 C 301, 61 P 937. A written contract may be modified by a contract in writing, by an oral contract executed by the parties, or, unless the contract or the statute of frauds requires that all amendments be made in writing, by an oral agreement supported by new consideration. CC §1698. Parties may establish their own procedures for amendments, even if those procedures are at variance with the Civil Code. See *Busch v Globe Indus.* (1962) 200 CA2d 315, 19 CR 441 (contract required "first communicating with [*exclusive agent*] and obtaining his agreement").

Every amendment or modification is as much a matter of contract as the original agreement, and the requirements for the validity of any amendment are generally comparable to those that applied when the contract was originally executed. *Main St. & Agric. Park R.R. v Los Angeles Traction Co., supra*. See Timbie, *Modification of Written Contracts in California*, 23 Hastings LJ 1549, 1553 (1972). The legal requirements for modification of most written agreements include the consent of the parties (see §19.14) and consideration (see §19.15). For discussion of requirements for contracts generally, see CC §1550.

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§19.14 A. Consent of Parties

A contract can generally be modified only by an agreement entered into with the mutual consent of all parties to the original agreement. *Riverside Rancho Corp. v Cowan* (1948) 88 CA2d 197, 208, 198 P2d 526. Because parties are free to include in the contract their own amendment procedures, however, they may provide that fewer than all parties can amend the agreement. *Snow Mountain Water & Power Co. v Kraner* (1923) 191 C 312, 216 P 589 (one party entitled to make reasonable unilateral changes); *Stohr v San Francisco Musical Fund Soc'y* (1890) 82 C 557, 22 P 1125 (board of directors entitled to unilaterally change bylaws).

The parties' consent to an amendment can be either express, as evidenced by their execution of an amendment or another agreement, or, if a party registers no objection to the amendment after having notice of it, implied. *Leboire v Black* (1948) 84 CA2d 260, 190 P2d 634. Before consent to an amendment will be implied, however, the courts require a showing that the parties' conduct was inconsistent with the provisions of the original written contract. *Garrison v Edward Brown & Sons* (1944) 25 C2d 473, 479, 154 P2d 377; *Daugherty Co. v Kimberly-Clark Corp.* (1971) 14 CA3d 151, 158, 92 CR 120.

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§19.15 B. Consideration

New consideration is usually required for the modification of a written contract to be valid. *Main St. & Agric. Park R.R. v Los Angeles Traction Co.* (1900) 129 C 301, 61 P 937; *Fairlane Estates, Inc. v Carrico Constr. Co.* (1964) 228 CA2d 65, 71, 39 CR 35. The parties must provide new reciprocal rights and duties for those surrendered by the amendment. *House v Lala* (1963) 214 CA2d 238, 29 CR 450. If the parties merely renew their promises to perform as in the original contract, the test for new consideration is not met. See *Fairlane Estates, Inc. v Carrico Constr. Co., supra*. See CC §1605 (identifying what constitutes consideration).

NOTE: An agreement modifying a contract for the sale of goods needs no consideration to be binding. Com C §2209(1). Such modifications must meet the test of good faith. See California UCC Sales and Leases §§6.2-6.5 (Cal CEB 2002).

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§19.16 V. PREPARING TO DRAFT AMENDMENT

Before drafting an amendment, counsel should answer the following questions:

- What form of amendment, written or oral, is required (or desirable) for the contract to be amended?
- What level of consent among the parties is required for the amendment?
- Are any third party consents required to approve the amendment?
- Are any procedural requirements imposed by law or by the original contract (*i.e.,* notice) that must be observed for the amendment to become effective?

For amendment language, see §§19.24-19.50.

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§19.17 A. Obtain and Review Copy of Original Agreement

The first step in amending or modifying an existing contract is to obtain a copy of the original contract, all exhibits and attachments to the original contract, and all existing amendments. Among the reasons for doing so are that:

- Counsel must understand the history of the contractual relationship between the parties to ensure that the amendment is accurately and appropriately drafted.
- The original contract identifies the parties and counsel and usually lists their addresses and telephone numbers (and possibly social security numbers), which counsel will need to properly draft the amendment, distribute it for approval, oversee its execution, and prepare all necessary notices.
- The original contract provides counsel with the information necessary to refer to it in the amendment. Including the dates of prior contracts and amendments is useful for a quick reference to a specific document.
- The original contract includes any additional requirements imposed by the parties for amendment, such as consents, notices, writings, or other formalities.
- A review of the original contract may highlight the need to update additional provisions affected by the amendment.

All parties to the contract (including any parties added by amendment) should have signed and dated copies of the original contract and all amendments to it; counsel should obtain the copies from the client. Counsel may already have these documents if the notice provisions of the contract require that copies of all notices be delivered to counsel for the party to whom notice is given. If a contract permits amendment by fewer than all parties (see §19.14), counsel should verify that he or she has received all amendments, exhibits, and attachments. Counsel should also verify that the client has not amended the agreement on its own. Copies of contracts recorded or filed with a government agency should be obtained through the public records to ensure that the copy in the client's or counsel's files are the most recent version of the contract.

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§19.18 B. Ascertain Format of Amendment

Although no particular form is required to amend a contract, the better practice is to formalize the amendment in a writing that clearly expresses the nature and extent of the modifications to the rights and obligations of the parties. See *Rosenberg v Geo. A. Moore & Co.* (1924) 194 C 392, 229 P 34 (letters exchanged between parties constituted modification of original contract); *Texas Co. v Todd* (1937) 19 CA2d 174, 64 P2d 1180 (contract modified by written stipulation evidenced by telegrams or letters).

Most contracts provide amendment procedures, which generally require, among other things, that all amendments be in writing. See §§17.5-17.6. The contract may even identify the individual (by name or title) authorized to execute the writing. Such provisions generally preclude controversy over whether the contract was orally amended by the parties. Even if the contract provides that it may not be varied or modified by an executory parol agreement, however, the facts of a particular case may create an equitable estoppel that prevents a party from denying that the contract was orally modified. See *Wilson v Bailey* (1937) 8 C2d 416, 65 P2d 770.

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§19.19 C. Ascertain Scope and Effect of Amendment

Counsel must ensure that the language of the amendment clearly and concisely reflects the parties' intentions and addresses all issues affected by the amendment. Counsel should question the principals on their intent, both at the time the original contract was executed and at the time of amendment. Counsel should understand the circumstances that led the parties to consider the amendment, as well as the manner in which relationships may have evolved since the date of the original contract or last amendment.

As with the original contract, counsel may need to consider the ethical responsibilities of representing multiple parties in the course of amending or modifying the contract. See §2.15.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/19 Amendments and Modifications to Executory Contracts/ D. Consents and Approvals/§19.20 1. Ascertain What Consents and Approvals Are Required

D. Consents and Approvals

§19.20 1. Ascertain What Consents and Approvals Are Required

Counsel must be cognizant of the type of consent required for the amendment to be approved. The tone and content of the amendment may have an effect on the approval process, particularly if the amendment is intended to modify the parties' reciprocal duties and obligations. Consent may be required from parties to the original contract who need not execute the amendment. If the contract permits amendment by fewer than all parties to the contract (see §19.14), counsel should understand how the interests of each of the key parties will influence the negotiation of the amendment.

In some transactions, the original agreement may permit one party to unilaterally amend it on the occurrence of certain events or conditions, without the other party's consent, simply by delivering a notice of amendment. See §19.51. For example, a lessor may be given the right to increase rental payments based on a change in the Consumer Price Index. Both parties may still need to enter into and consent to an amendment to address ancillary issues created by the increase, however, such as whether the security deposit should also be increased. Counsel should consider the advisability of obtaining consent from third parties who may be adversely affected by such changes.

EXAMPLE: A group of investors who purchase shares in a corporation early in its development may be asked to dilute or otherwise modify their voting rights in connection with a second or third round of financing. The willingness of those investors to agree to any modifications largely depends on whether they are satisfied that they will receive a sufficient benefit from the subsequent event. Advocates of the amendment would likely argue that the new financing enhances the possibilities that the investors will realize a meaningful return on their earlier investment.

Appropriate resolutions of the board of directors and shareholders should be prepared and adopted for the amendment if (1) their consent is required under the contract, (2) the contract constitutes a material obligation of the corporate party, or (3) the bylaws require their consent. If one party is a partnership, counsel should review the partnership agreement to ascertain whether the partner executing the amendment has the authority to do so under the partnership's governing instrument.

Consent may also be required from third parties, such as guarantors, creditors, or third party beneficiaries to the contract. But because the parties to the agreement may not want others to be privy to their negotiations, counsel should consider submitting the amendment to third parties only after all parties have agreed on its provisions. Waiting to submit the amendment, however, could jeopardize the transaction. To avoid potential problems, counsel or the parties should discuss the amendment with the third parties so that any issues that might cause them to withhold consent can be addressed in the submitted draft of the amendment.

PRACTICE TIP: Counsel should consider whether a nondisclosure agreement is appropriate to preserve the confidentiality of the amended agreement.

WARNING: In the absence of a waiver of CC §2819 in a guaranty agreement, a guarantor may be exonerated by an alteration of the original agreement.

If a party to the contract is a corporation, a signature by only one officer of the corporation may not be adequate. Corporations Code §313 has been interpreted to require the signature of (1) the chairman of the board, the president, or any vice president and (2) the secretary, any assistant secretary, the chief financial officer, or any assistant treasurer. The California Supreme Court concluded that under Corp C §313, a contract is binding on a corporation when an individual who in fact occupies the offices of president, chief financial officer, and secretary of a corporation executes a contract on behalf of the corporation, even when the contract expressly identifies the individual solely as its president. See *Snukal v Flightways Mfg., Inc.* (2000) 23 C4th 754, 98 CR2d 1.

PRACTICE TIP: The agreement should include several signature blocks to allow the individual to sign in each of his or her capacities. If an individual is also being personally bound by the contract (*e.g.,* as a guarantor), he or she

should also sign as an individual.

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§19.21 2. Procedure for Soliciting Consents

Once the amendment has been drafted and approved by the key parties to the contract, counsel should distribute the amendment to all parties who must approve or consent to it. Counsel should allow sufficient time in the amendment process to permit these parties to complete whatever procedures might be required for consent to be granted.

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§19.22 E. Finalize Amendment

Counsel should send a transmittal letter with the amendment, explaining its purpose and giving instructions for execution (*e.g.,* where to sign, the need for witnesses, notarization requirements) and return of the amendment. The letter should describe the material items in the amendment and any material change that the amendment might have on the parties' rights and obligations. If the amendment does not require the consent of all parties, the letter should clearly describe when and how the amendment might become effective without further action by the recipient. If the contract requires that notice be provided in a specified manner (*i.e.,* by certified mail or by courier), counsel should ensure that those procedures are followed. Counsel should keep evidence of mailing or distribution of the amendment in the file.

PRACTICE TIP: If sending the amendment by certified mail, return receipt requested, counsel should note on the green return card the contents of the envelope and the date mailed.

WARNING: Legal advice given to third parties with the knowledge that they may rely on that advice could result in professional liability. See, *e.g., Bily v Arthur Young & Co.* (1992) 3 C4th 370, 410, 11 CR2d 51.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/19 Amendments and Modifications to Executory Contracts/§19.23 F. Postamendment Considerations

§19.23 F. Postamendment Considerations

Once the amendment is executed and all requisite consents are obtained, counsel should address postamendment formalities:

- Counsel should send to each party to the contract, each party that consented to the amendment, and anyone else entitled to notice of the amendment, (1) a signed and dated copy of the executed amendment and (2) a statement of the date that the amendment became effective and, if finalized without the approval of all parties, the vote or level of approval that was obtained.
- Counsel and client should retain signed and dated copies of the amendment together with their copies of the original contract.
- If the contract contemplates additional milestones or dates on which amendments or elections must be made, counsel should calendar those dates to ensure smooth and timely compliance.
- If necessary, counsel should ensure that the amendment is properly recorded or filed.
- Counsel should mark a copy of the original contract showing all changes made by the current and prior amendments, or should prepare a statement explaining the purpose and effect of the amendment for the client's and counsel's files and attach it to the front of the original documents.

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VI. DRAFTING AMENDMENT AGREEMENT

§19.24 A. Identification of Original Agreement and Amendment

The amendment should be clearly identified as an "amendment" or a "modification" to the original contract. If more than one amendment has been made to the contract, the title to the amendment should state which amendment it is (*e.g.,* "Third Amendment of Loan and Security Agreement").

Counsel should identify the original contract and all earlier amendments in the recitals section of the amendment agreement. The amendment should include the date and place of execution of the original contract, its subject matter (*e.g.,* a description of any property involved in the contract), and the date and place of any previous amendments. It should also state the names, addresses, and, for corporations and partnerships, the state of incorporation or organization of each party to the amendment and any other party to the contract, if it was previously amended. If the agreement relates to various rights granted to similarly situated parties, the amendment may simply refer to a schedule that lists the names and addresses of each of those parties. If necessary, counsel can distinguish between different parties, as appropriate (*e.g.,* "First Round Investors" and "Second Round Investors").

PRACTICE TIP: Counsel should work with the client to identify all formal and informal amendments to the agreement, including instruments, letters, and faxes. If merely asked to supply "all amendments," the client may omit an important document that he or she did not think of as an amendment.

The amendment should also describe the changed circumstances that led to the amendment and the purpose of the amendment. If the original agreement addressed amendment procedures, this fact should be included in the recitals of the amendment.

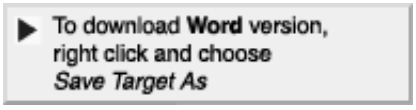
Although not required for an amendment to be effective, a copy of the contract and the earlier amendments may be appended to the amendment as an exhibit.

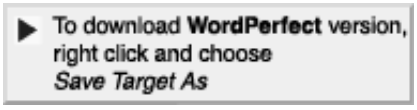
See forms in §§19.25-19.26 for the caption, identification of parties, and recitals of an amendment.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/19 Amendments and Modifications to Executory Contracts/§19.25 1. Form: Caption and Identification of Parties

§19.25 1. Form: Caption and Identification of Parties





19.25-1 Caption and identification of parties

_ _[*E.G., FIRST*]_ _ **AMENDMENT OF** _ _[*NAME OF ORIGINAL AGREEMENT*]_ _

[*Add one of the following alternatives*]

[*Alternative 1: Specifically naming all parties*]

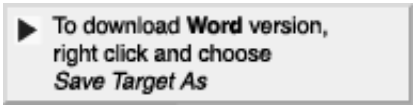
This _ _[*name of amendment*]_ _ **(this "Amendment") is made as of** _ _[*date*]_ _**, between** _ _[*name of first party*]_ _**, a** _ _[*e.g., Delaware corporation*]_ _ **(**_ _[*e.g., "Landlord"*]_ _**) and** _ _[*name of second party*]_ _**, a** _ _[*e.g., California limited partnership*]_ _ **(**_ _[*e.g., "Tenant"*]_ _**).**

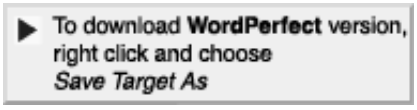
[*Alternative 2: Naming parties on schedule*]

This _ _[*name of amendment*]_ _ **(this "Amendment") is made as of** _ _[*date*]_ _**, between** _ _[*name of first party*]_ _**, a** _ _[*e.g., Delaware corporation*]_ _ **(**_ _[*e.g., "Company"*]_ _**) and the parties listed on Exhibit A to this Amendment (**_ _[*e.g., collectively, "Investors"*]_ _**).**

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§19.26 2. Form: Recitals





19.26-1 Recitals

RECITALS

A. _ _[*Name of first party*]_ _ **and** _ _[*name of second party*]_ _ **entered into an agreement to** _ _[*purpose of original agreement*]_ _ **on** _ _[*date*]_ _**, at** _ _[*location of execution*]_ _**,** _ _[*and subsequently amended such agreement on* _ _[*date*]_ _*, at* _ _[*location of execution*]_ _]_ _ **(**_ _[*as amended,*]_ _ **the "Original Agreement").** _ _[*A copy of the Original Agreement* _ _[*, as previously amended*]_ _ *is attached to this Amendment as Exhibit A*]_ _**.**

B. _ _[*Describe provisions of Original Agreement that are to be amended*]_ _**.**

C. Since the date of the Original Agreement, _ _[*describe changed circumstances leading to the amendment*]_ _**.**

D. Paragraph _ _[*paragraph number*]_ _ **of the Original Agreement provides** _ _[*relate procedures for amending Original Agreement*]_ _**.**

E. The parties wish to amend the Original Agreement _ _[*to provide/by* _ _[*describe purpose of the amendment*]_ _]_ _**.**

NOW, THEREFORE, in consideration of the mutual obligations in this Amendment _ _[*and in any ancillary agreements*]_ _**,** _ _[*and for other good consideration, the receipt and sufficiency of which are acknowledged,*]_ _ **the parties to this Amendment agree as follows:**

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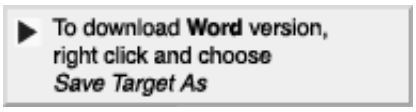
§19.27 B. Effectiveness

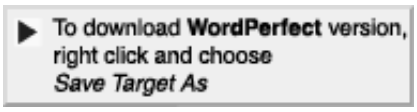
The effective date of amendments and the terms of the amendment itself require careful consideration. Consider that the terms of the amendment may govern future performance, or may be retroactive, or both. In fact, except for amendments that only add new and separable terms, most amendments have possible retroactive effect. Thus, the amendment should include an "effective date" and make clear whether the amendments are retroactive.

The amendment should further specify any conditions to its effectiveness. For example, the parties to the original contract may be required to execute an ancillary agreement or the amendment itself. At what time does the amendment take effect? Is the amendment retroactive?

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§19.28 1. Form: Effectiveness as of Specific Date





19.28-1 Effectiveness as of specific date

Effectiveness. **This Amendment will be effective as of** _ _[*date*]_ _

[*If applicable, add one of the following options*]

[*Option 1: If conditioned on consent*]

, subject to the receipt of consent from _ _[*party required to consent to the amendment*]_ _ **to this Amendment.** _ _[*If such consent has not been received by* _ _[*date*]_ _*, however, this Amendment will be canceled and be of no force and effect*]_ _

[*Option 2: If conditioned on compliance with other agreements*]

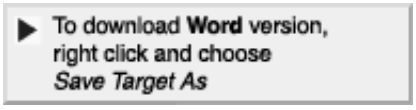
, subject to each party's full and complete compliance with the conditions of closing contained in any Ancillary Agreements. _ _[*If the conditions to effectiveness of this Amendment have not been satisfied by* _ _[*date*]_ _*, however, this Amendment will be canceled and be of no force and effect*]_ _

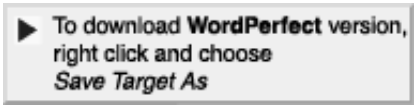
[*Option 3: Other conditions*]

, subject to _ _[*specify conditions*]_ _**.** _ _[*If the conditions to effectiveness of this Amendment have not been satisfied by* _ _[*date*]_ _*, however, this Amendment will be canceled and be of no force and effect.*]_ _

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§19.29 2. Form: Effective Without Execution By All Parties to Original Agreement





19.29-1 Effective without execution by all parties to original agreement

Effectiveness. **This Amendment will be deemed to have been duly approved in accordance with Paragraph _ _[*paragraph number*]_ _ of the Original Agreement when executed by _ _[*number or percentage of parties required to execute amendment*]_ _ of the parties to the Original Agreement, and will be binding on all parties to the Original Agreement, whether or not they actually executed a copy of this Amendment. Once duly approved, this Amendment will become effective as of _ _[*date*]_ _, and notice of this Amendment will be delivered to those parties to the Original Agreement who have not executed this Amendment.**

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C. Recital of Consideration for Amendment

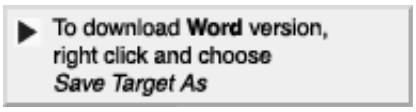
§19.30 1. General Principles

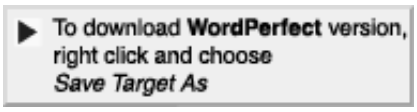
The amendment should recite that each party has given new consideration for the amendment and should identify any new rights and obligations undertaken by the parties at the time of the amendment. If an amendment is made in connection with an amendment to an ancillary agreement or with the execution of a new agreement, it may be sufficient to simply cross-refer to the transactions that are the subject of the other agreements. See form in §19.31.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/19 Amendments and Modifications to Executory Contracts/§19.31 2. Form: Consideration for Amendment

§19.31 2. Form: Consideration for Amendment





19.31-1 Consideration for amendment

Consideration for Amendment. _ _[*Name of first party*]_ _**, in consideration of** _ _[*amount and nature of consideration, including obligations undertaken in ancillary agreements*]_ _**, agrees to the modifications set forth in this Amendment. The effect of this Amendment** _ _[*describe material adverse effect that the amendment might have on rights of first party, e.g., may be to reduce the amount of compensation to be received by the first party under the Original Agreement*]_ _**.**

_ _[*Name of second party*]_ _**, in consideration of** _ _[*amount and nature of additional consideration, including obligations undertaken in ancillary agreements*]_ _**, agrees to the modifications set forth in this Amendment. The effect of this Amendment** _ _[*describe material adverse effect that the amendment might have on rights of second party, e.g., may be to reduce the amount of compensation to be received by the second party under the Original Agreement*]_ _**.**

Comment: The consideration should also be described in the transmittal letter accompanying the amendment when it is circulated for review, approval, and execution. See §19.22.

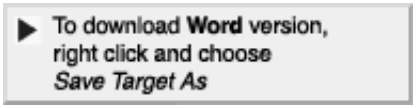
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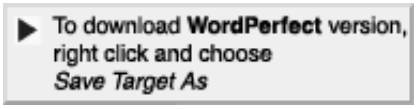
§19.32 D. Defined Terms

Because the amendment must be consistent with the provisions and format of the original contract, it should state that the defined terms in the original agreement will have the same meanings in the amendment. If new terms need to be defined or if different definitions will apply, however, the amendment should incorporate those terms that have the same meaning as in the original contract and list the new definitions. This section can also define ancillary agreements referred to in the amendment. See forms in §§19.33-19.34.

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§19.33 1. Form: Newly Defined Words and Phrases Used in Amendment





19.33-1 Newly defined words and phrases in amendment

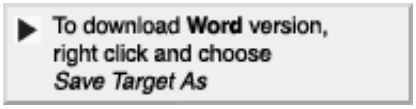
Definitions. **For purposes of this Amendment, the following words and phrases have the following meanings:**

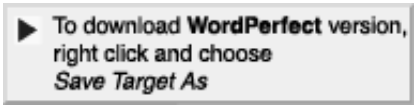
[*Insert defined words and phrases introduced and used in amendment*]

Any other words with initial capitalization that are used and not defined in this Amendment have the meanings ascribed to them in the Original Agreement.

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§19.34 2. Form: No New Words or Phrases Used in Amendment





19.34-1 No new words or phrases in amendment

Definitions. **Any capitalized words or phrases used and not defined in this Amendment have the meanings ascribed to them in the Original Agreement.**

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§19.35 E. Amending Operative Contract Provisions

The amendment should identify the portion of the contract being amended, either by referring to numbered paragraphs in the original contract or by quoting the contractual language to be amended and specifying its location in the original contract. The nature of the alteration should be described, whether it is the substitution, deletion, or addition of sentences, paragraphs, or sections, or a change within one or more paragraphs or sections that are to otherwise remain in effect. If a new provision is added, the amendment should indicate where the new language is to be inserted. In adding new provisions, counsel should number the new paragraphs so that other paragraph numbers need not be changed. For example, a new paragraph added between Paragraphs 5 and 6 could be numbered "Paragraph 5.1," allowing a "Paragraph 5.2" to be added, if necessary, in a later amendment. See forms in §§19.36-19.38 adding, deleting, and modifying provisions.

PRACTICE TIP: An amendment is usually easier to follow if a paragraph or section is deleted and replaced in its entirety, even if there are only a few changes made, rather than changing only sentences or parts of sentences.

In some transactions, counsel should consider amending and restating the entire agreement. See form in §19.39. Amendment and restatement are often appropriate if:

- The original agreement has been amended and modified many times.
- Earlier amendments were extensive.
- The current amendment creates a "ripple" or "domino" effect with respect to the provisions in the original agreement, or is otherwise substantial in its effect.

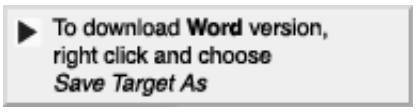
EXAMPLE: During the term of a lease agreement, the parties change their business arrangement from a triple net lease to a gross rental formula. This change affects so many different provisions in the lease agreement that it would be easier and more appropriate to prepare to execute an amended and restated lease.

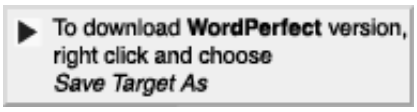
For modification of exhibits and reference to modifications of ancillary agreements, see §§19.40-19.42.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/19 Amendments and Modifications to Executory Contracts/§19.36 1. Form: Addition of New Provision

§19.36 1. Form: Addition of New Provision





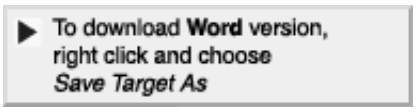
19.36-1 Addition of new provision

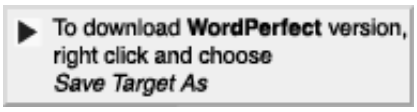
_ _[*Heading*]_ _**. The following new Paragraph** _ _[*paragraph number*]_ _ **is added to the Original Agreement:**

_ _[*Insert new provision*]_ _**.**

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§19.37 2. Form: Deleting Provision of Original Agreement





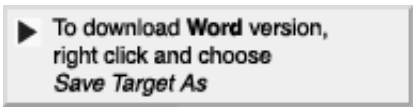
19.37-1 Deleting provision of original agreement

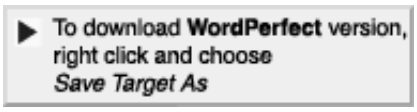
Deletion of Paragraph _ _[*paragraph number*]_ _**. Paragraph** _ _[*paragraph number*]_ _ **of the Original Agreement is deleted and is of no further force and effect.**

Comment: The parties can also make the change retroactive. The resulting relief of a prior duty then constitutes the consideration.

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§19.38 3. Form: Modifying Provision of Original Agreement





19.38-1 Modifying provision of original agreement

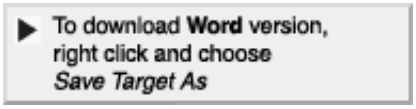
Modification of Paragraph **_ _**[*paragraph number*]**_ _. Paragraph _ _**[*paragraph number*]**_ _ of the Original Agreement _ _**[*titled* **_ _**[*paragraph heading*]**_ _**]**_ _ is modified to read in its entirety as follows:**

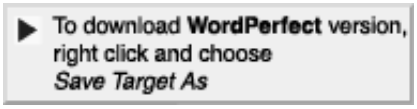
[*Insert new provision*]

Comment: If the modification results in additional payments being due (*e.g.,* increasing the security deposit due under a lease), the amendment should specify when the additional payment is due, *e.g.,* is the payment due contemporaneously with execution of the amendment or within a specified time after its execution?

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§19.39 4. Form: Amending and Restating Original Agreement in Its Entirety





19.39-1 Amending and restating original agreement

The Original Agreement is amended to read in its entirety as follows:

[*Insert complete new agreement*]

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/19 Amendments and Modifications to Executory Contracts/§19.40 F. Changing Exhibits and Ancillary Agreements

§19.40 F. Changing Exhibits and Ancillary Agreements

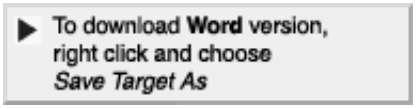
References to exhibits and ancillary agreements in the original contract and in the amendment should be consistent. If an amendment changes one or more exhibits to the original contract, the affected exhibits may be amended and restated in their entirety and appended to the amendment. Similarly, if an ancillary agreement is simultaneously amended, the ancillary agreement, as amended, may be appended to the amendment. If an exhibit to the original contract or to an ancillary agreement is changed or retitled, the amendment should state that all references in the original contract to the "old" exhibit or agreement are now references to the "new" exhibit or agreement. See forms in §§19.41-19.42.

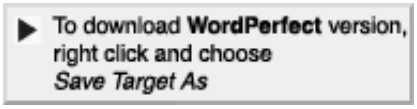
Agreements often contemplate that certain exhibits will be periodically amended and updated. For example, in a technology license agreement, the subject technology may continue to be improved and patent applications identified in an exhibit may mature into patents, new patent applications, or improvement patents. The parties should sign and date each new exhibit when it is amended.

PRACTICE TIP: Unless an exhibit is lengthy, an amended exhibit is usually easier to follow if it is replaced in its entirety, even if only a few changes are made.

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§19.41 1. Form: Modifying References to Exhibits in Original Agreement



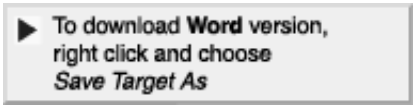


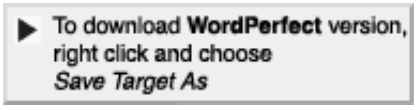
19.41-1 Modifying references to exhibits

Modification of Exhibits. **References to "Exhibit _ _[*specify exhibit*]_ _" in the Original Agreement must be deemed to be references to _ _[*e.g., "Exhibit A"*]_ _ to this Amendment.**

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§19.42 2. Form: Modifying References to Ancillary Agreements in Original Agreement





19.42-1 Modifying references to ancillary agreements

Modification of Ancillary Agreements. **References to "Ancillary Agreements" in the Original Agreement must be deemed to be references to the Ancillary Agreements, as amended.**

Comment: If the definition of "Ancillary Agreements" in the original agreement incorporated amendments made to them from time to time, this provision is unnecessary.

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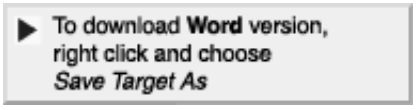
G. Representations and Warranties

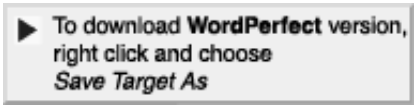
§19.43 1. General Principles

In most transactions, the parties make representations and warranties. The amendment process allows for these representations and warranties to be reaffirmed as of the date of the amendment and to apply to the amendment as well as to the original contract, either by restating each of them individually or by updating all of them in a single provision. The parties may also want to make additional representations and warranties, including those regarding their authority to execute and perform the amendment and those concerning receipt of all consents and approvals necessary for the parties to execute and perform the amendment. See form in §19.44.

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§19.44 2. Form: Representations and Warranties





19.44-1 Representations and warranties

___. *Representations and Warranties of* **_ _**[*name of first party*]**_ _. _ _**[*Name of first party*]**_ _ represents and warrants that:**

(a) The representations and warranties in Paragraph _ _[*paragraph number*]**_ _ of the Original Agreement were true and accurate when made and remain true and accurate in all material respects as of this date _ _**[*, subject to the matters set forth on the Schedule of Exceptions attached to this Amendment as Exhibit A*]**_ _.**

(b) _ _[*Name of first party*]**_ _ has obtained all consents and authorizations necessary or required for it to meet and perform the conditions of this Amendment.**

(c) The execution and delivery of this Amendment has been validly authorized by all requisite corporate action by _ _[*name of first party*]**_ _, and this Amendment constitutes its legal, valid, and binding obligation, enforceable in accordance with its provisions.**

(d) _ _[*Add any additional representations and warranties*]**_ _.**

Comment: The representations and warranties should be repeated for the second party, as appropriate.

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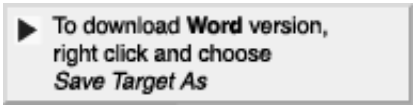
H. Incorporation of Unmodified Terms of Original Agreement

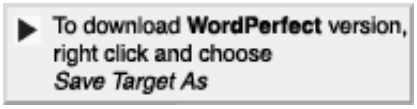
§19.45 1. General Principles

The amendment should state that the portions of the original contract that are not being modified by the amendment continue to be operative. The parties should ratify and reaffirm the unchanged portions of the original contract. Counsel may elect to restate one or more material provisions of the original contract (*i.e.,* the term or duration of the contract) that are *not* being amended, if there is any question about their continuing effect. The amendment should also contain an affirmative statement that the parties' performance under the amended agreement constitutes performance on the original contract. See form in §19.46.

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§19.46 2. Form: Effect of Original Agreement and Amendment





19.46-1 Effect of original agreement and amendment

Continued Effect of Original Agreement. **All provisions of the Original Agreement, except as modified by this Amendment, remain in full force and effect and are reaffirmed. Each party acknowledges that it, as its respective interests appear, is liable for all damages arising from nonperformance under this Amendment if all conditions of this Amendment are not met; and that if this Amendment is performed such performance must be accepted as full performance of its obligations under the Original Agreement. Other than as stated in this Amendment, this Amendment does not operate as a waiver of any condition or obligation imposed on the parties under the Original Agreement.**

Interpretation of Amendment. **In the event of any conflict, inconsistency, or incongruity between any provision of this Amendment and any provision of the Original Agreement, the provisions of this Amendment will govern and control.**

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§19.47 I. Miscellaneous Matters and Formalities

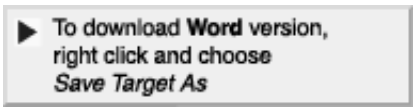
The amendment should address any postexecution obligations of the parties, such as filing or recording obligations, third party consent requirements, and notice requirements. See forms in §§19.48-19.49. If such compliance is necessary for the amendment to be effective, this fact should be stated.

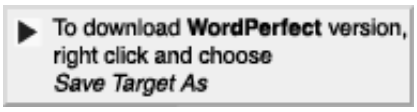
The amendment should also include appropriate provisions on governing law, severability, and, if appropriate, the use of counterpart signature pages. See §§16.55-16.56, 17.13-17.14, 18.47-18.48. Counsel should obtain signatures from guarantors and spouses, if necessary. See, *e.g.,* 3 Miller & Starr, California Real Estate §12:62 (3d ed 2000) on the treatment of community property contracts. Provision should also be made for acknowledgment of execution, if necessary. See, *e.g.,* Govt C §§27287-27288.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/19 Amendments and Modifications to Executory Contracts/§19.48 1. Form: Postexecution Filing or Recording Required

§19.48 1. Form: Postexecution Filing or Recording Required





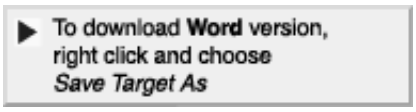
19.48-1 Postexecution filing or recording required

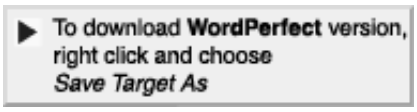
Filings. **Within _ _[*e.g., 2 days*]_ _ after execution of this Amendment, _ _[*name of party*]_ _ shall file or record a copy of this Amendment with _ _[*office where recorded*]_ _.**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/19 Amendments and Modifications to Executory Contracts/§19.49 2. Form: Postexecution Notices Required

§19.49 2. Form: Postexecution Notices Required



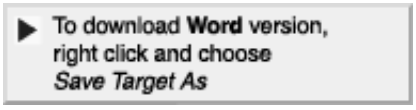


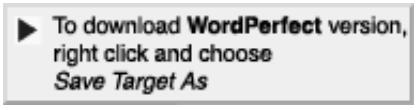
19.49-1 Postexecution notices required

Notice. **Within** _ _[*e.g., 5 days*]_ _ **after execution of this Amendment,** _ _[*name of party*]_ _ **shall deliver by** _ _[*specify means of delivery*]_ _ **a copy of** _ _[*the notice of*]_ _ **this Amendment to** _ _[*parties to receive notice of Amendment*]_ _**.**

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§19.50 3. Form: Other General Provisions





19.50-1 Other general provisions

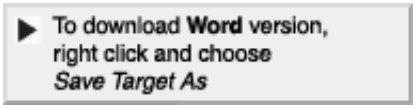
Governing Law and Severability. **THIS AMENDMENT IS GOVERNED BY AND MUST BE CONSTRUED IN ACCORDANCE WITH THE SUBSTANTIVE LAWS OF THE STATE OF CALIFORNIA, EXCLUDING ITS CONFLICT OF LAW PRINCIPLES. THE PARTIES AGREE THAT SUBJECT MATTER AND PERSONAL JURISDICTION ARE PROPER AND WAIVE ALL VENUE OBJECTIONS IN THE COURTS LOCATED IN UNITED STATES. DISTRICT COURT FOR THE _ _[*name of preferred district court*]_ _ DISTRICT OF CALIFORNIA AND THE STATE COURTS FOR _ _[*name of preferred city*]_ _, CALIFORNIA. IF A COURT OR OTHER TRIBUNAL OF COMPETENT JURISDICTION HOLDS ANY PROVISION OF THIS AMENDMENT TO BE UNENFORCEABLE, THE REMAINING PORTIONS OF THIS AMENDMENT WILL REMAIN IN FULL FORCE AND EFFECT.**

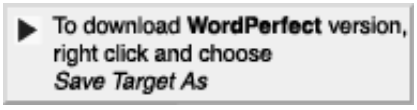
Entire Agreement. **This Amendment, together with the Original Agreement, constitutes the entire agreement between the parties to the Original Agreement pertaining to the subject matter of this Amendment, and any and all other written or oral agreements existing between the parties before the date of this Amendment with respect to the subject matter of this Amendment are expressly canceled.**

Comment: See chap 17 for additional general provisions.

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§19.51 J. Form: Notice of Unilateral Amendment





19.51-1 Notice of unilateral amendment

NOTICE OF _ _[*E.G., FIRST*]_ _ **AMENDMENT TO**
_ _[*NAME OF ORIGINAL AGREEMENT*]_ _

_ _[*Date*]_ _

To: _ _[*Name of recipient*]_ _

_ _[*Address*]_ _

On _ _[*date*]_ _**, at** _ _[*location of execution*]_ _**,** _ _[*name of first party*]_ _ **and** _ _[*name of second party*]_ _ **entered into an agreement to** _ _[*purpose of original agreement*]_ _ _ _[*, and subsequently amended such agreement on* _ _[*date of earlier amendment*]_ _*, at* _ _[*location of execution of earlier amendment*]_ _]_ _ **(**_ _[*as amended,*]_ _ **the "Original Agreement"). Paragraph** _ _[*paragraph number*]_ _ **of the Original Agreement provides for amendment of the Original Agreement by** _ _[*relate procedures for amending original agreement*]_ _**.**

Under the amendment procedures of the Original Agreement, the Original Agreement has been amended, effective as of _ _[*date*]_ _ **(the "Effective Date"), by** _ _[*name of amendment*]_ _ **(the "Amendment"). A copy of the Amendment is attached to this Notice as Exhibit A and incorporated into this Notice by this reference. From and after the Effective Date, each party to the Original Agreement continues to be bound by the Original Agreement, as modified by the Amendment.**

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VII. SPECIFIC AMENDMENTS

§19.52 A. Compensation

A common subject for an amendment is a change in the amount of compensation to be paid under the contract. The original contract may require that an adjustment be made in payment terms on the occurrence of certain events, such as an increase in the cost of labor or the Consumer Price Index. In this situation, the amendment should refer to the clause in the original contract that contemplates the adjustment, recite the circumstances leading to the amendment, and then modify the paragraph of the original contract that states the amount and level of compensation to be paid. Counsel should review all key provisions in the agreement, and the economic assumptions underlying it, to ascertain whether any related provisions must also be modified; *e.g.,* should salary review provisions or incentive pay formulas be modified?—are other obligations or performance standards affected?

EXAMPLE: The parties desire to change the manner of computing the amount of monthly lease payments from a flat fee to a percentage of monthly revenues generated from the business operated on the premises. In addition to stating the payment formula, the parties must also define "revenues," noting any adjustments to be made on returns, defaults on payment by customers, and credit arrangements. The amendment should include procedures for the examination of the lessee's books and records in order to verify the amounts that must be paid to the lessor under the amended plan. Because of the extent of these changes, the parties should consider executing an amended and restated lease. See §19.39.

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§19.53 B. Evidences of Indebtedness

The parties may wish to amend the terms of a long-term credit arrangement or reorganize a long-term project entirely as conditions change. The amendment to the credit arrangement could substitute a new debt instrument, which can be attached to the amendment as an exhibit. The amendment could also take the form of a novation, canceling the original debt instrument and replacing it with a new one, but this should be done only after careful consideration of all possible ramifications. Whatever the form, the parties must consider each key payment provision in order to identify any other changes that must be made; *e.g.,* the term of the instrument, the timing of payments, the interest rate, subordination and priority provisions, and the amount and nature of any security for the obligation.

WARNING: See §§19.11, 19.20 for discussion of the risks of changing credit terms without obtaining the consent of guarantors and junior lienholders.

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§19.54 C. Stock Restrictions

Employee stock purchase agreements may be subject to various restrictions. For example:

- The shares may vest over a specified time period.
- The corporation may have the right to repurchase unvested shares for a nominal amount if the employee ceases to be employed by the corporation.
- The corporation may have a right of first refusal for any proposed transfer of the employee's shares.

It may be appropriate over time to execute an amendment to the agreement to accelerate the vesting period or relax some of the transfer restrictions.

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D. Lease Arrangements

§19.55 1. Specific Provisions to Consider

The parties may wish to amend a lease to increase or decrease the leased space. Counsel should consider whether it is appropriate to modify any of the following provisions:

- The definition of the "leased premises" (to include the additional space);
- The rent to be paid under the lease;
- The security deposit to be paid under the lease;
- The method of calculating rent increases;
- Restrictions on subleasing or assignment;
- Applicable option clauses;
- The rights or duties that follow from the expansion of the leased premises (*e.g.,* increase in the number of reserved parking spaces, overhead charges, insurance requirements); or
- The method of calculating common area maintenance charges to be paid by the tenant.

Because the amendment is, in essence, a new lease of the additional space, it should include appropriate representations and warranties on the condition of the space and restrictions on its use. Instead of separately restating each representation and warranty, the amendment could include one representation reaffirming many or all of the representations and warranties of the original lease as of the date of the amendment (see §19.44), and one covenant imposing many or all of the restrictions in the lease to the new leased space.

A lease amendment allows the parties to consider other changes in the relationship, such as extending the term of the lease on the entire leased premises, granting options to the lessee to renew the lease or to purchase the property after expiration of the original term, or granting the right to sublease the premises.

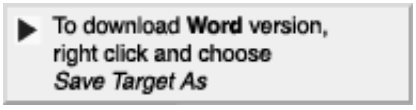
PRACTICE TIP: If additional space is leased during the term of the lease, counsel should ensure that the lease term and any options relating to the original leased space are the same as the term and options relating to the additional leased space, if this is the parties' intent. Counsel should also make a due diligence examination for hazardous or toxic substances in the additional space.

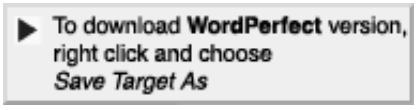
Although the continued effect of certain provisions should be clear from a reading of the amendment, it is sometimes useful to restate that certain material terms of the contract are *not* being modified.

For provisions specific to an increase in the size of the leased premises, see the sample form in §19.56.

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§19.56 2. Form: Sample Provisions for Occupation of Additional Leased Space





19.56-1 Sample provision for occupation of additional leased space

Lease of Additional Space. **Tenant will lease from Landlord an additional 3500 approximate gross square feet located on the second floor of the Building ("Additional Space") effective 5 days after Landlord gives written notice to Tenant of the availability of the Additional Space. Landlord and Tenant acknowledge that the effective date of possession of the Additional Space is contingent on the current tenant's vacating the Additional Space. Tenant agrees to accept the Additional Space when it becomes available. If the Additional Space is not available to Tenant on or before December 31, 1995, however, then at Tenant's option this Amendment may be canceled and will be of no force and effect. If Tenant cancels this Amendment because of the unavailability of the Additional Space, then Landlord shall not be liable to Tenant for any loss or damage of any kind resulting from the cancellation. If this Amendment is voided and is of no force and effect against either party, Tenant will remain obligated in all respects under the provisions of the Lease.**

Condition of Additional Space. **Tenant shall lease the Additional Space in an "as is" condition and any alterations or modifications must be made at Tenant's sole cost and expense in accordance with Paragraph 10 of the Lease. The time required for the construction of any addition or modification to the Additional Space may not delay the payment of the increased rent as set forth in Paragraph 3 of this Amendment. Tenant acknowledges that the Additional Space has been previously improved for the tenant currently occupying the space. If Tenant elects not to use any of these tenant improvements, then the improvements removed must be given to Landlord, at Landlord's election.**

Comment: The provisions in this sample are specific to this transaction and should be used with caution. Counsel should add provisions changing the definition of "Leased Premises" and payment terms, if applicable (*e.g.,* rental payments, security deposits, and common area maintenance charges), and general provisions for amendments. See §§19.24-19.50.

See *Brown v Green* (1994) 8 C4th 812, 35 CR2d 598, and *Hadian v Schwartz* (1994) 8 C4th 836, 35 CR2d 589, for discussion of which party is liable for curative actions of a substantial nature when property is leased "as is."

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E. Addition or Substitution of New Partners

§19.57 1. Specific Provisions to Consider

A contract may be amended to include additional parties who would have rights that are either the same as or different from the original parties to the contract. If an amendment is used to add new parties to an agreement, it should:

- Provide that new parties to the contract have the same rights as the original parties, or identify which rights are the same and which are different; and
- Incorporate any representations or warranties that may have been made by the original parties, including appropriate updates to take into account any developments since the original closing.

For example, the parties to a stock purchase agreement may wish to add additional investors who purchase shares after the original closing date. Investors added by amendment would have the same rights as investors who purchased their shares at the original closing (*e.g.*, a right of first refusal to participate in future financings, the right to have their shares registered on any registration statement filed by the issuer under the Securities Act of 1933 (15 USC §§77a-77aa), or the right to receive certain business and financial information from the issuer). The original investors could enter into an amendment to the original stock purchase agreement with the new investors to add them to the agreement or, if a second closing was anticipated at the time of the original closing, the original agreement may have provided for the use of addenda to add new investors. See form in §19.58.

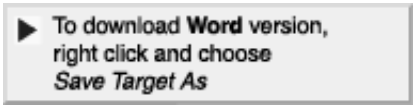
NOTE: Such changes may require compliance with Securities Exchange Commission rules and that the parties sign a nondisclosure agreement.

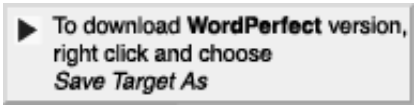
The parties may also want to substitute one of the parties under a contract. This change may require the consent of the original parties if the original contract restricts assignment of rights or delegation of duties. See CC §1457; *Montgomery v De Picot* (1908) 153 C 509, 96 P 305.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/19 Amendments and Modifications to Executory Contracts/§19.58 2. Form: Sample Addendum to Stock Purchase Agreement Adding Additional Investors

§19.58 2. Form: Sample Addendum to Stock Purchase Agreement Adding Additional Investors





19.58-1 Sample addendum to stock purchase agreement for additional investors

ABC CORPORATION FIRST ADDENDUM TO STOCK PURCHASE AGREEMENT

This FIRST ADDENDUM TO STOCK PURCHASE AGREEMENT (this "Addendum") is made as of June 1, 1995, between ABC Corporation, a California corporation (the "Company"), and John Doe (the "Investor").

RECITALS

A. On January 1, 1990, Jane Roe and Sally Smith (collectively, the "Initial Investors") and the Company entered into a Stock Purchase Agreement (as the same may have been amended or modified from time to time, the "Purchase Agreement") relative to the sale of 2000 shares of the Company's Series A Preferred Stock to each of the Initial Investors.

B. The Company wishes to sell 1000 shares of the Company's Series A Preferred Stock to Investor.

THEREFORE, in consideration of the mutual promises, agreements, and undertakings in this Addendum, the parties to this Addendum agree as follows:

1. *Purchase Agreement.* Investor, by execution of this Addendum, will become a party to the Purchase Agreement and be deemed to be an "Investor" for purposes of the Purchase Agreement as though Investor were an original signator of the Purchase Agreement. Investor will complete and file an Exemption Questionnaire, if required, and will execute a Nondisclosure Agreement in the form attached to this Addendum as Exhibit A.

2. *Purchase of Stock and Notes.* Subject to the provisions of the Purchase Agreement, on this date Investor shall purchase from the Company 1000 shares of the Company's Series A Preferred Stock at a purchase price of $75.00 per share; such shares will be deemed to be "Stock" for purposes of the Purchase Agreement.

3. *Representations and Warranties of Company.* The Company affirms to Investor that:

(a) The representations and warranties in Paragraph 7 of the Purchase Agreement were true and accurate when made, and they remain true and accurate in all material respects as of this date, subject to the matters set forth on the Schedule of Exceptions attached to this Addendum as Exhibit B;

(b) The conditions in Paragraph 9 of the Purchase Agreement have been satisfied; and

(c) The Company is not in breach of any covenant in Paragraph 11 of the Purchase Agreement.

4. *Representations and Warranties of Investor.* Investor acknowledges receipt of a copy of the Purchase Agreement and affirms to the Company that:

(a) Investor has reviewed the representations and warranties in Paragraph 8 of the Purchase Agreement, and they are true and correct as they relate to the Investor and the Investor's purchase of the Stock; and

(b) The Stock will be covered by the terms and provisions relating to compliance with federal and state securities laws as set forth in Paragraph 13 of the Purchase Agreement.

5. *Ratification of Purchase Agreement.* Except as amended by this Addendum, all provisions of the Purchase

Agreement are ratified and affirmed and govern the relationship of the parties with respect to the subject matter of this Addendum.

Comment: Exhibit B to the Addendum should be a Schedule of Exceptions to any representations and warranties in the Purchase Agreement. The provisions in this example are specific to this transaction and should be used with caution. Counsel should add general provisions for amendments.

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§19.59 F. Prior Financing Arrangements

A company that engages in a continuous series of financings may want to ensure that any special rights granted to investors can be effectively integrated into prior financing agreements to minimize the burden on the company and to avoid any conflicts among the various investor groups regarding the relative priority of their rights. To achieve this objective, the company may need to amend its prior financing agreements whenever it contemplates raising new funds, a process that could introduce complications to the new transaction if the old investors are not participating in the new financing but are being asked to change or modify their existing rights.

The issue of integration commonly arises if the company grants registration rights to its investors, permitting them to request that their shares be registered under the Securities Act of 1933 (15 USC §§77a-77aa) to allow resale of the shares to third parties. Instead of each investor group making its own separate request for registration under its specific agreement, the company can integrate the registration rights of all investors in one agreement. The registration rights granted to the earlier round investors can then be amended at the time of each financing to be identical to those granted in the current round. Other changes may be required, such as extending the duration of the rights and procedures that must be followed in order to make further amendments to the registration rights, each of which is included as a part of the "new" provisions at the time of the amendment.

The parties could amend each prior round agreement to ensure that all investors have consistent registration rights, but it is generally easier to use a separate agreement covering all rights that might be subject to future amendment or modification. In addition to the registration rights, the agreement might cover business and financial information, election of directors, any right of first refusal on future financings, and other covenants regarding the business operation that might be suitable for action by all the investors as a single group. Using a single "Investors' Rights Agreement" minimizes the level of formality required at the time of any new financing, because the new investors become parties to the agreement and approval of the amendments is sought from a single group of prior investors.

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§19.60 G. Mergers and Acquisitions

In merger or acquisition transactions, the parties execute a contract in anticipation of a later closing. If a change in the transaction is required during the waiting period, the parties must amend the original contract. For example, due diligence during the interim period could uncover a large contingent liability, causing the buyer to seek either adjustments in the purchase price or an agreement by the seller to fully indemnify the buyer for any damages caused by the contingency. The amendment should define the contingency, allocate the legal expenses and associated costs relating to the contingency, and make whatever other modifications might be required, such as amending an ancillary indemnification or escrow agreement.

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20

Letters of Intent

Ronald H. Star
Christopher E. Nordquist

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.1 I. CHECKLIST: LETTERS OF INTENT

§20.1 I. CHECKLIST: LETTERS OF INTENT

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

- Need for letter of intent
- To qualify interest (see §20.4)
- To narrow alternatives (see §20.7)
- To identify deal-breaking issues (see §20.8)
- To obtain legally binding agreement (see §20.9)
- To aid in negotiating with more powerful parties (see §20.10)
- To aid communication and control (see §20.5)
- To preserve rights (see §20.11)
- Other cost and efficiency considerations (see §20.4)
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§20.2 II. WHAT IS A LETTER OF INTENT?

A letter of intent is any writing that describes some or all provisions of a proposed transaction, in which one or more parties shows some level of interest in or commitment to the subject matter or the process of negotiating a definitive agreement. It encompasses a variety of writings, such as a commitment letter, a term sheet, a memorandum of agreement, or an agreement in principle. The document can be a very formal writing or an informal letter.

The letter of intent may be legally binding in whole or in part, or it may be legally nonbinding. See §§20.16-20.27. A letter of intent usually falls short of a definitive agreement, generally because certain provisions are not yet included, the parties intend to negotiate more detailed provisions, or the parties do not yet wish to be legally bound to some or all of the provisions.

The letter of intent may be an important tool in a multitude of negotiating and business situations. For example, it can be used:

- To focus the parties' expectations about a proposed transaction or to educate the parties in complex transactions;
- To define preliminary agreements, clarify terms, and identify issues for later discussion;
- To identify conditions precedent to the conclusion of the transaction and to define the scope of due diligence;
- To allow negotiations to continue when a third party's commitment is essential to the negotiations;
- To identify the different types of contracts that may be needed to complete the transaction;
- To provide a summary of the proposed business arrangement or an expression of the other party's level of commitment to be shown to a board of directors, investors, potential lenders, or other parties who must approve the transaction;
- To test a party's level of commitment in pursuing a transaction;
- To establish a preliminary timetable and sequence for the proposed transaction;
- To provide evidence that some or all of the provisions are part of a legally binding contract;
- In later negotiations to show that one party's position is inconsistent with the business arrangement contemplated by the original intent of the parties; and
- In later litigation to show what the parties had contemplated if no later contract is entered into or to further define missing or ambiguous provisions of the later contract.

See generally California Law of Contracts §4.17 (Cal CEB 2007).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.3 III. WHEN TO USE A LETTER OF INTENT: STRATEGIC AND COST CONCERNS

§20.3 III. WHEN TO USE A LETTER OF INTENT: STRATEGIC AND COST CONCERNS

The parties need to consider various factors in deciding whether to use a letter of intent: the personalities of the parties, the relationship and relative bargaining strength of the parties, possible alternative business arrangements, and the level of counsel's involvement. The more common points to consider are cost, timing, and efficiency considerations (see §20.4); communication and control (see §20.5); the need to demonstrate a commitment (see §20.6); narrowing alternatives (see §20.7); establishing common ground and identifying deal-breaking points (see §20.8); obtaining a legally binding agreement (see §20.9); strategies for negotiating with more powerful parties (see §20.10); and preserving rights when faced with trailing documentation (see §20.11).

All parties should recognize that the definitive written agreement will go beyond the letter of intent:

- Additional facts about the parties or the transaction that are revealed or discovered during negotiations will be addressed for the first time in the definitive agreement.
- The definitive agreement should address events that are less likely to occur and on which the business principals may not have focused in the letter of intent.
- The definitive agreement generally includes clauses that are common and important in business transactions, such as limitations of liability, warranty disclaimers, and indemnification provisions, which the parties may not have considered previously.

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§20.4 A. Cost, Timing, and Efficiency Considerations

Counsel must initially ascertain whether there is sufficient time to negotiate, draft, and execute a letter of intent. If time is short and the proposed transaction is relatively straightforward, bypassing the letter of intent and moving directly to the definitive document may be appropriate. However, a letter of intent may be the fastest means to establish a working relationship between the parties. It can be made binding on the parties until terminated by one of the parties or until a definitive agreement is established, and can set forth a schedule for further negotiations to address issues not set forth in the letter of intent.

Competing cost and efficiency considerations must also be evaluated. Negotiating and drafting a letter of intent can be an efficient and cost-effective way to evaluate the seriousness of the parties' interest and to identify potential impasses at the earliest possible stage. It also provides an opportunity to measure the resolve, strengths, and skills of the other party's negotiating team.

On the other hand, preparing a detailed letter of intent means creating two separate negotiating and drafting projects: the letter of intent and the definitive agreement. The delay involved in drafting and negotiating the definitive agreement may also postpone identification of important unanticipated issues that only appear when the parties begin to document the details of that agreement. Striking the correct balance involves weighing the strategic reasons for the letter of intent against cost and efficiency considerations.

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§20.5 B. Communication and Control During Negotiation Process

A letter of intent frequently receives greater scrutiny and prompts more discussion between counsel and client than does a definitive written agreement because the letter of intent is usually written in everyday business terms and specifically targets key issues. Accordingly, counsel can use the letter of intent to communicate with the principals and identify the issues that need the client's attention. For the business person, the relatively easy-to-understand letter of intent can be an important tool for monitoring and controlling negotiation of the definitive written agreements.

In complex transactions, the letter of intent can establish the scope of the various parties' responsibilities and the timing and sequence of events, providing a useful scheme for charting the transaction from the letter of intent through negotiation of the definitive documents to the closing and postclosing relations. In a complex transaction, the letter of intent can be useful in educating the parties about why and how the transaction should proceed, especially if it is driven by the need to comply with federal income tax requirements.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.6 C. Need to Demonstrate Commitment: The Chicken and Egg Problem

§20.6 C. Need to Demonstrate Commitment: The Chicken and Egg Problem

Many business situations arise in which evidence of the commitment from other parties is essential for the transaction to proceed. A letter of intent can provide a sufficient expression of interest to permit the negotiations to progress. For example:

(1) A bank may require a commitment for equity financing before the bank is willing to negotiate a loan.

(2) Equity investors may want to see expressions of interest from purchasers or distributors of a company's products before proceeding with an equity infusion.

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§20.7 D. Narrowing Alternatives

Experienced negotiators understand that they are in the strongest bargaining position when they have business alternatives to the deal being negotiated. Pursuing parallel negotiating tracks can be extremely costly, however, both in out-of-pocket expenses (*e.g.,* legal fees) and in diverting scarce managerial time and attention. The letter of intent can help the business principals gauge the seriousness of the other party's commitment to a transaction and the likelihood that the proposed transaction will be consummated. The letter of intent can also identify the form of the transaction that may best accommodate the interests of the parties.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.8 E. Establishing Common Ground and Identifying Deal-Breaking Issues

§20.8 E. Establishing Common Ground and Identifying Deal-Breaking Issues

The letter of intent can catalog the issues that the parties agree to, while identifying the issues that need further negotiating. This preliminary recognition of points of agreement enables the parties to concentrate on open issues and avoid spending time on points not in question. Once the parties begin negotiating the letter of intent, they may be able to recognize, at an early stage, the potential "deal-breaker" issues and the issues that are likely to be successfully resolved.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.9 F. Obtaining Legally Binding Agreement on Certain Matters

§20.9 F. Obtaining Legally Binding Agreement on Certain Matters

A letter of intent can express a general nonbinding intent to engage in a particular transaction, while simultaneously creating specific legally binding agreements that are a condition to moving forward with the intended transaction. Letters of intent used in acquisition transactions are most often legally binding. See §§20.44-20.49. The legally binding portions of the letter of intent typically relate to such matters as access to information, obligations of confidentiality, agreements not to solicit competing offers, public announcements, termination dates, and "bust-up" fees. Other aspects of the letter of intent, such as the structure of the transaction and conditions to closing, can demonstrate the parties' interest in the transaction without binding them to the specifics stated in the letter.

The letter of intent may allow one party the freedom to do a preliminary investigation of a possible acquisition target and to terminate further negotiations without liability if the investigation is not satisfactory. For example, a proposed purchaser may obtain a limited time in which to review a target company's business records and financial statements or to conduct an environmental survey of real property.

PRACTICE TIP: The parties should consider executing a separate confidentiality agreement to better protect sensitive business or technological information that might be disclosed if all or part of the letter of intent protecting confidentiality is found to be nonbinding.

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§20.10 G. Negotiating With Bigger Players

A relatively complete letter of intent can be advantageous to the party in the weaker negotiating position dealing with a company having a stronger negotiating position. The final negotiation process for the "weaker" party can focus on protecting the provisions agreed to in the letter of intent as the transaction wends its way through the other party's corporate hierarchy and legal department.

The letter of intent can also help guide and limit later negotiations if one party uses more than one person to negotiate and complete the transaction. The letter serves as a reminder of the preliminary agreement when persons not involved in the original negotiations attempt to make material changes in the deal.

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§20.11 H. Preserving Rights

A lawyer's recurring nightmare is a transaction in which the parties begin performance before they execute the definitive agreement. If that occurs, the letter of intent can:

- Settle different expectations about key issues;
- Clarify or protect the parties' rights and duties pending execution of the definitive agreement;
- Reduce the risk of surprise when the agreement is completed; and
- Provide evidence of the contemplated provisions if the definitive agreement is never completed and problems arise.

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IV. THE NEGOTIATING AND DRAFTING PROCESS

§20.12 A. Who Should Negotiate?

Many business people prefer to exclude counsel from the negotiation of a letter of intent. This approach may be cost effective in the short run, but not necessarily in the long run. If key issues are not addressed or serious implications not considered, the parties may be forced to renegotiate or restructure the entire deal later (*e.g.,* for tax or other reasons). What is more important, the party who raises new issues as a result of later legal input may be forced to make major concessions in return for consideration of those issues. Thus, counsel's involvement from the beginning of the process can provide more protection for the client.

Clients who are knowledgeable about the proposed transaction and are familiar with its important provisions are most able to make the letter-of-intent process efficient and productive. If the client is not as sophisticated about the particular transaction as the other party, but the dynamics of the discussions make it inappropriate for counsel to participate in the negotiations directly, then, at a minimum, counsel should prepare the client in advance as to the key issues and should review the letter of intent before it is finalized.

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§20.13 B. Who Should Draft?

The decision of which side should draft the letter of intent should reflect considerations of cost, custom, bargaining power, and the opportunity to craft provisions that are in the client's interest. It is not always cheaper for the other party to proffer the first draft of an agreement. Preparing a document from one's own forms can be more efficient than having to carefully review a new agreement. See §1.12. The author of the first draft has the first chance to make certain important judgments, identifying:

- The level of specificity of the draft,
- Potential "deal-breakers,"
- The issues that the author would rather address later, and
- The enforceability of particular provisions.

Although the reviewing attorney can make changes to the draft, it is the initial author who has the first opportunity to embody the client's strategy choices in the letter of intent. For further discussion of the drafting process, see chap 1.

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§20.14 C. Timing; Degree of Specificity

The appropriate degree of specificity for any letter of intent is driven by the strategic purposes of the letter. A letter of intent that is primarily used to deal with the "chicken and egg" problem (see §20.6) generally has relatively few detailed provisions so that negotiating those provisions does not delay production of the letter of intent. If a party's negotiating position would improve over time because, for example, the other party becomes more dependent on the completion of the deal and his or her alternatives narrow, that party generally should try to make the letter of intent less complete because it may be more likely to prevail on issues that are negotiated later for the definitive agreement. More detailed provisions and the consequent delay may be appropriate, however, if the client is in a stronger bargaining position before it executes the letter of intent and commits itself to a particular course of action.

EXAMPLE: A start-up company seeking venture capital finance typically wants a term sheet (see §20.52) that details the venture capital investors' rights, as well as any restrictions that will be required to attach to the founders' shares. If the company has alternative avenues for financing, its bargaining position will decline as it "turns off" those alternatives. Accordingly, using the term sheet or letter of intent to negotiate the key provisions may be more desirable for the start-up company and less desirable for the venture capital investors.

The level of specificity may also affect the letter of intent's enforceability, because courts typically conclude that a higher degree of specificity indicates that the parties intended to be bound by the letter of intent. See §20.20.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.15 D. Format of Letter of Intent

§20.15 D. Format of Letter of Intent

It is difficult to generalize about the format of the letter of intent; different applications require different formats. See, *e.g.*, §§20.41-20.61. However, some common forms of a letter of intent are:

- A letter from one party to the other;
- An outline in which the headings are on the left side of the page and the description of each point is on the right side; or
- A document that is similar to a standard formal agreement.

Often, both parties execute the letter of intent, although in some transactions it is an unsigned document. However, any person who would be bound by any provision of the letter of intent or who controls any party who would be bound by any of its provisions should sign the document. For discussion of enforceability of letters of intent, see §§20.16-20.27.

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V. ENFORCEABILITY OF LETTERS OF INTENT

§20.16 A. Early Consultation Between Counsel and Client

The attorney's task is simpler when the client consults legal counsel to prepare the letter of intent or to review it before the client signs it. More often, however, the client has negotiated and executed a writing outlining certain terms of the proposed transaction and meets with counsel only (1) to prepare or review documents based on that writing, (2) to change the provisions of the letter of intent, or (3) to terminate negotiations and cancel the proposed transaction. See discussion in §20.17 on three levels of enforceable letter of intent.

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§20.17 B. Parties' Intent Controls Enforceability

There are three levels of enforceability that a court can apply to a letter of intent. Depending on how it interprets the parties' intent, the court may treat a letter of intent as creating:

- A binding contract between the parties. See §§20.18-20.25.
- A "preliminary commitment," which imposes on the parties the somewhat uncertain obligation to negotiate further in good faith. See §20.26. (This obligation to negotiate is distinct from the covenant of good faith and fair dealing that is generally implied in contracts in California. See *Del Taco, Inc. v University Real Estate Partnership V* (2003) 111 CA4th 16, 3 CR3d 311).
- A basis for a claim of promissory estoppel. See §20.27.

These three levels could be applied to the letter of intent as a whole or to certain provisions only.

Under California law, the parties are bound by the letter of intent if they intend to be bound. *California Food Serv. Corp. v Great Am. Ins. Co.* (1982) 130 CA3d 892, 182 CR 67 (letter of intent enforced when all essential terms were in letter of intent and parties performed); Restatement (Second) of Contracts §27 (1981). See also *Arcadian Phosphates, Inc. v Arcadian Corp.* (2d Cir 1989) 884 F2d 69 (letter of intent not enforced when it contained express disclaimer of binding effect); *City of Santa Cruz v MacGregor* (1960) 178 CA2d 45, 2 CR 727 (letter of intent enforced when parties performed under it).

Consequently, in drafting or evaluating a letter of intent, it is vital to understand how the parties intend or intended that the letter be enforced. Do they or did they intend:

- To be bound to all agreed-on provisions as if to a final contract?
- To be bound only to some of the agreed-on provisions?
- To be bound only to negotiate further in good faith?
- Not to be bound at all?

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§20.18 C. Determining Parties' Intent

The parties' intent to be bound controls the enforceability of the letter of intent. Courts infer the parties' intent from the facts and circumstances of each case. This may be a simple principle, but its application can be complex and unpredictable. Some factors the courts consider in ascertaining intent are the following (*Teachers Ins. & Annuity Ass'n v Tribune Co.* (SD NY 1987) 670 F Supp 491):

- **Language of the agreement.** Did the parties express an intent to be bound or not to be bound by the words in the letter of intent?
- **Context of negotiations.** Were the parties working toward a binding letter of intent? Did negotiations contemplate a binding agreement? Did counsel advise the client that the letter of intent would be binding?
- **Existence of open issues.** Were so many essential terms left open that the agreement was illusory?
- **The parties' behavior.** Did the parties publicly announce the agreement? Did they terminate negotiations with others or begin performance of the agreement?
- **Partial performance.** Did the parties behave as if the letter of intent was binding by performing in accordance with its provisions?
- **Industry custom or practice.** Are similar letters of intent treated as if they are binding and enforceable within the industry?

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§20.19 1. Court's Determination of Enforceability in *Texaco v Pennzoil*

Courts may sometimes unexpectedly enforce letters of intent. See *Texaco*, *Inc*. *v Pennzoil*, *Co*. (Tex App 1987) 729 SW2d 768. In this well-known case, Texaco was found liable for tortious interference with a "memorandum of agreement" on Pennzoil's acquisition of the Getty Oil Company. The court upheld a jury verdict for $10.53 billion against Texaco.

The memorandum of agreement did not include language establishing a binding effect. The press release announcing the proposed acquisition agreement referred to it as an "agreement in principle" for a transaction that was "subject to execution of a definitive merger agreement." 729 SW2d at 789. Unexecuted drafts of the final merger documents stated that the parties' obligations accrued "after the execution and delivery of this agreement." 729 SW2d at 790.

Despite these precautions, the court found sufficient evidence of the parties' intent to be bound by the facts and circumstances surrounding the negotiations to enforce the memorandum of agreement. To support the verdict, the court found that:

- The press release used indicative language (*e.g.,* "the shareholders will receive"), instead of conditional language (*e.g.,* "if we were to agree"), demonstrating an intent to be bound. 729 SW2d at 789.
- The clause, "the transaction is subject to execution of a definitive merger agreement," did not undermine the possibility that the memorandum of agreement was also intended to be a binding agreement. 729 SW2d at 789.
- It was reasonable for the jury to conclude that the phrase "after the execution and delivery of this agreement," which appeared before each of the parties' obligations in the unexecuted merger contracts, merely indicated the timing of various acts and did not condition their occurrence on execution and delivery of the contracts. 729 SW2d at 790.
- The phrase "agreement in principle" was sufficiently ambiguous to support the jury's conclusion that it referred to a binding agreement. 729 SW2d at 791.

Many commentators have disagreed with the *Texaco* holding, but it provides a clear example of the need for careful analysis and drafting of letters of intent to avoid unintended results. See, *e.g.,* Ranck, *Letters of Intent and Preliminary Agreements*, 6 Corp Couns Q 1 (1990).

As demonstrated by *Texaco,* the courts' interpretations of letters of intent is extremely fact specific. Some factors that courts have considered relevant to deciding whether the parties intended to be bound by all or part of the letter of intent are:

- Specificity (see §20.20);
- Contemplation of formal documents (see §20.21);
- Conditional approvals (see §20.22);
- Word choice (see §20.23);
- Subsequent conduct (see §20.24); and
- The complexity and size of the transaction (see §20.25).

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§20.20 2. Specificity

Courts consider the level of specificity as an indication of binding intent. The more specifically the letter of intent addresses the essential terms of the proposed agreement, *i.e.,* the fewer terms left open, the more likely that the parties intended to be bound. *Computer Sys. v IBM* (1st Cir 1986) 795 F2d 1086. Because the parties' intent is the test, however, lack of specificity will not preclude the court from determining that the parties intended to be bound. *Chrysler Capital Corp. v Southeast Hotel Prop.* (SD NY 1988) 697 F Supp 794, 799, aff'd without published opinion (2d Cir 1989) 888 F2d 1376.

An agreement may be enforced as a final contract even if it is incomplete, *i.e.,* if it contains gaps or open issues. Courts require only that the document either state the essential terms of the agreement (and not necessarily its details or particulars) or provide sufficient parameters to determine the essential terms. The courts may then supply any open issues by inference from the surrounding circumstances or by operation of law. See, *e.g.,* Com C §2305; *Roth v Garcia Marquez* (9th Cir 1991) 942 F2d 617, 627 (letter of intent that omits essential terms not binding); *Hotel del Coronado Corp. v Foodservice Equip. Distributors Ass'n* (9th Cir 1986) 783 F2d 1323; *Okun v Morton* (1988) 203 CA3d 805, 817, 250 CR 220.

In most transactions, which provisions are "essentials" and which are mere "particulars" is a factual determination based on the surrounding circumstances (see *Hotel del Coronado Corp. v Foodservice Equip. Distributors Ass'n* (9th Cir 1986) 783 F2d 1323, 1325):

> [It] depends upon the relative importance and the severability of the matter left to the future; it is a question of degree.... The importance of a term may depend in part on the intentions of the parties.

NOTE: A letter of intent that addresses every conceivable aspect of a transaction will not bind the parties if the court finds that the parties did not intend to be bound by it. *Teachers Ins. & Annuity Ass'n v Tribune Co.* (SD NY 1987) 670 F Supp 491, 497. On the other hand, a letter of intent that omits essential terms, although not legally binding, could obligate the parties to negotiate in good faith (see §20.26). Therefore, while the level of specificity may determine the enforceability of the letter of intent, it is not a substitute for a clear statement of intent.

PRACTICE TIP: The drafter desiring enforceability should include in the letter of intent (1) the provisions that are judicially recognized as essential to enforcement of the proposed agreement and (2) language indicating that the parties intend to be bound by these provisions. A drafter wishing to decrease the likelihood of enforceability should (1) leave to be resolved in the definitive agreement the provisions that are essential to enforcement and (2) include language stating that the parties intend that the letter of intent not be binding.

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§20.21 3. Execution of Formal Documents Expressly Contemplated

A provision in a letter of intent that expressly contemplates the future execution of a formal contract indicates an intent not to be bound. See, *e.g., Beck v American Health Group Int'l* (1989) 211 CA3d 1555, 1562, 260 CR 237. Any ambiguity in this provision, however, can allow a court to interpret it as expressing the intent to reduce an obligation to writing rather than the intent not to be bound until the execution of formal documents. See *Arnold Palmer Golf Co. v Fuqua Indus.* (6th Cir 1976) 541 F2d 584, 589. Even the statement that an agreement is "subject to" execution of formal contracts has not always prevented the enforcement of letters of intent. See 541 F2d at 590; *Teachers Ins. & Annuity Ass'n v Tribune Co.* (SD NY 1987) 670 F Supp 491, 499.

In *Kitty-Anne Music Co. v Swan* (2003) 112 CA4th 30, 4 CR3d 796, the parties entered into a "deal memo" for the transfer of copyrights. The copyright owner refused to sign a contract subsequently prepared by the acquiring party because certain terms in the deal memo were materially altered or omitted from the final contract. In an action filed by the acquiring party, summary judgment was granted to the copyright holder, and the finding of the trial court that the deal memo was not a binding contract was affirmed by the court of appeal.

PRACTICE TIP: To minimize the risk of unintended enforcement, counsel should include an unequivocal statement that the parties do not intend to be bound until they execute and deliver formal documents, or that the parties do not intend to be bound by the letter of intent. See, *e.g., Roth v Garcia Marquez* (9th Cir 1991) 942 F2d 617; *Skycom Corp. v Telstar Corp.* (7th Cir 1987) 813 F2d 810, 816; *Reprosystem, B.V. v SCM Corp.* (2d Cir 1984) 727 F2d 257, 262; *Chrysler Capital Corp. v Southeast Hotel Prop.* (SD NY 1988) 697 F Supp 794, 801, aff'd without published opinion (2d Cir 1989) 888 F2d 1376. See §§20.33-20.35.

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§20.22 4. Conditional Third Party Approvals

Requirements that the board of directors, legal counsel, or other third parties approve the transaction described in the letter of intent also tend to show an intent not to be bound by a letter of intent. See *A/S Apothekernes Laboratorium v I.M.C. Chem. Group* (7th Cir 1989) 873 F2d 155; *Jewel Cos. v Pay Less Drug Stores Nw., Inc.* (9th Cir 1984) 741 F2d 1555 (merger agreement subject to shareholder approval was not intended to be legally binding, but board of directors did bind itself to refrain from considering other offers).

PRACTICE TIP: The provision that the letter of intent not be binding until approval is granted must be completely unambiguous. See *Teachers Ins. & Annuity Ass'n v Tribune Co.* (SD NY 1987) 670 F Supp 491, 499; *Arnold Palmer Golf Co. v Fuqua Indus.* (6th Cir 1976) 541 F2d 584, 590. The provision should also state that such approval is not the only condition to the transaction.

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§20.23 5. Language Choice and Verb Tense

Language that contemplates being bound only at an indefinite future time ("we will agree in the future"), or use of the subjunctive ("if we were to agree") tends to show that the parties do not intend to be bound by the letter of intent. *Beck v American Health Group Int'l* (1989) 211 CA3d 1555, 1562, 260 CR 237. See also *Arcadian Phosphates, Inc. v Arcadian Corp.* (2d Cir 1989) 884 F2d 69, 72. Conversely, using the present or past tense ("we agree" or "we have agreed") demonstrates an intent to be bound. *Texaco*, *Inc*. *v Pennzoil*, *Co*. (Tex App 1987) 729 SW2d 768. See also *Itek Corp*. *v Chicago Aerial Indus*. (Del 1968) 248 A2d 625, 627.

PRACTICE TIP: See discussion in §§20.29, 20.33, 20.36, and 20.39 for specific language to use or avoid.

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§20.24 6. Subsequent Conduct

Courts carefully examine the parties' conduct at the time of and after execution of the letter of intent to ascertain their intent to be bound. Conduct such as celebrations or ceremonies, press releases announcing the transaction, public filings, suspending or forgoing negotiations with others, preparations for performance, or actual performance can indicate the intent to be bound. See, *e.g., Seaman's Direct Buying Serv. v Standard Oil Co.* (1984) 36 C3d 752, 760, 206 CR 354, overruled on other grounds in *Della Penna v Toyota Motor Sales, U.S.A.* (1995) 11 C4th 376, 45 CR2d 436 (execution of letter was "momentous occasion"; performance begun; letter of intent binding); *California Food Serv. Corp. v Great Am. Ins. Co.* (1982) 130 CA3d 892, 897, 182 CR 67 (performance begun; letter of intent binding); *City of Santa Cruz v MacGregor* (1960) 178 CA2d 45, 54, 2 CR 727 (performance begun; letter of intent binding).

PRACTICE TIP: To avoid enforcement, the parties should refrain from publicizing the transaction. They may want to add a provision to the letter of intent requiring confidentiality and avoidance of certain other conduct. If others must be informed of the transaction, press releases, public filings, and other notices should be carefully drafted.

WARNING: Securities laws may require disclosure of some letters of intent. Executing a letter of intent may trigger the premerger notice requirement of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (15 USC §18a). See §§20.63-20.64.

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§20.25 7. Complexity and Size of Transaction

In larger and more complex transactions, the courts are more willing to infer that the parties did not intend to be bound until complete, formal documents were executed. *Skycom Corp. v Telstar Corp.* (7th Cir 1987) 813 F2d 810, 816; *Computer Sys. v IBM* (1st Cir 1986) 795 F2d 1086; *Reprosystem, B.V. v SCM Corp.* (2d Cir 1984) 727 F2d 257. The courts often find that parties do not intend to become engaged in complex transactions without a detailed description of their rights and obligations. *Teachers Ins. & Annuity Ass'n v Tribune Co.* (SD NY 1987) 670 F Supp 491, 503.

PRACTICE TIP: The sobering result in *Texaco, Inc. v Pennzoil, Co.* (Tex App 1987) 729 SW2d 768, demonstrates, however, that one cannot rely on this factor to avoid enforceability. The better practice is to specifically deny an intent to be bound in the letter of intent, if this is the desired result.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.26 D. Duty to Negotiate in Good Faith

§20.26 D. Duty to Negotiate in Good Faith

If the court finds that the parties to a letter of intent intended it to be a final (though informal) contract binding them to the substance of their bargain, it may enforce that bargain by awarding damages or ordering specific performance. If the court finds that the parties did not intend to be bound to the letter of intent, neither remedy is available.

Courts in some jurisdictions, however, have found that parties sometimes intend to bind themselves only to "preliminary commitments" to negotiate further in good faith. *Arcadian Phosphates, Inc. v Arcadian Corp.* (2d Cir 1989) 884 F2d 69, 72. In this situation, the resulting contractual duties are much less clear. See Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 Colum L Rev 217, 263 (1987). This intermediate level of enforceability can also arise if the parties show an intent to be bound in some respect, but their agreement lacks the specificity required for a binding contract, or contemplates contingent approvals or further documentation. See *A/S Apothekernes Laboratorium v I.M.C. Chem. Group* (7th Cir 1989) 873 F2d 155, 157; *Channel Home Ctrs., Grace Retail v Grossman* (3d Cir 1986) 795 F2d 291; *Teachers Ins. & Annuity Ass'n v Tribune Co.* (SD NY 1987) 670 F Supp 491, 498. For example, the parties may obligate themselves to "negotiate in good faith," to use "reasonable" or "best" efforts to negotiate a definitive agreement, to "negotiate an agreement containing commercially reasonable terms," or to "negotiate terms that are in accordance with similar transactions in the industry." *Thompson v Liquichimica of Am., Inc.* (SD NY 1979) 481 F Supp 365, 366; *Itek Corp. v Chicago Aerial Indus.* (Del 1968) 248 A2d 625, 629. See §§20.39-20.41. In *Copeland v Baskin Robbins* (2002) 96 CA4th 1251, 1257, 117 CR2d 875, the court found that a letter of intent created an agreement to negotiate in good faith. In withdrawing from negotiations, Baskin Robbins failed to act in good faith, exposing the breaching party to "reliance" damages, including the out-of-pocket costs incurred by Copeland. By using this type of language, the parties are binding themselves to the somewhat vague duty to negotiate in good faith, thereby subjecting themselves to liability or judicial enforcement.

Courts that have recognized the existence of the duty to negotiate in good faith have not articulated its scope with consistency. The courts have also had difficulty fashioning a remedy in such circumstances. It is unclear whether expectation or reliance damages are appropriate for breach of this vague duty. See *Budget Marketing, Inc. v Centronics Corp.* (8th Cir 1991) 927 F2d 421; *Arcadian Phosphates, Inc. v Arcadian Corp.* (2d Cir 1989) 884 F2d 69.

In some jurisdictions, the courts are reluctant to enforce an agreement to negotiate in good faith and will only do so if the duty to negotiate is presented with definite, objective, and clear guidelines. See *Reprosystem, B.V. v SCM Corp.* (2d Cir 1984) 727 F2d 257; *Jillcy Film Enters. v Home Box Office, Inc.* (SD NY 1984) 593 F Supp 515, 520. The rationale for this approach is twofold:

- The courts do not think it possible to fashion an appropriate remedy; and
- The courts cannot determine the scope of the obligation or duty.

See Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 Colum L Rev 217, 263 (1987) (which disputes these rationales).

NOTE: *Copeland v Baskin Robbins*, *supra*, found that a letter of intent created an agreement to negotiate in good faith. In a case arising from an alleged breach of an oral agreement, the Ninth Circuit held that an oral agreement may have existed, which obligated the parties to negotiate in good faith toward a definitive agreement. *Cable & Computer Technology, Inc. v Lockheed Sanders, Inc.* (9th Cir 2000) 214 F3d 1030.

Meeting the obligation to negotiate in good faith does not necessarily mean that the parties will reach agreement. *Teachers Ins. & Annuity Ass'n v Tribune Co.* (SD NY 1987) 670 F Supp 491. A duty to negotiate in good faith does not prevent a party from bargaining to its own economic advantage, nor does it require parties to conclude the transaction. *Phoenix Mut. Life Ins. Co. v Shady Grove Plaza Ltd. Partnership* (D Md 1990) 734 F Supp 1181, 1190, aff'd (4th Cir 1991) 937 F2d 603; *Philmar Mid-Atlantic v York St. Assoc.* (Pa Super 1989) 566 A2d 1253 (leasing negotiations broke down after landlord could not obtain zoning approval to allow tenant to operate). See also Restatement (Second) of Contracts §§84, 245-246 (1981) (letter of intent imposes good faith requirement to do everything necessary to complete

transaction).

Commentators have analyzed the scope of the duty to negotiate in good faith by analogy to the comparatively well-developed field of labor law. That analogy suggests that possible breaches of the duty of good faith negotiation include renouncing the transaction, abandoning or refusing to negotiate, presenting unreasonable proposals or conditions that do not conform to the preliminary agreement, improper bargaining tactics, negotiation with others, reneging on agreed provisions, and breaking off negotiations. *Teachers Ins. & Annuity Ass'n,* 670 F Supp at 498. See 87 Colum L Rev at 273.

PRACTICE TIP: To avoid a claim based on the duty to negotiate in good faith, the letter of intent should specifically deny the existence of such a duty. If negotiations are terminated, the parties can protect against later litigation by acknowledging in writing that, although they did negotiate in good faith, they were unable to reach a final agreement. See §20.42.

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§20.27 E. Promissory Estoppel

Promises allegedly made in a letter of intent can be grounds for a promissory estoppel claim. The required elements for promissory estoppel are (*Thomson v International Alliance of Theatrical Stage Employees* (1965) 232 CA2d 446, 454, 42 CR 785):

- There was a clear and unambiguous promise;
- The party to whom the promise was made relied on it;
- Reliance was both reasonable and foreseeable; and
- The party asserting the estoppel was injured by its reliance.

See Restatement (Second) of Contracts §90 (1981).

If the letter of intent clearly shows the parties' intent not to be bound, the writing would tend to negate a clear and unambiguous promise on which the other party could reasonably rely. See, *e.g., Doll v Grand Union Co.* (11th Cir 1991) 925 F2d 1363, 1371; *Reprosystem, B.V. v SCM Corp.* (2d Cir 1984) 727 F2d 257, 264; *Laks v Coast Fed. Sav. & Loan Ass'n* (1976) 60 CA3d 885, 890, 131 CR 836. Some courts, however, have accepted the possibility that even if a letter of intent is generally nonbinding, some of its provisions may support a promissory estoppel theory. See *Arcadian Phosphates, Inc. v Arcadian Corp.* (2d Cir 1989) 884 F2d 69, 73; *Skycom Corp. v Telstar Corp.* (7th Cir 1987) 813 F2d 810, 817. Further, the nonbinding nature of the letter of intent does not necessarily defeat a theory of promissory estoppel based on oral promises made in connection with or separate from the letter of intent. See *Budget Marketing, Inc. v Centronics Corp.* (8th Cir 1991) 927 F2d 421, 427.

Claims based on promissory estoppel and the duty to negotiate in good faith (see §20.26) may arise from similar fact patterns. See *Arcadian Phosphates, Inc.,* 884 F2d at 74 (buyer relied on seller's clear, unambiguous promise to negotiate in good faith). They differ on the remedies available, however. A breach of the duty to bargain in good faith may allow recovery equal to the full expected return on the contract if the amount of expected returns can be proven. However, failure to bargain in good faith (see *Copeland v Baskin Robbins* (2002) 96 CA4th 1251, 117 CR2d 875) and promissory estoppel may allow the plaintiff to recoup only actual expenses incurred in reliance on the promise. 884 F2d at 73; *Budget Marketing, Inc.,* 927 F2d at 428.

PRACTICE TIP: Because parts of a letter of intent could be held to support an estoppel theory and because allegations of collateral promises are always possible, counsel should include a "no reliance" statement in a letter of intent that is intended to be nonbinding. See, *e.g.,* §20.34.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.28 VI. DRAFTING LETTERS OF INTENT TO EXPRESS LEVEL OF ENFORCEABILITY

§20.28 VI. DRAFTING LETTERS OF INTENT TO EXPRESS LEVEL OF ENFORCEABILITY

The parties to the letter of intent should clearly express whether they intend to be bound by any specific provisions of the letter of intent or to undertake any specific obligations regarding further negotiations. Although it is sometimes preferable to make the letter of intent entirely binding or entirely nonbinding, the letter of intent can include both legally binding and nonbinding provisions. See §§20.36-20.38. Counsel should consider drafting the following as legally binding provisions:

- Access to the other party's premises or business records to facilitate a due diligence review;
- The kind of public announcements that the parties may make;
- Confidential treatment of the fact of the proposed transaction;
- Confidential treatment of information that is exchanged;
- Preclosing indemnifications; and
- Sharing of certain expenses if the transaction is not consummated.

PRACTICE TIP: The better practice is to assemble the provisions that are intended to be binding in a separate agreement or letter and, as much as possible, avoid having a partially binding letter of intent.

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§20.29 A. Preparing Legally Binding Letters of Intent

If the parties intend that the letter of intent be enforceable if the parties fail to enter into a definitive agreement, the title of the document, the introductory paragraph, the language choices in the body of the agreement, the closing paragraph, and the countersignature should all reflect the fact that the document is meant to be binding:

- If the document has a title or a reference, it should be clearly labeled as a binding document. For example:
- "Binding Letter of Intent"
- "Letter of Intent (Binding)"
- "Re: Binding Letter of Intent"
- In the introductory paragraphs, the document should specifically state that the parties' intent is to impose binding obligations consistent with the provisions in the document. See §20.30.
- In the body of the document, counsel should use terminology that states that the parties have agreed to binding obligations or state that one party is making an offer that is binding on acceptance. For example, the following language supports an intent to be bound (see *Texaco*, *Inc*. *v Pennzoil*, *Co*. (Tex App 1987) 729 SW2d 768):
- "The parties agree…."
- "The parties have agreed…."
- "Party A obligates itself to…."
- "Party A hereby offers to…."
- At the conclusion of the document, it should reiterate that the document is intended to be binding. See §20.32.
- The document should use "agreement" and "acceptance" language in the signature or countersignature block to the document. For example, the responding party should countersign the letter under words stating: "Agreed to as of [date]" or "Accepted and agreed to as of [date]."

PRACTICE TIP: If at least some sections of the letter of intent are intended to be binding, all issues relevant to drafting binding agreements should be considered, including procedural issues such as choice of law and attorney fee clauses. See §§16.55-16.61, chap 17.

A court that is asked to enforce a letter of intent may be forced to supply certain provisions in order to complete the contract's provisions; if the court cannot supply the missing provisions, it cannot enforce the agreement. The parties should therefore establish a reference for provisions to be added to the contract or a procedure by which they may be added if the parties do not execute a definitive agreement. For example, the parties could refer to a particular industry's practice, prior arrangements or practices between the parties, arrangements involving particular third parties, or an arbitrator who can be called on to supply the missing provisions. See form in §20.31.

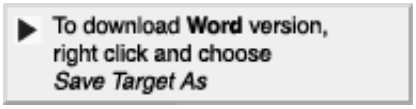
For discussion of alternative dispute resolution procedures and provisions describing them in agreements, see chap 16.

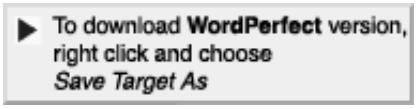
PRACTICE TIP: Giving a court or an arbitrator broad latitude in supplying missing provisions can have unexpected results and should be undertaken only in extraordinary circumstances. Such language can be the basis for lengthy and expensive litigation.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.30 1. Form: Introductory Provision Stating Binding Effect of Letter of Intent

§20.30 1. Form: Introductory Provision Stating Binding Effect of Letter of Intent





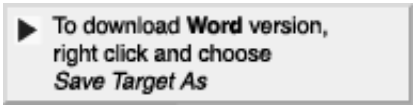
20.30-1 Introductory provision stating binding effect of letter of intent

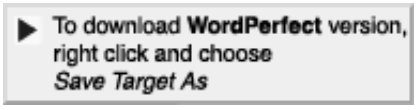
This letter is intended to provide both guidance in the preparation of a more complete written agreement and evidence of a legally binding agreement between the parties, enforceable in accordance with the terms set forth below. The parties agree to use their best efforts to negotiate a more complete agreement that will supersede this agreement. However, failure to achieve a more complete agreement will not limit the enforceability of the agreement reflected in this letter.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.31 2. Form: Method for Supplying Missing Terms if Definitive Agreement Not Signed

§20.31 2. Form: Method for Supplying Missing Terms if Definitive Agreement Not Signed





20.31-1 Method for supplying missing terms if definitive agreement not signed

[*Add one of the following alternatives*]

[*Alternative 1: Reference to commercially reasonable provisions*]

The definitive agreement will contain the representations, warranties, covenants, conditions, and other terms and provisions that are commercially reasonable and typical for transactions of this type between similarly situated parties. If the parties do not enter into a complete, definitive agreement, they agree that any provisions necessary to construe and enforce this agreement will reflect such commercially reasonable provisions.

[*Alternative 2: Reference to particular industry's practice*]

The definitive agreement will contain the representations, warranties, covenants, conditions, and other terms and provisions that are usual and customary in _ _[*refer to industry and describe transaction*]_ _ between similarly situated parties. If the parties do not enter into a complete, definitive agreement, they agree that any provisions necessary to construe and enforce this agreement will reflect such usual and customary provisions.

[*Alternative 3: Reference to particular prior arrangements between the parties*]

The definitive agreement will contain the representations, warranties, covenants, conditions, and other terms and provisions that are usual and customary in agreements between the parties _ _[*as illustrated by* _ _[*list sample agreements*]_ _]_ _. If the parties do not enter into a complete, definitive agreement, they agree that any provisions necessary to construe and enforce this agreement will reflect such usual and customary provisions.

[*Alternative 4: Reference to arrangements between third parties*]

The definitive agreement will contain the representations, warranties, covenants, conditions, and other terms and provisions that are usual and customary in agreements between _ _[*specify party*]_ _ and third parties who are currently engaged in similar arrangements with _ _[*specify party*]_ _. If the parties do not execute a complete, definitive agreement, they agree that any provisions necessary to construe and enforce this agreement will reflect such usual and customary provisions.

[*Alternative 5: Reference to arbitrator*]

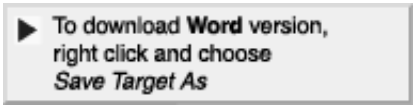
Any provisions necessary to construe and enforce this agreement will reflect commercially reasonable provisions usual and customary for transactions of this type between similarly situated parties and will be determined by arbitration under _ _[*describe arbitration procedure*]_ _.

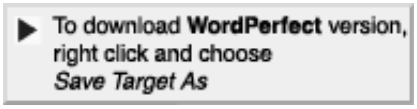
Comment: Without a general description of the specific industry and the nature of the transaction, the provision in Alternative 2 does not offer sufficient guidance to the courts.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.32 3. Form: Concluding Provision Stating Binding Effect of Letter of Intent

§20.32 3. Form: Concluding Provision Stating Binding Effect of Letter of Intent





20.32-1 Concluding provision stating binding effect of letter of intent

As indicated above, this letter is intended to be a legally binding agreement, enforceable in accordance with the provisions set forth in this letter.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.32A B. Preparing Provisionally Binding Letters of Intent

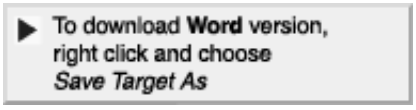
§20.32A B. Preparing Provisionally Binding Letters of Intent

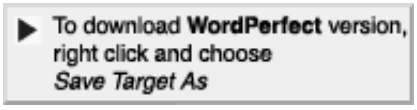
The parties may wish to immediately establish a business relationship and start working together with the intent that a more definitive agreement be established. The letter of intent will set forth the basic terms necessary to establish a binding agreement (such as the obligations of the parties and consideration), establish a requirement to act in good faith to prepare and execute the definitive agreement, indicate that the letter of intent is binding on the parties, and provide for the letter of intent to terminate on a defined date if not mutually extended by the parties or if the definitive agreement is not executed. The letter of intent may also include an option for either party to terminate the letter of intent without cause if that party decides not to proceed to completion of the definitive agreement.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.32B 1. Form: Introductory Provision Stating Letter Binding Until Terminated or Until Definitive Agreement Executed

§20.32B 1. Form: Introductory Provision Stating Letter Binding Until Terminated or Until Definitive Agreement Executed





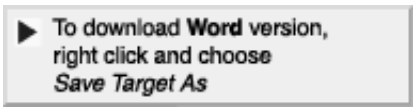
20.32B-1 Introductory provision stating letter binding until terminated or until definitive agreement executed

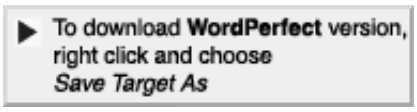
This letter is intended to provide both guidance in the preparation of a more complete written agreement and evidence of a legally binding agreement between the parties, enforceable in accordance with the terms set forth below. The parties agree to use their best efforts to negotiate a more complete agreement that will supersede this agreement. However, failure to achieve a more complete agreement will not limit the enforceability of the agreement reflected in this letter. This letter will be binding on the parties until terminated in accordance with the terms set forth below or the parties execute a definitive agreement.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.32C 2. Form: Termination Clause

§20.32C 2. Form: Termination Clause





20.32C-1 Termination clause

This Letter of Intent will be binding on the parties unless terminated by:

The failure of the parties to sign a definitive agreement within _ _[*specify term*]**_ _ of the last date of execution set forth below;**

The mutual agreement of the parties to extend the period set forth above;

The execution of a definitive agreement by the parties to this letter of intent; or

The notice by either party to the other party of termination.

Comment: The last paragraph may be qualified by allowing termination for due cause, for no cause, or with a demand for performance (*e.g.,* the conclusion of a definitive agreement) or at least for resolution of a key issue not set forth in the letter of intent that is delaying progress toward a definitive agreement.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.33 C. Preparing Nonbinding Letters of Intent

§20.33 C. Preparing Nonbinding Letters of Intent

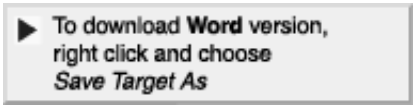
If the parties intend that their letter of intent is to be completely nonbinding, they should clearly express that intent. The following drafting suggestions help clarify the intent not to be bound:

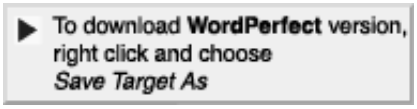
- If the document has a title or a reference, it should be clearly labeled as a nonbinding document. For example:
- "Nonbinding Letter of Intent"
- "Letter of Intent (Nonbinding)"
- "Re: Nonbinding Letter of Intent"
- In the introductory paragraphs, the letter should specifically state that (1) the parties' intent is to set forth the status of negotiations or provisions for further discussion and not to impose any binding obligations, (2) no binding obligation exists as to the intended transaction, and (3) there is no binding obligation to attempt to negotiate terms. See form in §20.34.
- In the body of the document, counsel should avoid terminology suggesting that the parties have agreed to any binding obligations or that one party is making an offer that would be binding on acceptance. For example, *avoid* language such as the following (see *Texaco*, *Inc*. *v Pennzoil*, *Co*. (Tex App 1987) 729 SW2d 768):
- "The parties agree…."
- "The parties have agreed…."
- "The parties will negotiate in good faith…."
- "The parties will use reasonable efforts to agree…."
- "Party A obligates itself to…."
- "Party A hereby offers to…."
- In the body of the document, the letter should refer to the possibility that negotiations might fail and that the parties contemplate executing a future binding agreement, by using conditional or hypothetical language or a listing of terms, such as the following (see *Arcadian Phosphates, Inc. v Arcadian Corp.* (2d Cir 1989) 884 F2d 69):
- "In the event we are unable to negotiate a definitive agreement…."
- "If we were to enter into a formal, binding Agreement, Party A would…."
- "As discussed, Party A would…."
- "If we agree on all terms and conditions, we would then attempt to negotiate and execute a binding agreement…."
- Counsel should identify closing conditions, such as satisfactory results from a due diligence investigation, financing commitments, approval of ancillary agreements, and internal approvals. If approvals are required, the letter should clearly state that they may be withheld in the sole discretion of the relevant body. See form in §20.34. The letter should also provide that the specified conditions are some, but not all, of the conditions to the transaction, if that is the parties' intent.
- The letter of intent should include an expiration date giving either party a right to terminate it if the parties, negotiating in good faith, cannot agree on terms by that date for the subsequent definitive agreement. This provides further evidence that the parties believed that necessary terms were to be negotiated and they did not intend the letter of intent to be binding. See form in §20.41. The letter may also provide for termination if either party believes that the other party is not proceeding in good faith.
- At the conclusion of the document, the letter should reiterate that the document is not intended to be binding. See §20.35.
- The letter should avoid "agreement" or "acceptance" language in any signature or countersignature to the document. For example, the responding party should not countersign the letter under words stating: "Agreed as of [date]" or "Accepted as of [date]." Instead, the letter should use language such as "Acknowledged as the nonbinding intent of the parties as of [date]."

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.34 1. Form: Introductory Provision Stating Intent Not to be Legally Bound

§20.34 1. Form: Introductory Provision Stating Intent Not to be Legally Bound





20.34-1 Introductory provision stating intent not to be legally bound

This letter is intended to review the status of our negotiations concerning _ _[*describe transaction*]**_ _. It reflects our present understanding of our discussions during negotiation of the terms and conditions of the proposed transaction. It is not intended to be or to evidence any legally binding agreement or obligation on the part of either party. No agreement will be binding unless and until each party has reviewed, approved (in its sole discretion), and executed, after review by legal counsel, a definitive written agreement. The legal rights and obligations of each of us will then be only those that are set forth in the definitive agreement. Neither party has any obligation to negotiate or conclude the business arrangement described in this letter. Each party acknowledges that it will not take action or refrain from taking action in reliance on this letter or the negotiations, and that any such reliance would be at its own risk.**

This letter is not a complete statement of all terms and conditions of the proposed transaction. For example, the following essential issues, among others, are not addressed in this letter but are intended to be addressed in a definitive written agreement, if one is executed: _ _[*identify open issues*]**_ _.**

[*Add if approvals required*]

The parties acknowledge that any tentative agreement that may result from further negotiations will be subject to approvals of _ _[*identify approvals required, e.g., our respective boards of directors, our respective shareholders, specific government agencies, or other third persons*]**_ _, which approvals may be withheld in their sole discretion.**

Comment: For discussion of the impact of open issues on enforceability, see §20.20; for discussion of the impact of required approvals on enforceability, see §20.22.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.35 2. Form: Concluding Provision Reiterating Intent Not to be Legally Bound

§20.35 2. Form: Concluding Provision Reiterating Intent Not to be Legally Bound

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

20.35-1 Concluding provision reiterating intent not to be legally bound

As indicated above, the parties do not intend that the terms in this letter be legally binding. Neither party intends, by setting forth in this letter the provisions of a possible transaction, to create for itself or any other person or entity any legally binding obligation or liability. No subsequent oral agreement or conduct of the parties (including partial performance) will be deemed to impose any such obligation or liability. The parties will be bound only on execution of a definitive written agreement.

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§20.36 D. Preparing Partially Binding Letters of Intent

In many letter of intent situations, the parties intend to bind themselves only to certain discrete provisions. The parties must specify which provisions are intended to be unenforceable and which are intended to be legally binding. Counsel can clarify the legal effect of the different parts of the letter of intent by collecting the provisions that are intended to be enforceable in one or more numbered or otherwise easily identifiable paragraphs. In many cases, counsel should advise the client to produce two separate documents: one containing the binding provisions and the other the nonbinding provisions. If the letter must include both, the following principles help define the parties' intent:

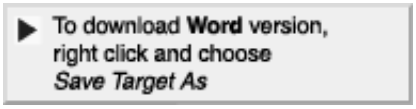
- If the document has a title or a reference, it should be clearly labeled as partially binding. For example:
- "Partially Binding Letter of Intent"
- "Letter of Intent (Partially Binding)"
- "Re: Partially Binding Letter of Intent"
- In the introductory paragraphs, the letter should specifically state that (1) the parties' intent is to set forth the status of negotiations or provisions; (2) the document imposes some specified binding obligations, but those are the only obligations intended to be binding; (3) all other obligations are not intended to be binding, or the document includes some specified provisions that are not intended to be binding; and (4) there is no binding obligation to attempt to negotiate terms. See form in §20.37.
- At the conclusion of the document, the letter should reiterate that the document is only partially binding, specifically identifying the binding and nonbinding provisions. See §20.38.
- The letter should avoid "agreement" or "acceptance" language in any signature or countersignature to the document. For example, the responding party should not countersign the letter under words stating: "Agreed as of [date]" or "Accepted as of [date]." Instead, the letter should use language such as "Acknowledged as the nonbinding intent of the parties, except as otherwise stated, as of [date]."

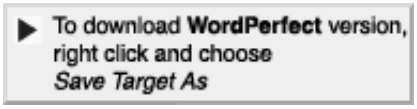
PRACTICE TIP: All issues relevant to drafting binding agreements should be considered, including procedural issues such as choice of law and attorney fees clauses, if the letter of intent is intended to be partially binding. See §§16.55-16.61, chap 17.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.37 1. Form: Introductory Provision Stating Partially Binding Effect of Letter of Intent

§20.37 1. Form: Introductory Provision Stating Partially Binding Effect of Letter of Intent





20.37-1 Introductory provision stating partially binding effect of letter of intent

Except as expressly stated in paragraphs _ _[*paragraph numbers of binding provisions*]_ _, titled _ _[*headings for binding provisions*]_ _, the parties acknowledge and agree that this letter is not intended to be or to evidence any legally binding agreement or obligation on the part of either party. No further agreement will be entered into unless and until each party has reviewed, approved (in its sole discretion), and executed, after review by counsel, a definitive written agreement. Neither party has any obligation to negotiate or conclude the business arrangement described in this letter. Each party acknowledges that it will not take action or refrain from taking action in reliance on the portions of this letter intended to be legally nonbinding, and that any such reliance would be at its own risk.

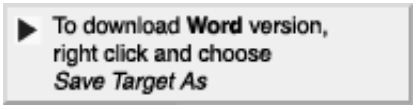
The parties agree that the provisions in paragraphs _ _[*paragraph numbers for binding provisions*]_ _, titled _ _[*headings for binding provisions*]_ _ represent the parties' legally binding agreements, enforceable in accordance with their terms. The enforceability of those provisions is not conditioned on further negotiations or the successful outcome of any further negotiations.

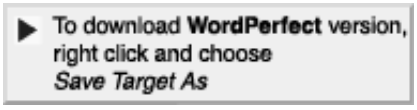
If the parties execute a definitive agreement, that agreement will supersede this letter. However, failure to achieve a more complete agreement will not limit the enforceability of the provisions in this letter specified to be binding.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.38 2. Form: Concluding Provision Reiterating Intent to be Bound as to Specified Provisions Only

§20.38 2. Form: Concluding Provision Reiterating Intent to be Bound as to Specified Provisions Only





20.38-1 Concluding provision reiterating intent to be bound as to specified provisions only

As indicated above, this letter is intended to be legally binding only as to the provisions stated in paragraphs _ _[*paragraph numbers for binding provisions*]_ _, titled _ _[*headings for binding provisions*]_ _ and nonbinding as to all other provisions. Neither party intends, by setting forth in this letter the provisions of a possible transaction, to create for itself or any other person or entity any legally binding obligation or liability, except as specifically stated in this letter. No subsequent oral agreement or conduct of the parties (including partial performance) will be deemed to impose any such obligation or liability.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.39 E. Preparing Letters of Intent Binding Parties Only to Negotiate in Good Faith

§20.39 E. Preparing Letters of Intent Binding Parties Only to Negotiate in Good Faith

If the parties do not wish to bind themselves to specific provisions in the letter of intent but do wish to bind each other to negotiate further, the letter of intent can be employed to impose a duty to negotiate in good faith. The letter of intent should establish clear guidelines on the scope of that duty. Counsel should also observe the following principles:

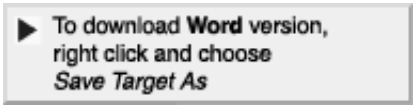
- In the introductory paragraphs, the letter should specifically state that the parties intend to bind themselves to negotiate in good faith. See §20.40.
- The letter should state that the parties have agreed to negotiate in good faith. For example, use language such as the following:
- "The parties will negotiate in good faith…."
- "The parties will use reasonable efforts to agree…."
- "Party A obligates itself to negotiate in good faith…."
- At the conclusion of the document, the letter should reiterate that the document is intended only to bind the parties to negotiate in good faith. See §20.41.

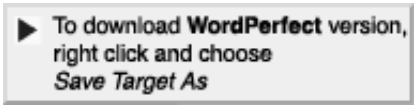
PRACTICE TIP: Because California law is unclear on both the scope of the duty to negotiate and the remedies for its breach, the letter should provide guidance to the parties as to when the duty is satisfied, particularly if the duty will terminate if an agreement is not reached within a certain time.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.40 1. Form: Introductory Provision Binding Parties to Negotiate

§20.40 1. Form: Introductory Provision Binding Parties to Negotiate





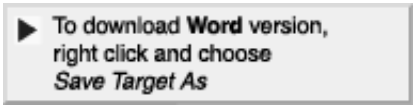
20.40-1 Introductory provision binding parties to negotiate

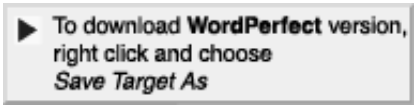
This letter is intended to review the status of our negotiations concerning _ _[*describe transaction*]_ _. It reflects our present understanding of the discussions we have had in our negotiations about the terms and conditions of the proposed transaction. It is not intended to be or to evidence any legally binding agreement on the part of either party. No agreement will be binding unless and until each party has reviewed, approved (in its sole discretion), and executed, after review by counsel, a definitive written agreement. The legal rights and obligations of each of us will then be only those that are set forth in the definitive agreement. Each party agrees to act in good faith to negotiate toward execution of a definitive agreement.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.41 2. Form: Concluding Provision Reiterating Intent to Negotiate in Good Faith Only

§20.41 2. Form: Concluding Provision Reiterating Intent to Negotiate in Good Faith Only





20.41-1 Concluding provision reiterating intent to negotiate in good faith

As indicated above, the parties do not intend that the terms in this letter of intent be legally binding. Neither party intends, by setting forth in this letter the provisions of a possible transaction, to create for itself or any other person or entity any legally binding obligation or liability, other than to act in good faith to negotiate toward execution of a definitive agreement. No subsequent oral agreement or conduct of the parties (including partial performance) will be deemed to impose any such obligation or liability.

Either party may terminate this letter of intent on or after 60 days from the date last signed by the parties by sending a written notice of termination to the other party if the parties have not reached agreement concerning acceptable terms and executed a definitive agreement setting forth such terms within that 60-day period.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.42 3. Form: Termination of Negotiations

§20.42 3. Form: Termination of Negotiations

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20.42-1 Termination of negotiations

This letter acknowledges that we have terminated our good faith negotiations concerning _ _[*describe transaction*]**_ _. We confirm that neither party has any obligation or liability to the other regarding those negotiations or the failure to consummate the proposed transaction.**

Comment: Both parties should sign (or countersign) the letter. The parties can also include clean-up provisions, such as confirmation that any information previously shared will be returned to the party that produced it and will be treated in a confidential manner.

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§20.43 VII. LETTERS OF INTENT FOR SPECIFIC SITUATIONS

Letters of intent can be appropriate in any negotiated transaction. Particular forms of letters of intent have become standard in certain types of situations, however, raising specialized drafting issues.

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§20.44 A. Acquisition Transactions

One of the most common uses of a letter of intent is in business acquisitions. The document, usually prepared by the buyer, expresses the parties' mutual intent to have one party acquire the other.

Special drafting considerations are relevant in acquisition letters of intent. From the acquirer's standpoint, it may be desirable to include binding provisions that protect the acquirer if the offer generates a more attractive bid from a third party or if the parties fail to complete the transaction. Three types of such provisions are commonly included in the letter of intent:

- A "no-shop" provision prevents the acquiree from soliciting or, in some cases, entertaining competing bids. See form in §20.45.
- An expense reimbursement or "bust-up" fee provision provides that (1) the acquiree will reimburse the acquirer for its out-of-pocket expenses if the acquisition is not consummated or if the acquiree accepts another offer, and (2) the acquiree will pay a fee if the deal is not consummated for certain specified reasons (both within and outside the acquirer's control). Frequently, the provision imposes a cap on the amount of reimbursable expenses and sets the fee at a fixed amount. See form in §20.46.
- "Topping fees" represent the agreement by the acquiree to pay to the potential acquirer a portion of the higher purchase price if the acquiree accepts a higher bid from a third party. See form in §20.47.

From the acquiree's standpoint, concerns about confidentiality and properly observing the board of director's fiduciary duty to the shareholders frequently lead to two types of specialized binding clauses in the letter of intent:

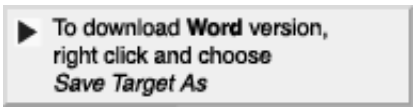
- Confidentiality provisions require the potential acquirer to preserve the confidentiality of the acquiree's confidential information and to refrain from using information for improper purposes (*e.g.,* for competition with the acquiree). They generally also require that all copies of all documents be returned to the original owner if the transaction is not consummated. See form in §20.48.
- The "fiduciary-out" clause frequently arises in response to the acquirer's attempt to limit the solicitation of competing bids or to bind the board of directors to support the transaction. The clause permits the acquiree's board to terminate the transaction if a higher bid is received from a third party. See form in §20.49.

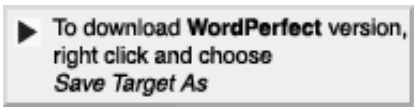
See §20.64 for discussion of premerger notification requirements.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.45 1. Form: 'No-Shop' Provision

§20.45 1. Form: "No-Shop" Provision





20.45-1 "No-shop" provision

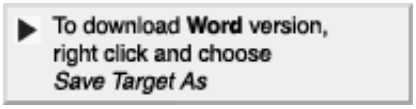
Until _ _[*date*]_ _, the undersigned Seller agrees, and agrees to cause the shareholders, officers, directors, representatives, and agents of Seller, not to solicit interest in, encourage, supply information in connection with, negotiate, or entertain, directly or indirectly, any transaction involving (1) the acquisition of Seller, (2) a business combination involving Seller, (3) the sale of any significant equity interest in Seller, or (4) the sale of all or a significant portion of the business or assets of Seller.

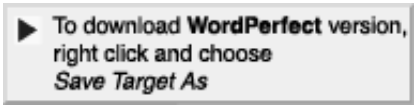
Comment: This provision may be used in a letter of intent relating to the possible sale of a closely held company. It cannot be used with a "fiduciary-out" provision.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.46 2. Form: Expense Reimbursement and 'Bust-Up Fee' Provision

§20.46 2. Form: Expense Reimbursement and "Bust-Up Fee" Provision



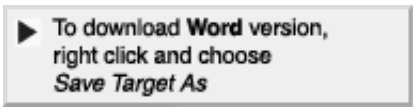


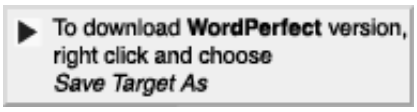
20.46-1 Expense reimbursement and "bust-up fee"

If for any reason not the fault of _ _[*acquirer*]_ _**,** _ _[*a definitive agreement is not reached/the transaction contemplated by this letter does not close*]_ _ **on or before** _ _[*date*]_ _**, Seller shall pay to Buyer on such date an amount in cash equal to $**_ _[*amount*]_ _ **plus the reasonable expenses incurred by Buyer (including without limitation investment banking, legal, and accounting fees and costs) associated with the transaction, including without limitation the negotiation and documentation of this letter of intent and the definitive documents.**

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§20.47 3. Form: "Topping Fees" Provision





20.47-1 "Topping fees"

If for any reason not the fault of _ _[*acquirer*]_ _, _ _[*a definitive agreement is not reached/the transaction contemplated by this letter does not close*]_ _ **on or before** _ _[*date*]_ _**, and if before** _ _[*alternative date*]_ _**, Seller or its shareholders enter into a definitive agreement related to, or consummate, a transaction (the "Subsequent Transaction") that constitutes disposition of a controlling interest in Seller, sale or distribution of a majority of the assets of Seller measured by fair market value, or merger of Seller into or with a third party incident to which control of Seller or its business is transferred, then Seller will pay to Buyer an amount equal to** _ _ **percent of the difference between (1) the consideration paid on a per common equivalent share basis in the Subsequent Transaction multiplied by the number of common equivalent shares then outstanding, plus the aggregate distributions paid to the shareholders of Seller between the date of this letter of intent and the date of the closing of the Subsequent Transaction, less (2) $**_ _[*the aggregate consideration to be paid in the transaction covered by the letter of intent*]_ _**. Seller shall pay this amount to Buyer on or before the closing of the Subsequent Transaction.**

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§20.48 4. Form: Confidentiality Provision

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20.48-1 Confidentiality

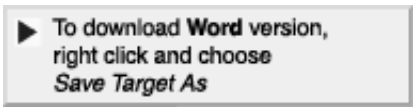
Each party agrees to preserve the confidentiality of all information that it acquires from the other party and not to use such information except in considering whether to complete the transaction contemplated by this letter. At the disclosing party's written request, the other party will return to the disclosing party all tangible expressions (including copies) of all such information _ _[*, except for one copy retained for archive purposes*]_ _. The other party will certify in writing as to any and all tangible expressions that have been lost or destroyed. The obligations stated in this paragraph will not apply to information that is publicly disclosed or for which disclosure is required under applicable law.

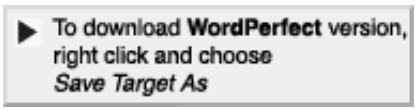
Comment: The party receiving confidential information should consider including the optional language about retaining a copy for archive purposes. To defend against later claims of use of confidential information, the party receiving the information must have the ability to determine what was actually received, which is provided by the archived copy.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.49 5. Form: 'Fiduciary-Out' Provision

§20.49 5. Form: "Fiduciary-Out" Provision





20.49-1 "Fiduciary-out"

To the extent that the board of directors of Seller determines to do so in exercising its fiduciary duties, Seller and its directors, officers, employees, representatives, and agents may solicit interest in, encourage, supply information in connection with, negotiate, or entertain any possible transaction involving (1) the acquisition of Seller, (2) a business combination involving Seller, (3) the sale of all or a significant equity interest in Seller, or (4) the sale of all or any significant portion of Seller's business or assets.

Comment: This provision is the converse of a "no-shop" provision, and therefore the two provisions cannot be used together.

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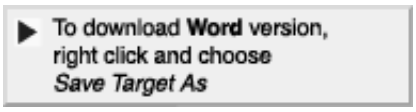
B. Financing Commitment Letters

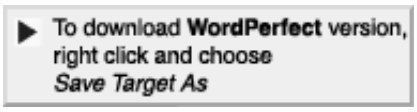
§20.50 1. General Principles

Sources of debt and lease financing, such as banks and leasing companies, frequently issue nonbinding commitment letters. Typically, these letters reflect key financial provisions, detailed conditions to funding (including representations and warranties and opinions of counsel), and the requirement that standard form financing documents be executed. See §20.51.

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§20.51 2. Form: Letter of Intent to Lend





20.51-1 Letter of intent to lend

_ _[*Name of borrower*]_ _
_ _[*Address of borrower*]_ _
Dear _ _[*Name of borrower*]_ _**:**

_ _[*Name of lender*]_ _ **is pleased to provide $**_ _[*amount*]_ _ **of acquisition financing and $**_ _[*amount*]_ _ **of working capital financing to facilitate the acquisition of all or substantially all of the assets of** _ _[*name of seller*]_ _ **by you.**

_ _[*Name of lender*]_ _**'s commitment to lend and your obligations must be evidenced by legal documentation, including such terms and conditions as may be satisfactory to** _ _[*name of lender*]_ _ **and its counsel in their sole discretion. The terms and conditions for this transaction are outlined in the attached Term Sheet. Further,** _ _[*name of lender*]_ _**'s commitment to lend is conditioned on** _ _[*specify conditions*]_ _**.**

This commitment will terminate at _ _[*name of lender*]_ _**'s option if, in** _ _[*name of lender*]_ _**'s opinion, a material adverse change in the properties, business prospects, senior management, profits, or financial condition of** _ _[*name of seller*]_ _ **has occurred or occurs before the loans are funded. Subject to the preceding sentence,** _ _[*name of lender*]_ _**'s commitment will be effective on your acceptance, if a copy of your acceptance is received by** _ _[*date*]_ _**, or otherwise it will expire on that date.**

_ _[*Name of lender*]_ _
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Agreed to and accepted
as of _ _[*date*]_ _**:**
_ _[*Name of borrower*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: This letter attempts to provide the lender with the right to cancel the commitment for certain causes and the right to dictate the definitive documentation. Subject to those conditions, on acceptance of this letter the lender will have an obligation to fulfill its commitment.

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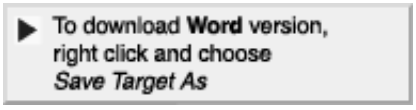
§20.52 C. Venture Capital Transactions; Term Sheet

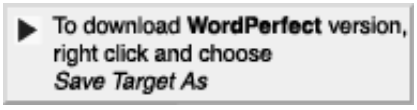
An extremely stylized form of letter of intent has developed for venture capital financing. Venture capitalists and the company receiving the capital infusion usually negotiate a "term sheet." The typical term sheet includes two columns, with the left-hand column identifying a category of terms or provisions and the right-hand column providing a relatively detailed description of those terms. In addition to covering the basic pricing terms, the term sheet usually describes specialized items. See §§20.53-20.61.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.53 1. Form: Introduction to Nonbinding Venture Capital Term Sheet

§20.53 1. Form: Introduction to Nonbinding Venture Capital Term Sheet





20.53-1 Introduction to nonbinding venture capital term sheet

MEMORANDUM OF TERMS FOR PRIVATE PLACEMENT OF EQUITY SECURITIES IN _ _[*NAME OF COMPANY*]_ _

This memorandum ("Memorandum") is intended to review the status of negotiations concerning a possible private placement of equity securities of _ _[*name of company*]_ _ (the "Company"). It reflects our present understanding of our discussions during negotiation of the terms and conditions of the proposed transaction. It is not intended to be or to evidence any legally binding agreement or obligation on the part of any party. No agreement will be binding unless and until each party has reviewed, approved (in its sole discretion), and executed, after review by counsel, a definitive written agreement. The legal rights and obligations of each of us will then be only those that are set forth in the definitive agreement. Neither party has any obligation to negotiate or conclude the business arrangement described in this Memorandum. Each party acknowledges that it will not take action or refrain from taking action in reliance on this Memorandum or the negotiations, and that any such reliance would be at its own risk.

Introduction

The Company was incorporated in _ _[*state of incorporation*]_ _ in _ _[*year of incorporation*]_ _. Effective as of the closing of this transaction, the Company will have an authorized capitalization consisting of _ _[*number*]_ _ shares of Common Stock ("Common Stock") and _ _[*number*]_ _ shares of Preferred Stock ("Preferred Stock"). The closing of this transaction is referred to as the "Closing."

Proposed Private Placement

The Company and the investors propose a private placement of shares of Preferred Stock on the following terms:

Amount: **$_ _[*amount*]_ _**

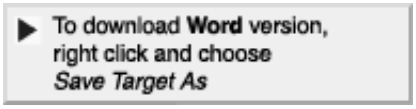
Type of Security: **Series A Preferred Stock**

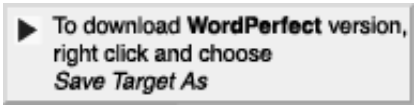
Purchase Price per Share: **$_ _[*amount*]_ _ (the "Original Purchase Price")**

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.54 2. Form: Rights, Preferences, Privileges, and Restrictions of Preferred Stock

§20.54 2. Form: Rights, Preferences, Privileges, and Restrictions of Preferred Stock





20.54-1 Rights, preferences, privileges, and restrictions of preferred stock

PREFERRED STOCK.

(1) *Dividend Provisions.* If any dividend is declared on the Common Stock, the holders of the Preferred Stock will be entitled to receive dividends pari passu from legally available funds as if each such share of Preferred Stock had been converted to Common Stock. No dividend may be paid on the Common Stock at a rate greater than the rate at which dividends are paid on the Preferred Stock (based on the number of shares of Common Stock into which the Preferred Stock is convertible on the date the dividend is declared). Dividends on the Preferred Stock will be noncumulative.

(2) *Liquidation Preference.* In the event of any liquidation or winding up of the Company, the holders of the Preferred Stock will be entitled to receive in preference to the holders of Common Stock an amount equal to the Original Purchase Price of the Preferred Stock plus any dividends declared on the Preferred Stock but not paid. Thereafter, the Preferred Stock will have no further participation in liquidation proceeds. A consolidation or merger of the Company in which preexisting shareholders of the Company do not continue to hold a majority interest in the successor entity, or a sale of all or substantially all of the Company's assets, will be deemed to be a liquidation or winding up for purposes of the liquidation preference.

(3) *Conversion.* A holder of the Preferred Stock will have the right and option, at any time, to convert the Preferred Stock into shares of Common Stock. The total number of shares of Common Stock into which a given number of shares of the Preferred Stock may be converted will be ascertained by multiplying the number of shares of Preferred Stock by a fraction, the numerator of which is the Original Purchase Price and the denominator of which is an amount, called the "Conversion Price," which will initially be the Original Purchase Price, but which will be subject to adjustment as provided in paragraph (5) below.

(4) *Automatic Conversion.* The Preferred Stock will be automatically converted into Common Stock, at the then-applicable Conversion Price, in the event (a) an underwritten public offering is made of shares of Common Stock at a public offering price per share (prior to underwriter commissions and other expenses) that is at least _ _ _ times the Original Purchase Price in an offering of not less than $_ _[*amount*]_ _, or (b) more than 50 percent of the originally issued shares of the Preferred Stock have been previously voluntarily converted into Common Stock.

(5) *Antidilution Provisions.* The Conversion Price of the Preferred Stock will be subject to adjustment to prevent dilution if the Company issues additional shares (other than the Reserved Employee Shares described under "Reserved Employee Shares," below) at a purchase price less than the then-applicable Conversion Price. The Conversion Price will be subject to adjustment on a weighted average basis. Similar adjustments will be made to the Conversion Price in the event of a subdivision or a combination of the outstanding Common Stock without a proportionate and corresponding subdivision or combination of the Preferred Stock.

(6) *Voting Rights.* Except with respect to election of directors as described under "Board Representation and Meetings," below, a holder of the Preferred Stock will have the right to that number of votes equal to the number of shares of Common Stock issuable on conversion of its Preferred Stock.

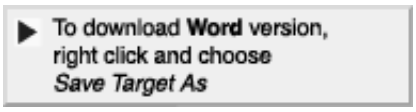
(7) *Protective Provisions.* Consent of the holders of at least a majority of the Preferred Stock will be required for any action, including amendment to the bylaws or articles of incorporation that (a) materially and adversely alters or changes the rights, powers, preferences, or privileges of the Preferred Stock; (b) increases the authorized number of shares of Preferred Stock; (c) authorizes or issues any new class of shares or series of stock, or reclassifies any class or series of Common Stock into shares having preference over or being on a parity with the Preferred Stock; (d) materially changes the principal business of the Company; or (e) applies

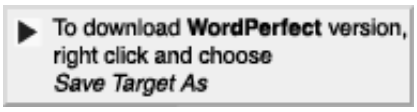
any Company assets to the redemption, retirement, purchase, or acquisition of any shares of any series of Common Stock, with limited exceptions for stock held by current or former employees, officers, directors, and others who provide services to the Company.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.55 3. Form: Information Rights

§20.55 3. Form: Information Rights



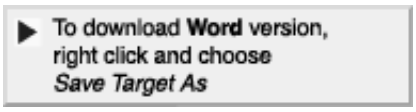


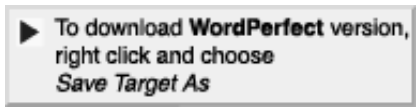
20.55-1 Information rights

INFORMATION RIGHTS. Holders of at least 10 percent of the initially issued shares of the Preferred Stock will, on request, receive annual, quarterly, and monthly financial statements, and annual operating budgets, subject to confidentiality obligations.

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§20.56 4. Form: Registration Rights





20.56-1 Registration rights

REGISTRATION RIGHTS.

(1) *Registration Rights.* All shares of Common Stock issued and issuable on conversion of the Preferred Stock (the "Registrable Securities") will receive the registration rights described in paragraphs (2)-(7) below.

(2) *Demand Rights.* If, at any time after the earlier of _ _[*date*]_ _, or the Company's initial public offering (but not within 6 months after the effective date of a registration), investors holding a majority of the Registrable Securities request that the Company file a Registration Statement, then, if the anticipated aggregate offering price, net of underwriting discounts and commissions would exceed $_ _[*amount*]_ _, the Company will use its best efforts to cause such shares to be registered. The Company will not be obligated to effect more than two registrations (other than on Form S-3, as provided in paragraph (3) below) under these demand right provisions.

(3) *Registrations on Form S-3.* Holders of Registrable Securities who plan to dispose of such securities will have the right to require the Company to file an unlimited number (but not to exceed two per year) of Registration Statements on Form S-3 (or any equivalent successor form) if the anticipated aggregate offering price, net of underwriting discounts and commissions, would exceed $_ _[*amount*]_ _.

(4) *Piggy-Back Registration.* The investors will be entitled to "piggy-back" registration rights on Company registrations before the fifth anniversary of the effective date of the Company's first registration statement. Despite the foregoing statement, if such registration involves an underwriting, the investors agree that they will enter into an underwriting agreement with an underwriter selected by the Company, and that, in that event, the Company and its underwriters will have the authority, in view of market conditions, to reduce the number of shares of the investors proposed to be registered (pro rata as between holders of Registrable Securities and all other holders of shares with piggy-back registration rights).

(5) *Registration Expenses.* The registration expenses (exclusive of underwriting discounts, selling commissions, and special counsel fees of more than one counsel for the selling shareholders) of one demand registration under paragraph (2) above and of three piggy-back registrations under paragraph (4) above will be borne by the Company, and all other expenses of registered offerings must be borne pro rata among the selling shareholders and, if it participates, the Company. All expenses of registration on Form S-3 registrations under paragraph (3) above must be borne pro rata among the selling shareholders.

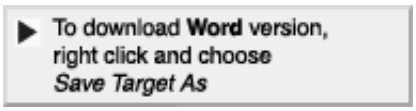
(6) *Transfer of Registration Rights.* The registration rights of any transferor holder of Registrable Securities may be transferred to a transferee who either (a) holds at least 10 percent of the originally issued shares of Registrable Securities subsequent to such transfer, or (b) is an affiliate (a partner, retired partner, shareholder, equity holder, or officer) of such transferor.

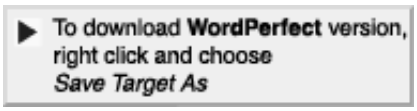
(7) *Other Registration Provisions.* Other registration rights provisions include cross-indemnification; the Company's ability to delay the filing of the demand registration for a period of no more than 120 days; the agreement by holders of Registrable Securities, if requested by the underwriter in a public offering, not to sell any unregistered Common Stock they hold for a period of up to 210 days after the effective date of the Registration Statement of such offering, during which time the Registration Statement will be kept effective; underwriting arrangements; and the like.

The registration rights will apply only to Common Stock issued on conversion of the Preferred Stock, and the Company shall have no obligation to register an offering of Preferred Stock.

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§20.57 5. Form: Board Representation





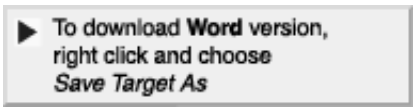
20.57-1 Board representation

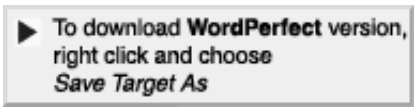
BOARD REPRESENTATION AND MEETINGS. The Company will have a _ _[*number*]_ _-member Board of Directors. As long as at least 50 percent of the originally issued shares of Preferred Stock are outstanding, the Preferred Stock will have a right to elect _ _[*number*]_ _ directors, with the balance to be elected by the remaining shareholders. The Board will meet at least quarterly.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.58 6. Form: Reserved Employee Shares

§20.58 6. Form: Reserved Employee Shares





20.58-1 Reserved employee shares

RESERVED EMPLOYEE SHARES.

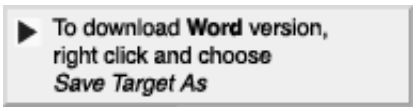
(1) The Company will reserve _ _[*number*]_ _ shares of its common stock (the "Reserved Employee Shares") for issuance to employees, independent contractors, customers, suppliers, etc.

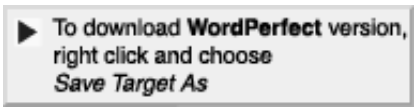
(2) The Reserved Employee Shares will be issued from time to time under such arrangements, contracts, or plans as are recommended by management and approved by the Board. Issuance of shares to employees in excess of the Reserved Employee Shares will be dilutive events requiring adjustment of the Conversion Price as provided above, unless otherwise waived.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.59 7. Form: Stock Purchase Agreement

§20.59 7. Form: Stock Purchase Agreement





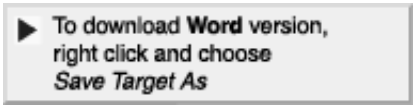
20.59-1 Stock purchase agreement

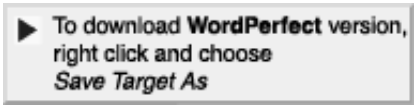
STOCK PURCHASE AGREEMENT. The purchase of the Preferred Stock will be made under a Stock Purchase Agreement. The Stock Purchase Agreement will contain, among other things, appropriate representations and warranties of the Company, covenants of the Company, reflecting the provisions in this Memorandum, and appropriate conditions, including qualification of the shares under applicable Blue Sky Laws, the filing of a Certificate of Amendment to the Company's Articles of Incorporation to authorize the Preferred Stock, and opinions of counsel.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.60 8. Form: Expenses

§20.60 8. Form: Expenses





20.60-1 Expenses

EXPENSES. The Company and the investors will each bear their own legal and other expenses with respect to the transaction (except that, assuming a successful completion of the offering, the Company will pay at the Closing the reasonable legal fees (not to exceed $_ _[*amount*]_ _) incurred by a single counsel to all investors).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.61 9. Form: Finder's Fee

§20.61 9. Form: Finder's Fee

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20.61-1 Finder's fee

FINDER'S FEE. The Company and the investors will each indemnify the other for any finder's fees for which either is responsible.

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VIII. SPECIFIC LEGAL IMPLICATIONS OF LETTERS OF INTENT

§20.62 A. Discoverability

Letters of intent are discoverable documents in the context of litigation. CCP §2017.010; Fed R Civ P 26(b)(1). They can assist third parties in litigation and administrative actions by helping them understand and characterize a transaction. Accordingly, counsel should make sure that the transactional structure proposed in the letter of intent and the language of the letter of intent do not mischaracterize the manner in which the definitive agreement addresses or is intended to address sensitive legal, structural, and tax issues.

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§20.63 B. Public Disclosure Obligations

If one or more parties to a particular transaction have public reporting obligations under applicable securities laws, they may be obligated to make public disclosure of the transaction at some point during the negotiation process. *Basic Inc. v Levinson* (1988) 485 US 224, 232, 99 L Ed 2d 194, 108 S Ct 978 (disclosure obligation under §13(d) of the Securities Exchange Act of 1934 (15 USC §78j(b)) and SEC Rule 10b-5 (17 CFR §240.10b-5)). See Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 Va L Rev 723 (1989). Although there are complex and sensitive considerations that relate to when a possible transaction should be disclosed under the securities laws, the execution of a letter of intent can be a key event triggering the disclosure obligation. Such obligations may be relevant both for the companies involved as well as for persons who have disclosure obligations because of their relationship to a company, such as officers, directors, and major shareholders.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.64 C. Premerger Notification

§20.64 C. Premerger Notification

For acquisition transactions that require compliance with the premerger notification rules under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (15 USC §18a), the execution of a letter of intent marks the earliest date for possible filing of premerger notification. The persons making the filing must supply affidavits stating that they have executed a contract, agreement in principle, or a letter of intent to merge or acquire, and that they have a good faith intention to complete the transaction. 16 CFR §803.5(b).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/20 Letters of Intent/§20.65 D. Other Antitrust Implications

§20.65 D. Other Antitrust Implications

Issues can arise under federal and state antitrust laws as a result of the sharing of information between competitors and agreements between competitors concerning interim operations. Both occasionally occur under letters of intent.

For example, if the parties were to share current pricing information in a way that leads to coordination of prices, or if the parties were to enter into an interim operating agreement that gave one party control over product pricing by the other party, significant price-fixing concerns would be raised.

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21

Promissory Notes

Brenda T. Dieck
Edith R. Warkentine

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II. INTRODUCTION §21.2

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/21 Promissory Notes/§21.1 I. CHECKLIST: PROMISSORY NOTES

§21.1 I. CHECKLIST: PROMISSORY NOTES

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- Parties (see §21.4)
- Single or multiple draw notes (see §§21.5-21.6)
- Maturity date (see §21.7)
- Interest rate (see §§21.8-21.11)
- Payment terms (see §21.12)
- General terms of payment (see §21.13)
- Interest only (see §21.14)
- Installments of principal (see §21.15)
- Payment-in-kind interest (see §21.16)
- Post-default interest rate (see §21.17)
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- Prepayment (see §§21.19-21.22)
- Events of default and remedies (see §21.23)
- Acceleration (see §21.24)
- Late payment fees (see §§21.25-21.26)
- Security (see §21.27)
- Nonrecourse provision (see §21.28)
- Waivers by maker (see §21.29)
- Purpose of loan (see §21.30)
- Time of the essence (see §21.31)
- General provisions, physical handling of note (see §§21.32-21.33)
- Negotiable or nonnegotiable (see §§21.34-21.37)
- Conditional or unconditional (see §21.38)
- Usury laws (see §§21.39-21.44)

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/21 Promissory Notes/§21.2 II. INTRODUCTION

§21.2 II. INTRODUCTION

A promissory note is an instrument promising to pay money. See Com C §3104(e). It may be negotiable or nonnegotiable, conditional or unconditional, interest-bearing or non-interest-bearing, and secured or unsecured. Repayment of the principal may be required in a lump sum on a date certain or in periodic installments. Sections 21.3-21.33 present a series of standard promissory note provisions. Sections 21.34-21.44 discuss certain legal aspects of promissory notes, including negotiability, usury, and payment terms.

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III. STANDARD NOTE PROVISIONS

§21.3 A. Title, Definitions

Although there is no legal requirement to title the note, it helps to identify the instrument. Common titles include:

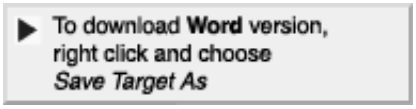
- Promissory Note
- Term Promissory Note
- Revolving Promissory Note
- Unsecured Promissory Note
- Secured Promissory Note

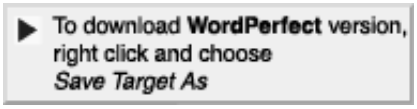
A term promissory note is a note for an amount certain that, once repaid, may not be reborrowed. A revolving note is essentially a line of credit for an amount that can be borrowed and repaid and then borrowed again until the maturity date, provided that the aggregate principal amount outstanding at any time cannot exceed the total committed amount of the note. A secured note is a payment obligation that is backed by collateral. If the maker fails to fulfill its obligations to the payee, the payee may look to designated personal or real property as a means of repayment up to the amount of the obligations owed.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/21 Promissory Notes/§21.4 B. Parties

§21.4 B. Parties





A simple note usually has one maker and one payee. However, a note may also have an accommodation party—one who, without being a direct beneficiary, signs the note as a co-obligor and becomes obliged to pay it. Com C §3419(a). For example, a parent or subsidiary of a corporate borrower may sign the note as a co-issuer or in its capacity as a guarantor or pledgor. In other circumstances, a sole shareholder may sign the note of a corporate borrower, expressly stating, however, that he or she is signing as an individual. As another example, all general partners of a partnership might be asked to sign a note.

NOTE: If the maker is a partnership, consider the following provision:

Maker is a partnership and the agreement herein contained shall remain in full force and effect notwithstanding any changes in the individuals composing such partnership, and the term "Maker," as used herein, shall include any alternate or successor partnerships, but any predecessor partnerships and their respective partners shall not be released from any liability.

In additional to co-signors, a third party may provide credit support in the form of a guaranty or as a pledgor of collateral in support of the maker's obligations under the note. An accommodation party is a surety and has a right of recourse against the principal maker if the accommodation party has to pay the note. Com C §3419(e). See generally §22.4 on subrogation rights.

NOTE: In community property states such as California, if the maker is an individual, the payee should obtain a spousal consent if the spouse is not a co-signor.

Normally, the payee can sue an accommodation party for the entire amount of the note without having to sue the principal obligor. By adding the words "collection guaranteed" to its signature, the accommodation party can limit its liability so that the payee must either pursue collection from the principal to the point of obtaining an unsatisfied judgment or be able to show that collection efforts would be futile. Com C §3419(d). Use of the phrase "payment guaranteed," on the other hand, means that the accommodation party will pay the note if the principal obligor does not.

NOTE: If an accommodation party's guaranty does not state a restriction, it is treated as a guaranty of payment rather than as the more limited guaranty of collection. Com C §3419(d); Official Comment 4 to UCC §3-419. This rule deals only with words of guaranty added to signatures on instruments. Most guaranties are not part of the note instrument but are separate documents; accordingly, Commercial Code Division 3 does not apply to them. See chap 22 on guaranties.

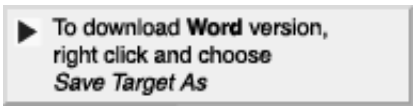
The status of payees may also raise drafting issues. If a note is payable to two or more persons alternatively (*e.g.,* "To *A* or *B*"), it is payable to either or both of them and may be negotiated, discharged, or enforced by either or both of them. Payment in full to one party satisfies the obligations of the maker with respect to both parties A and B. If a note is payable to two or more persons jointly (*e.g.,* "To *A* and *B*"), it is payable to all of them and may be negotiated, discharged, or enforced only by all of them collectively. If payment in full to one party satisfies the obligations of the maker with respect to both parties A and B, the drafter should consider whether contribution rights between parties A and B should be addressed, either in the note or a separate agreement. If the note is ambiguous regarding whether it is payable to either or both (*e.g.,* "To *A* and/or *B*"), it is presumed to be payable alternatively. Com C §3110(d); Official Comment 4 to UCC §3-110.

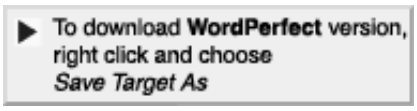
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C. Single or Multiple Draw Notes

§21.5 1. Form: Promise to Pay Principal Under Single Draw





Principal amount: $_ _[*amount*]**_ _**
Date: _ _ _ _ _ _

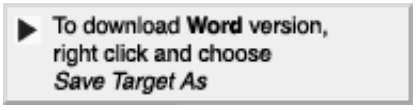
On or before _ _[*maturity date*]**_ _, for value received, the undersigned ("Maker") unconditionally promise(s) to pay to the order of _ _**[*name of lender*]**_ _ ("Payee"), in the manner and at the place provided below, the principal sum of $_ _**[*amount*]**_ _.**

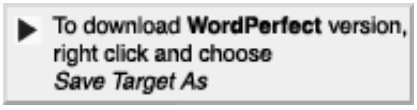
Comment: A standard term note has a stated principal amount, and all money is disbursed at the time the note is executed.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/21 Promissory Notes/§21.6 2. Form: Promise to Pay Principal Under Multiple Draw or Revolving Note

§21.6 2. Form: Promise to Pay Principal Under Multiple Draw or Revolving Note





Principal amount: $_ _[*aggregate committed amount*]_ _
Date: _ _ _ _ _ _

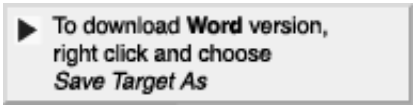
On or before _ _[*maturity date*]_ _**, for value received, the undersigned ("Maker") unconditionally promise(s) to pay to the order of** _ _[*name of lender*]_ _ **("Payee"), in the manner and at the place provided below, the lesser of (i)** _ _[*aggregate loan commitment*]_ _ **and (ii) the unpaid principal amount of all advances made by Payee to Maker.**

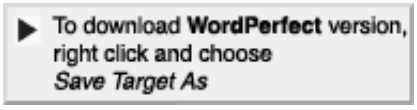
Comment: In certain instances, the transaction may contemplate multiple advances from time to time up to a stated principal amount. The advances may be multiple advances up to a stated amount that may not be reborrowed, *e.g.,* as in the case of a multiple draw term note. Alternatively, the advances may be repaid and subsequently borrowed up to the stated amount during the term of the note, as in the case of a revolving note. In each case, a grid note form with an attached schedule of the date and amount of each advance and the amount of each payment of principal and interest paid is recommended.

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§21.7 D. Form: Maturity Date





For value received, the undersigned ("Maker") promise(s) to pay to _ _[*name of lender*]_ _ **("Payee"), or to order, at** _ _[*address of place for payment*]_ _**, or other place as the holder of this Note ("Holder") may from time to time designate in writing, the principal amount of** _ _[*insert principal amount in words and numbers*]_ _ **on demand, but in any event no later than** _ _[*insert final maturity date*]_ _**.**

Comment: To satisfy the statutory requirement that a fixed amount be payable on demand or at a definite time (see Com C §3104(a)(2)), a promissory note should state the maturity date. Even if a note is payable on demand, an outside maturity date is usually stated.

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E. Interest Rate

§21.8 1. Form: Fixed Interest Rate

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Interest on the unpaid principal balance of this Note is payable from the date of this Note until this Note is paid in full, at the rate of _ _[*interest rate*]_ _ percent per annum.

Comment: The simplest form of interest rate is expressed as a fixed rate per annum.

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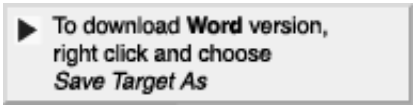
§21.9 2. Variable Interest Rate

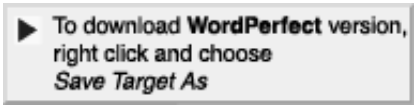
In notes specifying a variable interest rate, the precise rate is not established when the loan is made. Instead, a means for computing the interest rate and adjusting it at intervals over the term of the loan is provided. Usually, the note's interest rate is indexed to an external rate that reflects the lender's cost of borrowing funds. In drafting a note with a variable interest rate, counsel must clearly explain when and how the rate will change (*e.g.,* the same date the index changes, on the first day of the next month after the index changes, semiannually) and should specify any requirements for notice of a changed rate. To protect against an uncertain interest rate resulting from discontinuance of the initial index, a replacement index should be designated to apply if the initial index becomes unavailable. External references for variable interest rates can include (1) Eurodollar rates; (2) the London Inter-Bank Offered Rate (called LIBOR); (3) "floor" rates, which are minimum interest rates below which the variable rate cannot fall; (4) applicable margins, which are spreads added to the variable rate in connection with variables of performance; and (5) any combination of the foregoing.

PRACTICE TIP: Many banks no longer refer to a "prime rate" but instead use the terms "reference rate" or "base rate," in response to lawsuits claiming that a customer who borrows money at the "prime rate" should receive the bank's "best" rate. The form in §21.10 uses the "reference rate" as the external index. See §8.25 for further discussion of variable interest rates.

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§21.10 3. Form: Variable Interest Rate





Interest accrues to and is charged by Payee only on

[*Add one of the following alternatives*]

[*Alternative 1: Single advance of principal*]

the amounts outstanding under this Note,

[*Alternative 2: Fluctuating principal*]

the sums actually disbursed and on the other amounts owed to Payee under the Loan Documents, and only from the date of disbursement through the date of repayment,

[*Continue*]

at a rate (the "Interest Rate") equal to _ _[*e.g., 2 percent per year in excess of*]**_ _ the rate publicly announced from time to time by _ _**[*name of institution*]**_ _ ("Bank") as its reference rate (the "Reference Rate")**[.]

[*If appropriate, add*]

, except that the Interest Rate may never exceed _ _[**_ _** *percent per year/the maximum lawful rate*]**_ _ and may not be less than _ _**[*minimum rate*]**_ _ per year.**

Any change in the Reference Rate will cause a corresponding change in the Interest Rate, effective _ _[*e.g., on the date the change in the Reference Rate is publicly announced/at the opening of business on the day after public announcement of the change in the Reference Rate*]**_ _. The Reference Rate represents an index above, at, or below which the interest rate to be charged on certain loans is determined. The Reference Rate is determined by Bank from time to time as a means of pricing credit extensions to certain customers and neither is tied to any external interest rate or index nor is necessarily the lowest interest rate charged by Bank at any given time for any particular class of customers or credit extensions. If Bank fails to establish or publish a Reference Rate, then for purposes of this Note the Reference Rate will be considered _ _**[*specify replacement index, e.g., the average Reference Rate for each calendar month of the three largest banking institutions (measured by total assets) in the continental United States then publishing a Reference Rate*]**_ _.**

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§21.11 4. Form: Interest Calculation

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[*Alternative 1: Interest calculated on basis of 365 or 366 days per year*]

Accrued interest will be computed on the basis of a 365-day or 366-day year, as the case may be, based on the actual number of days elapsed in the period during which it accrues.

[*Alternative 2: Interest calculated on basis of 360 days per year*]

Accrued interest will be computed on the basis of a 360-day year, based on the actual number of days elapsed.

Comment: If interest is calculated on any basis other than a 365-day year, the basis must be stated in the note. See *Fletcher v Security Pac. Nat'l Bank* (1979) 23 C3d 442, 153 CR 28 (quoting interest calculated on basis of 360-day year as "per annum" is in violation of Bus & P C §17500); *South Bay Chevrolet v General Motors Acceptance Corp*. (1999) 72 CA4th 861, 889, 85 CR2d 301 (permitting use of 365/360 interest calculation according to industry custom and practice). The note must be dated if interest accrues "from the date of" the note.

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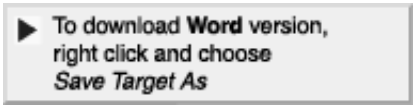
§21.12 F. Payment Terms

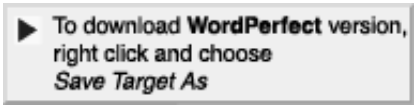
The note should set forth the terms of payment of interest, principal, and prepayment premium, if applicable (see §21.19). The most common terms of payment are periodic payments of interest only, scheduled principal payments with periodic interest payments, periodic payments of principal and interest fully amortized over the life of the loan, and periodic payments of principal and interest with a final payment at maturity, which is different in amount from the regular payments (*i.e.,* a balloon payment). Periodic payments may be monthly, quarterly, semiannually, annually, or any other term of payment acceptable to the parties. See §§8.23-8.25 for further discussion of payment terms.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/21 Promissory Notes/§21.13 1. Form: General Terms of Payment

§21.13 1. Form: General Terms of Payment





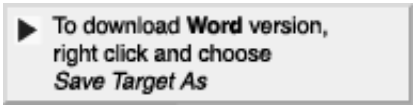
All payments of principal and interest in respect of this note shall be made in lawful money of the United States of America in same day funds, without offset, deduction, or counterclaim of any kind, at _ _[*address of place for payment*]_ _, or other place as the holder of this Note ("Holder") may from time to time designate in writing.

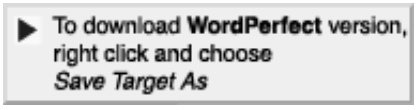
Comment: The note should specify the currency and place of payment. Some notes expressly provide for payment in cash or by wire transfer to avoid sham payment schemes such as those described in *McElroy v Chase Manhattan Mortgage Co*. (2005) 134 CA4th 388, 36 CR3d 176.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/21 Promissory Notes/§21.14 2. Form: Interest Only

§21.14 2. Form: Interest Only

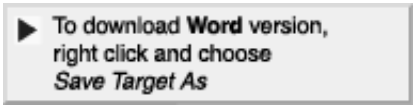


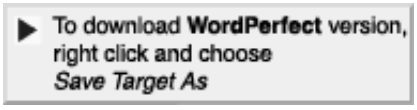


Interest only will be payable _ _[*e.g., monthly/quarterly/semiannually/annually*]**_ _, beginning on _ _**[*date first payment due*]**_ _, and continuing thereafter on _ _**[*e.g., the first day of each month/specify date*]**_ _ until the principal is paid in full. On _ _**[*maturity date*]**_ _, all sums remaining unpaid under this Note will be due and payable.**

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§21.15 3. Form: Installments of Principal



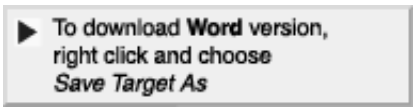


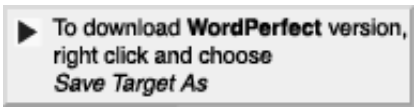
Principal and interest will be payable in _ _[*e.g., 179*]_ _ **consecutive** _ _[*e.g., monthly*]_ _ **installments of** _ _[*regular payment amount*]_ _**, beginning on** _ _[*date first payment due*]_ _**, and continuing on the** _ _[*e.g., first day of each month*]_ _**, together with a** _ _[*e.g., 180th monthly*]_ _ **payment on** _ _[*maturity date*]_ _**, in an amount equal to all sums remaining unpaid under this Note. Each payment will be credited first to** _ _[*specify*]_ _**, then to accrued interest, and then to principal, and interest will then cease on the portion of principal credited.**

Comment: This form may be used for balloon payment obligations as well as for fully amortizing obligations.

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§21.16 4. Form: Payment-in-Kind Interest



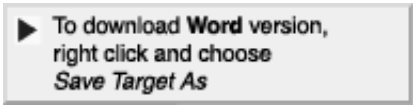


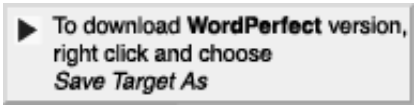
Interest shall accrue at the rate of _ _[*interest rate*]_ _ percent per annum, payable by capitalizing and adding such interest to the then outstanding principal amount of this Note on each interest payment date.

Comment: Payment-in-kind (PIK) interest may be used for subordinated debt obligations or obligations for which the maker does not have the current ability to make scheduled interest payments but will have the ability to pay the interest accruing on the note at some future date (usually the maturity date). Note that the PIK interest that accrues is added to the principal of the Note. Future interest therefore includes interest on the added interest amount, making the principal more costly.

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§21.17 5. Form: Postdefault Interest Rate





Any unpaid principal amount of this Note and any other amounts due and payable under this Note, including interest, in each case whether at stated maturity, by required prepayment, declaration, acceleration, demand, or otherwise (both before as well as after judgment) will bear interest payable on demand at

[*Add one of the following alternatives*]

[*Alternative 1: Fixed rate*]

the rate of _ _[*interest rate*]**_ _ percent per year.**

[*Alternative 2: Variable rate*]

a rate (the "Default Interest Rate") equal to _ _[*e.g., 6 percent per year in excess of the Reference Rate/4 percent per year in excess of the Interest Rate*]**_ _.**

[*Continue*]

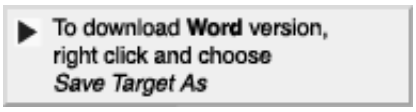
As used in this Note, "maturity" means (1) the date on which this Note is due and payable in full under Paragraph _ _[*specify*]**_ _ of this Note or (2) an Event of Default, followed by acceleration of the balance due under this Note.**

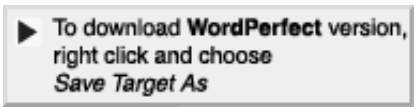
Comment: If the predefault interest rate is variable, a fixed postdefault interest rate could actually be lower than the predefault interest rate. The practice, therefore, is to include a postdefault rate that provides for an additional margin added to the predefault rate. If the variable rate is used, the terms (*e.g.,* "Interest Rate," "Reference Rate") must be defined. A postdefault increased interest rate is avoided by a Chapter 11 plan that cures default. *Great W. Bank v Entz-White Lumber & Supply, Inc. (In re Entz-White Lumber & Supply, Inc.*) (9th Cir 1988) 850 F2d 1338. But see *In re Tri-Growth Centre City, Ltd.* (Bankr SD Cal 1992) 136 BR 848 (postdefault interest rate enforceable when proposed Chapter 11 plan that defers payments does not cure default by plan's effective date).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/21 Promissory Notes/§21.18 6. Form: Maximum Interest Rate Provisions

§21.18 6. Form: Maximum Interest Rate Provisions





In no event shall the interest rate payable on this Note exceed the maximum rate of interest permitted to be charged under applicable law.

Comment: In setting the interest rate, counsel should be mindful of usury law restrictions. If the note does not provide for a maximum rate of interest that is within the usury limit, the external index may cause the note's rate of interest to exceed what the usury law will allow during periods of rising interest rates. On usury issues, see §§21.39-21.44; Martinson and Jain, *California Usury Law for the Lender's Lawyer,* 20 CEB Cal Bus L Prac 1 (Winter 2005). Default rates of interest are usually *not* subject to usury limitations. Under certain circumstances, however, postmaturity interest may be subject to challenge as usurious. The language above should be included to comply with applicable law. For an alternative usury savings clause, see §21.44.

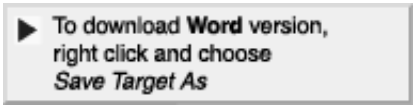
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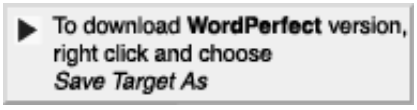
§21.19 G. Voluntary Prepayments

In the absence of a statute, regulation, or contrary agreement between the parties, a borrower has no right to prepay amounts due. CC §1490. See *Smiddy v Grafton* (1912) 163 C 16, 124 P 433. In certain transactions the payment of premium may be required on the occurrence of a certain event, such as the early prepayment of the note, in order to compensate the payees for the loss of their anticipated investment. Provisions requiring payment of a prepayment penalty or premium are enforceable unless proscribed by statute or regulation. See, *e.g.,* CC §§1916.5(a), 1916.7, 2954.9 (limiting charge when note relates to financing of purchase of real property having four or fewer residential units or of construction of such units); Bus & P C §10242.6 (restricting prepayment penalty when note is secured by mortgage or deed of trust on single-family, owner-occupied dwelling); 24 CFR §207.253 (allowing prepayment without penalty of certain federally insured multifamily housing mortgages). For more detailed discussion of prepayment in the context of notes secured by a deed of trust or mortgage, see California Real Estate Finance Practice: Strategies and Forms §§3.22-3.36 (Cal CEB 2000).

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§21.20 1. Form: Prepayment Permitted Without Premium





Maker may prepay this Note, _ _[*add payment amount restrictions, e.g., in whole or in part/in whole or in multiples of $5000/in whole only*]**_ _, _ _**[*add payment time restrictions, e.g., on any date/on any scheduled payment date/after at least 5 business days' written notice*]**_ _.**

[*If applicable, add one or both of the following options*]

[*Option 1: Prepayment required after notice given*]

Once Maker has given notice to Holder of its election to make a prepayment, the amount to be paid is due and payable on the date stated in the notice, and failure to so pay constitutes an Event of Default.

[*Option 2: Credit for partial prepayments*]

Any partial prepayment will be credited _ _[*e.g., first to accrued interest, then to principal*]**_ _. Prepayments will be applied to the _ _**[*last-due payment of principal/next principal payment that becomes due*]**_ _. No prepayment extends or postpones the due date or changes the amount of any subsequent payment.**

Comment: The prepayment may be applied in forward chronological order or inverse chronological order. In the event that there are two or more payees on the note, the prepayment may be applied equally or *pro rata* among the payees. If the payee relies on the prepayment being made once notice is given, the optional language should be included so that failure to pay triggers default remedies. The terms of a payment provision may be read to permit prepayment if the payment amount is described as "$_ _[*amount*]_ _ or more" or the due date is given as "on or before _ _[*date*]_ _."

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/21 Promissory Notes/§21.21 2. Form: Prepayment Premium Required

§21.21 2. Form: Prepayment Premium Required

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Maker may prepay this Note, _ _[*add restrictions, e.g., in whole or in part/in whole or in multiples of $5000/in whole only*]**_ _, on any date, as long as each prepayment is made together with a premium equal to _ _**[*e.g., $100/5 percent of the amount prepaid*]**_ _.**

[*If applicable, add the following option*]

[*Option: Partial prepayment allowed*]

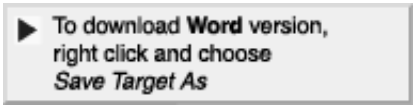
Any partial prepayment will be credited first to accrued interest, then to principal. No prepayment extends or postpones the due date or changes the amount of any subsequent payment.

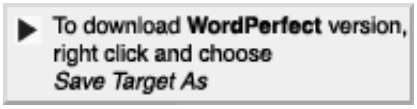
Comment: Prepayment premiums may include a percentage of the amount prepaid, premiums, or fees to indemnify a payee for London Inter-Bank Offered Rate (LIBOR) breakage fees or premiums designed to make the payee "whole" by determining a discounted interest amount that, if added to the principal prepaid and reinvested, would give the payee the same rate of return over the original period of the note. On prepayment premiums following acceleration of note due to default in the context of a real property deed of trust or mortgage, see California Real Estate Finance Practice: Strategies and Forms §3.30 (Cal CEB 2000).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/21 Promissory Notes/§21.22 3. Form: Prepayment Prohibited

§21.22 3. Form: Prepayment Prohibited





Maker has no right to prepay this Note, in whole or in part, at any time.

Comment: A prohibition on prepayment for a period of time is commonly referred to as a "non-call" provision.

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§21.23 H. Form: Events of Default; Holder's Waivers; Remedies Cumulative

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All sums remaining unpaid under this Note become immediately due and payable, at Holder's option, without notice, demand, or presentment, and regardless of any prior forbearance, on the occurrence of any of the following events:

(a) Maker's failure to make any payment when due under the terms of this Note, including without limitation the final payment due under this Note at its maturity _ _[*, and any prepayment not made on the date provided for in the prepayment notice*]**_ _;**

(b) the filing of a petition in bankruptcy by, or the initiation of any proceeding under any bankruptcy or insolvency laws against, the Maker _ _[*or any guarantor of this Note*]**_ _;**

(c) the making of a general assignment for the benefit of creditors by Maker _ _[*or any guarantor of this Note*]**_ _;**

(d) Maker's _ _[*or any guarantor's*]**_ _ default under any agreement or instrument executed in connection with this Note;**

(e) Maker's default under any other promissory note executed by Maker in favor of Holder; or

(f) the revocation of any guaranty of this Note by any guarantor.

No delay or omission by Holder in exercising any right or remedy under this Note or any other agreement executed in connection with this Note operates as a waiver of the future exercise of that right or remedy or of any other rights or remedies under this Note or any other agreement executed in connection with this Note. To the extent permitted by law, Maker waives the right, in any action on this Note, to assert that the action was not commenced within the time required by law for commencement of the action. All rights of Holder stated in this Note are cumulative and in addition to all other rights provided by law, in equity, or in any agreement executed in connection with this Note.

Comment: The default clause of the promissory note may be tailored to include other concerns of the lender. A common addition is a "cross-default" provision such as item (d) above, which typically defines a default under any other debt obligation executed by the same maker as a default under the instant note. A note may also be cross-defaulted to the maker's performance under another agreement, such as a lease or loan agreement. The debt obligation or other agreement may be between the maker and the holder or may be an obligation by the maker to a third party whom the holder deems material to its credit analysis. See §§14.21-14.23 for discussion of cross-default and cross-acceleration clauses. "Events of Default" can also be tied to other events, including, but not limited to, (1) financial performance, such as the maker's failure to maintain certain balance sheet or income statement ratios; (2) dissolution or change of control of a corporate maker; (3) invalidity of the loan documents, such as invalidity of the security agreement or guaranty, or a repudiation of the obligations under any of the loan documents; (4) the occurrence of a material adverse change or effect (see generally Kuney, *Material Adverse Change Clauses,* 23 CEB Cal Bus L Prac 101 (Fall 2008)); and (5) certain judgments or attachments against the maker. The lender may wish to provide the maker with a grace period for curing any default. See chap 14 for further discussion and forms for defining events of default.

NOTE: The statute of limitations for an action to enforce payment of a note due at a definite time is 6 years after the due date (or the extended due date if the note is amended) or, if the due date is accelerated, 6 years after the accelerated due date. Com C §3118(a). See §21.22.

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§21.24 I. Acceleration Issues

Notes commonly provide for acceleration of the balance due on the borrower's default. Acceleration can be automatic or at the election of the holder. An acceleration clause does not affect the negotiability of a note. Com C §3108(b). Commercial Code §1309 limits acceleration, however, when the alleged default is the lender's "insecurity," a "material adverse change in the financial condition" of the maker or guarantor, or words to similar effect. See *Hexion Specialty Chems., Inc. v Huntsman Corp.* (Del Ch 2008) 965 A2d 715 (regarding material adverse effect); Kuney, *Material Adverse Change Clauses,* 23 CEB Cal Bus L Prac 101 (Fall 2008). In these instances, the lender has the power to accelerate the debt only if it in good faith believes that the prospect of payment or performance is impaired or a material adverse change has occurred. The burden of establishing lack of good faith is on the party against whom the power has been exercised. See Com C §1309. For further guidance, see Anno, *What Constitutes "Good Faith" Under UCC §1-208*, *Dealing With "Insecure" or "At Will" Acceleration Clauses,* 85 ALR4th 284 (1991) and recent litigation in the area of leveraged acquisitions.

NOTE: An acceleration clause in a note should be distinguished from a note that is payable on demand by the holder. The demand note may be called by the holder without reference to the borrower's ability to pay.

"Ipso facto" provisions that allow one party to terminate an executory contract on the insolvency or bankruptcy of the other party are not enforceable under federal bankruptcy law. 11 USC §365(e)(1), (2)(A); *Spieker Props., LP v MFM The SPFC Liquidating Trust (In re Southern Pac. Funding Corp.)* (9th Cir 2001) 268 F3d 712. A promissory note, however, is usually not considered an executory contract if the only performance that remains is repayment. *Kaler v Craig (In re Craig)* (8th Cir 1998) 144 F3d 593. Consequently, a provision for automatic acceleration of a note on the bankruptcy of the debtor should be enforceable. If a note is part of a complex transaction in which the creditor has ongoing performance obligations, the court may look at the entire transaction and refuse to enforce the ipso facto clause. See *Burley v American Gas & Oil Investors* (*In re Heafitz)* (Bankr SD NY 1988) 85 BR 274. Current practice is to include a provision in the note triggering an automatic acceleration of payment on the occurrence of an insolvency or bankruptcy event. See §§14.16-14.20 for further discussion of bankruptcy and insolvency.

Generally, when the holder accelerates a note, it cannot recover interest unearned at the time of acceleration. See *Furesz v Garcia* (1981) 120 CA3d 793, 174 CR 803 (holder of note not entitled to 12 years' monthly payments of principal and interest remaining unpaid at time of foreclosure and acceleration).

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§21.25 J. Late Payment Fees

In general, a late payment fee is not enforceable if it is intended to be punitive. See §21.26. For example, a late fee calculated as a percentage of the unpaid principal balance of the note, rather than as a percentage of the installment not timely paid, is probably not enforceable.

Federal law governs the validity of late payment fees imposed by national banks on credit cards. *Smiley v Citibank* (1995) 11 C4th 138, 44 CR2d 441, aff'd (1996) 517 US 735, 135 L Ed 2d 25, 116 S Ct 1730. See Credit Card Accountability Responsibility and Disclosure Act of 2009 (Pub L 111-24, 123 Stat 1734) (limiting interest rate, fee, and finance charge increases applicable to outstanding credit card balances). In *Smiley*, the United States Supreme Court upheld the determination of the California Supreme Court that the term "interest" in the National Bank Act (12 USC §85) covers late payment fees if those fees are allowed by a national bank's home state. Accordingly, federal law preempts state law regarding the validity of late payment fees. State law probably would also be preempted by federal law on the issue of the validity of late payment fees in promissory notes evidencing loans by national banks.

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§21.26 K. Form: Late Payment Fee

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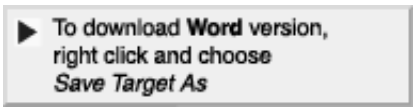
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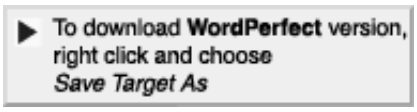
It would be impracticable to fix the amount of Holder's extra expense involved in handling a delinquent payment if any installment under this Note is not paid when due. Accordingly, Maker agrees to pay to Holder a late payment charge equal to _ _[*e.g., 5 percent of the installment due*]**_ _ if all or part of any installment is not received by Holder within _ _**[*e.g., 10 days*]**_ _ after the date on which it is due. Maker agrees that this charge is a reasonable estimate of extra expenses Payee will incur.**

Comment: This clause is essentially a liquidated damages provision and is therefore governed by CC §1671(b) or, in the case of consumer contracts, CC §1671(c)-(d), unless other law (such as federal banking law) is applicable. See California Law of Contracts §§10.39-10.47 (Cal CEB 2007). In general, outside the consumer context, a late payment charge is probably valid unless a borrower can show that it constitutes a penalty because it was unreasonable under the circumstances at the time the contract was made. See CC §1671(b); *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 73 CR2d 378 (prepayment fee was penalty because it bore no relationship to potential damages that lender would incur from late interest payment). In consumer contracts, liquidated damages provisions are void unless it would be extremely difficult or impracticable to fix the actual damages. See CC §1671(c)-(d); *Utility Consumers' Action Network, Inc. v AT&T Broadband of S. Cal., Inc*. (2006) 135 CA4th 1023, 37 CR3d 827. With respect to a note issued in connection with a mortgage or deed of trust on a single-family home, the maximum late payment fee is 6 percent of the payment due, and that payment is not considered late until after 10 days. See CC §2954.4.

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§21.27 L. Form: Security for Note





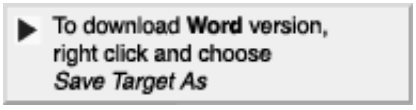
This Note is secured by _ _[*describe security*]_ _.

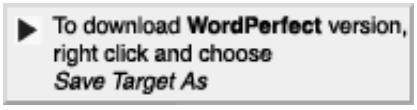
Comment: A note may recite that it is secured, without losing its status as a negotiable instrument. Com C §3104(a)(3). For discussion of the security agreement and personal property collateral, see Secured Transactions in California Commercial Law Practice, chap 2 (2d ed Cal CEB 2001). For discussion of notes secured by real property, see California Real Estate Finance Practice: Strategies and Forms, chap 3 (Cal CEB 2000).

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§21.28 M. Form: Nonrecourse Agreement





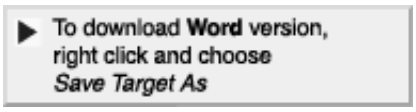
Notwithstanding anything to the contrary in this Note, and without in any manner affecting its validity, in the event of any default under the terms of this Note, Holder's sole recourse will be to the security for this Note described in Paragraph _ _[*specify*]_ _.

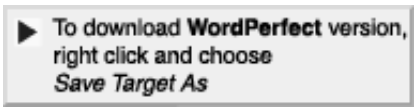
Comment: A lender may agree to limit the personal liability of the maker of the note and to rely instead on the value of the security as a guaranty of payment. For more detailed discussion of limiting recourse in a real estate transaction, see California Real Estate Finance Practice: Strategies and Forms §3.51 (Cal CEB 2000).

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§21.29 N. Form: Maker's Waivers



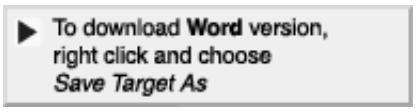


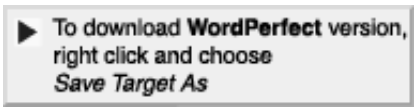
Diligence, demand, presentment, notice of dishonor, and protest are waived by all makers, sureties, guarantors, and endorsers of this Note.

Comment: Presentment (see Com C §3501) and notice of dishonor (see Com C §§3502-3503) are conditions precedent to an endorser's liability. Although both are identified in this form for clarity, a waiver of presentment is also a waiver of notice of dishonor. Com C §3504(b). A "protest" is a formal declaration in writing executed by a notary to the effect that an instrument was presented at a certain time and place and was dishonored. It is not a condition to the liability of endorsers or drawers in California, but it may be a requirement for liability on international drafts governed by foreign law. See Comment to UCC §3-505.

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§21.30 O. Form: Purpose of Loan





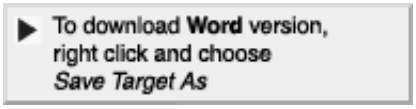
The proceeds of this Note are to be used by Maker exclusively for commercial or business purposes and not for personal, family, or household purposes.

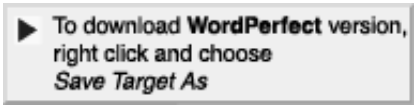
Comment: This clause is used to prevent the application of consumer credit laws and to clarify the applicable interest rate for purposes of complying with the usury laws. In addition, restrictions on the use of proceeds in violation of the margin stock regulations may be added, such as the following:

> **No proceeds of this Note shall be used by Maker in any manner that might cause the borrowing or the application of such proceeds to violate Regulation U, Regulation T, or Regulation X of the Board of Governors of the Federal Reserve System or any other regulation of such Board or violate the Securities Exchange Act of 1934, as amended.**

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§21.31 P. Form: Time of the Essence





Time is of the essence for every obligation under this Note.

Comment: If it is important to the lender that loan payments be made on time, it is imperative that this or a similar provision be included in the note. See *Bisno v Sax* (1959) 175 CA2d 714, 346 P2d 814. Even if the note contains a "time of the essence" provision, a court may be reluctant to allow a lender to enforce its rights for minor delays in payment. See *Baypoint Mortgage Corp. v Crest Premium Real Estate Invs. Retirement Trust* (1985) 168 CA3d 818, 214 CR 531. See also §§17.17-17.18.

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§21.32 Q. General Provisions for Notes

Many of the miscellaneous provisions used in other business agreements can be adapted and used in notes, *e.g.:*

- Representations and warranties;
- Affirmative and negative covenants;
- Governing law (see §§16.55-16.56);
- Indemnification, expense reimbursement, attorney fees and costs (see §§16.57-16.61);
- Dispute resolution (see chap 16);
- Headings and captions (see §§17.29-17.30);
- Joint and several liability (see §§17.25-17.26);
- Notices (see §§17.3-17.4);
- Severability (see §§17.13-17.14); and
- Waiver (see §§17.27-17.28).

A severability provision could be particularly important if the interest rate is held to be usurious (see §§21.39-21.44) or if a prepayment penalty or late fee is found to be unlawful (see §§21.19-21.22, 21.25), because the note would remain enforceable to the extent it was lawful. See §§17.13-17.14.

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§21.33 R. Physical Handling of Note

In most business transactions, it is common for the parties to sign multiple copies of the contract documents. For promissory notes, however, the maker must be careful to sign only one original note and *not* multiple copies. When the note is paid or refinanced, it should be returned to the maker marked "paid in full."

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IV. DEFINITIONS AND APPLICABLE LAW

A. Negotiability

§21.34 1. Definition

A negotiable note permits a purchaser of the note to have the rights of a *holder in due course.* See Com C §3302. The concept of a "holder in due course" is a cornerstone of the law of negotiable instruments. When ordinary contracts are transferred from one person to another by assignment, the assignee steps into the shoes of the assignor and has the same, but no greater, rights as the assignor. See chap 13 on assignments generally.

In contrast, the transferee of a negotiable note who meets the requirements of a holder in due course obtains rights to collect on the note even in situations where the maker may have a valid reason for refusing payment to the holder's transferor. The Commercial Code grants the holder in due course a privileged status as an aid to the free flow of negotiable instruments. A holder in due course takes the note free of claims by others that they have a property or possessory right in the note or its proceeds. Com C §3306. A holder in due course also takes the note free of defenses to payment, except for claims concerning the following (Com C §3305(a)(1), (b)):

- The infancy of the maker;
- Duress, lack of legal capacity, or illegality of the transaction that, under other law, nullifies the maker's obligation;
- Fraud that induced the maker to sign the note without the knowledge, or a reasonable opportunity to learn, of its character or essential terms; and
- Discharge of the maker in bankruptcy or insolvency proceedings.

For further discussion of the rights of a holder in due course, see Burt, *Negotiability of Promissory Notes in California Commercial Transactions,* 6 CEB Cal Bus L Prac 137 (Summer 1991).

PRACTICE TIP: After assignment of the note, it is recommended practice to notify the maker of the assignment because the maker may have the right to pay the original holder-payee until the maker receives notice of the assignment.

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§21.35 2. Requirements for Negotiability

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To be negotiable, a note must meet the following requirements (Com C §3104):

- It must be signed by the maker or drawer. Com C §3103(9).
- It must contain an unconditional promise or order to pay a fixed amount of money. Com C §§3106-3107. A variable or fluctuating interest rate does not affect negotiability; "fixed amount" refers only to the principal amount of the note. Com C §3112; Comment 1 to UCC §3-112.
- It must be payable on demand or at a definite time. Com C §3108.
- It must not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money. However, the promise or order may contain (1) an undertaking or a power to give, maintain, or protect collateral to secure payment; (2) an authorization or a power to the holder to confess judgment or realize on or dispose of collateral; and (3) a waiver of the benefit of any law intended for the advantage or protection of an obligor. Com C §3104(a)(3).
- It must be payable "to order" or to the bearer of the note. Com C §3109.

To satisfy the statutory requirement that it be payable to order, a promissory note should use one of the following two forms for the promise to pay:

_ _[*Name of maker*]_ _ **promises to pay to the order of** _ _[*name of payee*]_ _ **....**

[*or*]

_ _[*Name of maker*]_ _ **promises to pay to** _ _[*name of payee*]_ _**, or order ....**

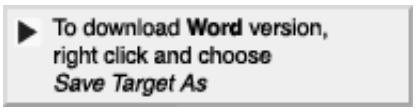
A negotiable note may provide that the borrower promises to pay "to bearer," but bearer notes are seldom used because anyone obtaining possession of such a note could enforce the obligation to pay it.

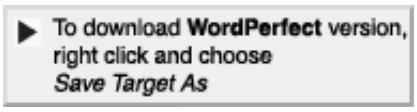
NOTE: Some promissory notes not only contain the provisions of a security agreement but also operate as a loan agreement by including covenants common to loan agreements. These covenants will likely make this type of note nonnegotiable.

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§21.36 3. When Nonnegotiability Desired





From time to time, a nonnegotiable note may be desirable. For example, the purchaser of a business may give a note to the seller for the purchase price and retain the seller as a consultant or an employee to help with the transition. The purchaser may want the note to be nonnegotiable in that circumstance; a seller who is precluded from cashing out through a sale of the note will have a greater interest in the success of the transition because payment may depend on the health of the business. In this event, the note should be titled "Nonnegotiable Promissory Note," and the "to order" or bearer language should be deleted:

_ _[*Name of maker*]_ _ **promises to pay to** _ _[*name of payee*]_ _ **....**

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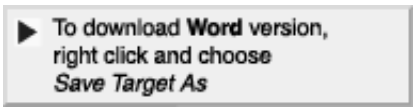
§21.37 4. Governing Law

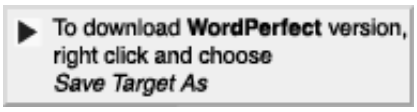
Negotiable instruments are governed by Division 3 of the California Commercial Code. Nonnegotiable notes are not governed by Division 3. Com C §3102. The parties to a nonnegotiable note may, however, provide by agreement that one or more of the provisions of Division 3 determine their rights and obligations under the writing. Comment 2 to UCC §3-104.

Notes used in consumer transactions may also be regulated by state or federal consumer legislation, such as the Unruh Act (CC §§1801-1812.20) (governing retail installment sales), the Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.4), the federal Truth in Lending Act (15 USC §§1601-1667f), and the Federal Trade Commission Act §5 (15 USC §45). This legislation may require that certain provisions be included in promissory notes used in consumer sales and may limit the payee's enforcement options. It is beyond the scope of this book to discuss specific requirements for promissory notes used in consumer transactions, but counsel should investigate whether other restrictions apply. See generally California Law of Contracts §6.39 (Cal CEB 2007).

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§21.38 B. Conditional or Unconditional





A promise or an order is unconditional unless it states (1) an express condition to payment; (2) that the promise or order is subject to or governed by another writing; or (3) that the rights or obligations with respect to the promise or order are stated in another writing. Com C §3106(a). The reasoning is that the holder of a negotiable instrument should not be required to examine another document to determine its repayment rights. Official Comment 1 to UCC §3-106. A mere reference to another writing, however, does not itself make the promise or order conditional. Com C §3106(a). The following examples illustrate the difference between a reference to another writing (an unconditional promise) and a statement that the promise or order is subject to another writing (a conditional promise):

Reference:	**This Note arises from a separate loan agreement between the parties entered into on the same date.**
Subject to:	**Maker's obligations under this Note are subject to all rights and remedies set forth in the loan agreement between the parties entered into on the same date.**

Moreover, a promise or order is not made conditional simply by a reference to another writing for a statement of the holder's rights regarding collateral, prepayment, or acceleration, or because the holder's recourse under the note is limited to a particular fund or source. Com C §3106(b).

In other situations when there is a preexisting loan or credit relationship between the borrower and a third party creditor, the lender may enter into a subordination agreement with the third party creditor in which payments on the note are subordinated to payment of the third party creditor's obligation. In such a subordination agreement, payment under the note may be permitted only as long as there is no default under the senior debt, after which further payments on the note are suspended. Alternatively, payments on the note may be permitted, but only on condition that the payments are made to the third party creditor. These subordination agreements are typically between the lender and the third party creditor and do not usually involve the borrower. They are common and respected by the bankruptcy courts in a bankruptcy of the borrower. See *Spieker Props., LP v MFM The SPFC Liquidating Trust (In re Southern Pac. Funding Corp.)* (9th Cir 2001) 268 F3d 712. See also *HSBC Bank USA v Branch (In re New England Corp.)* (1st Cir 2004) 364 F3d 355, 362, cert denied (2004) 543 US 926.

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C. Usury Laws

§21.39 1. Overview

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The essential elements of usury are as follows (*Ghirardo v Antonioli* (1994) 8 C4th 791, 798, 35 CR2d 418):

- The transaction is a loan or forbearance;
- The interest to be paid exceeds the statutory maximum;
- The loan and interest are absolutely repayable by the borrower; and
- The lender has a willful intent to enter into a usurious transaction.

California's usury laws (Cal Const art XV, §1; CC App I, §§1-3) provide a four-tiered structure regarding interest limitations, as follows:

(1) For any loan or forbearance of any money, goods, or things in action "for use primarily for personal, family or household purposes," a lender who is not exempt from the interest limitations of California usury laws may contract for a rate not exceeding 10-percent simple interest per year.

(2) For loans or forbearances in writing that are not "for use primarily for personal, family or household purposes" (which includes loans primarily for the purchase, construction, or improvement of real property), the interest rate that a nonexempt lender may charge is limited to the higher of (a) 10 percent or (b) 5 percent over the discount rate charged by the Federal Reserve Bank of San Francisco (FRBSF) under Federal Reserve Act §13 (12 USC §347) to member banks for money advanced on the applicable date. The current FRBSF discount rate is available at http://www.frbsf.org/banking/data/discount/index.html.

NOTE: The applicable date for determining the allowable interest rate is the 25th day of the month preceding the earlier of (1) the date the contract to make the loan or forbearance is executed or (2) the date of making the loan or forbearance.

(3) Certain lenders are expressly exempted from the interest limitations of the usury laws. See §21.41.

(4) Certain loans are expressly exempted from the usury laws. See §21.42.

The defense of usury cannot be waived by the borrower at the time a loan is made. *Baruch Inv. Co. v Huntoon* (1967) 257 CA2d 485, 65 CR 131. The use of a "usury savings clause" such as that found in §21.18 or §21.44 cannot ensure that the lender will be protected from claims that it violated the usury laws, but using the clause may help to avoid treble penalties. See *Smith v Miller* (*In re Dominguez*) (9th Cir 1993) 995 F2d 883, in which the court held that such a savings clause was effective. If a lender is relying on a particular exemption from the usury laws, it is good practice to identify the exemption in the usury savings clause. For example:

This loan was made or arranged by _ _[*name*]_ _, a real estate broker duly licensed by the State of California.

For further discussion of usury in California, see Martinson & Jain, *California Usury Law for the Lender's Lawyer,* 20 Cal Bus L Prac 1 (Winter 2005).

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§21.40 2. Credit Sales Not Subject to Usury Laws

A credit sale in California is not subject to usury laws because it does not constitute a loan or forbearance. When property is sold on credit, any additional charges imposed by the seller over the cash price are explained as a function of the "time price differential" doctrine; that is, the seller is charging more for the property because it is permitting payment to be made over a period of time. *Southwest Concrete Prods. v Gosh Constr. Corp.* (1990) 51 C3d 701, 705, 274 CR 404; *Boerner v Colwell Co.* (1978) 21 C3d 37, 45, 145 CR 380. The modification of an obligation that began as a credit sale does not constitute a "loan or forbearance" and is therefore not subject to usury law. *Ghirardo v Antonioli* (1994) 8 C4th 791, 804, 35 CR2d 418.

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§21.41 3. Lenders Exempt From Usury Laws

Certain lenders are expressly exempted from the interest limitations of the usury laws. The following list of lenders is illustrative, not exclusive: national banks, state banks incorporated under the laws of the State of California, foreign (other nation) banks that maintain branch or agency offices in California, foreign (other state) banks, commercial finance lenders, California savings and loan associations, California credit unions, insurance companies, pension funds, and certain California nonprofit agricultural lenders. Any successor in interest to a loan made by a member of an exempt class is also exempt. Cal Const art XV, §1.

The legislature periodically adds new categories of lenders to the list of exempt entities. For a detailed list of California usury law exemptions, see California Real Estate Finance Practice: Strategies and Forms §3.39 (Cal CEB 2000).

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§21.42 4. Loans Exempt From Usury Laws

Certain types of loans are expressly exempted from the interest limitations of California usury laws. *Stickel v Harris* (1987) 196 CA3d 575, 242 CR 88. These include shared appreciation loans (CC §1917; see *Jones v Wells Fargo Bank* (2003) 112 CA4th 1527, 5 CR3d 835 (upholding shared appreciation loans against claim of unconscionability)), loans arranged by real estate brokers and secured in whole or in part by liens on real property (CC §1916.1), certain debt instruments issued under the California securities laws (Corp C §25116), certain debt instruments of publicly held companies (Corp C §25117), debt of certain large commercial borrowers that meet certain financial criteria (Corp C §25118(a)), and certain business loans of at least $300,000 that are not made to or guaranteed by individuals (Corp C §25118(b)). Credit extensions in connection with the sale of goods or property are likewise exempt under the "time price differential." See *Boerner v Colwell Co.* (1978) 21 C3d 37, 145 CR 380. Similarly, interest on a note may be exempt from usury laws if payment is entirely contingent on the occurrence of a future event, such as the receipt of royalties under a patent license. *D-Beam Ltd. Partnership v Roller Derby Skates, Inc*. (9th Cir 2004) 366 F3d 972. Federal law also exempts from state usury laws any "federally related" loan secured by a first lien on residential real property. See 12 CFR §590.3.

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§21.43 5. Remedies

If a lender is not an exempt lender and the loan is not an exempt loan, and if California usury law applies to a proposed loan or forbearance and the effective interest rate exceeds the appropriate usury ceiling, the following civil remedies apply (CC App I, §1):

- The borrower is not obligated to pay interest on the loan and, in an action to recover the principal of the loan, any interest paid on the loan can be applied against the principal amount of the loan;
- The borrower can recover all interest actually paid on the loan if an action for it is brought within 2 years after any payment of interest (to the extent not offset against principal); and
- If an action is brought within 1 year after the date of an interest payment, the borrower can recover (or offset) triple the amount of any interest on the loan during the preceding year.

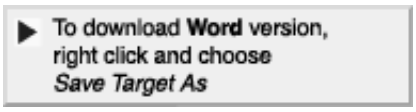
PRACTICE TIP: In determining whether the note violates the usury limitations, counsel must determine what interest is called for in the note. The following are not usually included in the calculation of interest: points, bonuses, and fees (see *Forte v Nolfi* (1972) 25 CA3d 656, 102 CR 455), commitment fees (see *Gonzales County Sav. & Loan Ass'n v Freeman* (Tex 1976) 534 SW2d 903), prepayment fees (see *Lazzareschi Inv. Co. v San Francisco Fed. Sav. & Loan Ass'n* (1971) 22 CA3d 303, 99 CR 417), and late charges (see *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845). For more detailed discussion, see California Real Estate Finance Practice: Strategies and Forms §3.38 (Cal CEB 2000).

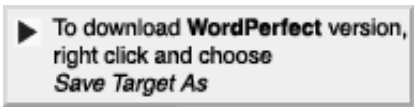
The borrower's obligation to pay principal is unaffected except that principal is not due until the expiration of the loan and cannot be accelerated as a result of a default in the payment of interest. CC App I, §2.

In addition to the civil remedies described above, violators of the usury laws may be subject to criminal penalties. CC App I, §1.

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§21.44 6. Form: Compliance With Usury Laws





Maker and Holder intend to comply with all applicable usury laws. In fulfilling this intention, all agreements between Maker and Holder are expressly limited so that the amount of interest paid or agreed to be paid to Holder for the use, forbearance, or detention of money under this Note may not exceed the maximum amount permissible under applicable law. If for any reason payment of any amount required under this Note is prohibited by law, the obligation will be reduced to the maximum allowed by law. If for any reason Holder receives as interest an amount that would exceed the highest lawful rate, the amount that would be excessive interest will be applied to the reduction of the principal of this Note and not to the payment of interest. If any conflict arises between this provision and any provision of any other agreement between Maker and Holder, this provision controls.

Comment: For alternative usury savings clauses, see §§8.29, 21.18. For a usury savings clause in the context of an equipment lease, see Financing and Protecting California Businesses §10.59 (Cal CEB 2006). For further discussion of usury in California, see Martinson & Jain, *California Usury Law for the Lender's Lawyer,* 20 Cal Bus L Prac 1 (Winter 2005).

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22

Guaranties

Edith R. Warkentine
Pauline M. Stevens

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.1 I. CHECKLIST: GUARANTIES

§22.1 I. CHECKLIST: GUARANTIES

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

- Consideration (see §22.7)
- Extent of liability (see §22.3)
- Continuing guaranty or limited to certain transactions (see §§22.5, 22.17)
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- To settle, compromise, and release (see §22.24)
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- Of right to be informed of circumstances bearing on risk of nonpayment (see §§22.4, 22.24)
- Of subrogation or reimbursement (see §22.4, 22.24)
- Of presentment, demand for performance, notices of nonperformance, protest, notices of protest, notices of dishonor, and notices of acceptance (see §§22.4, 22.24)
- Of other statutory protections (see §§22.25-22.28)

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.2 II. DEFINITIONS AND APPLICABLE LAW

§22.2 II. DEFINITIONS AND APPLICABLE LAW

A guaranty is an original, independent undertaking to answer for the debt, default, or miscarriage of another. CC §2787. A contract of guaranty creates an obligation separate and independent from that which binds the principal obligor or debtor. *Coppola v Superior Court* (1989) 211 CA3d 848, 259 CR 811.

Typically, there are three parties relevant to a guaranty:

- The person or entity whose obligations are guaranteed is the debtor, the principal, the obligor, or the borrower;
- The person or entity guaranteeing the obligations is the guarantor or the surety; in California, there is no legal distinction between the two terms (CC §2787); and
- The person or entity for whose benefit the guaranty is made is the creditor, the obligee, the lender, or the bank.

For simplicity of discussion, this chapter will use the terms "debtor," "guarantor," and "creditor."

A guaranty is requested when the creditor is concerned that the debtor lacks the necessary financial strength or business experience to meet its obligations. The guaranty gives the creditor another party to look to if the debtor defaults.

To have an effective guaranty, the guarantor cannot be otherwise liable for the guaranteed obligation. For example, if a general partner guarantees the obligation of the partnership, the guaranty is not valid because the general partner is liable on the guaranteed debt in its position as a general partner. See *Westinghouse Credit Corp. v Barton* (CD Cal 1992) 789 F Supp 1043; *River Bank Am. v Diller* (1995) 38 CA4th 1400, 45 CR2d 790. Similarly, when an inter vivos revocable trust is the principal debtor, a guaranty by the trustee and settlor of the trust is ineffective because the guarantor and the debtor are essentially the same. See *Cadle Co. II v Harvey* (2000) 83 CA4th 927, 933, 100 CR2d 150.

A guaranty may relate to virtually all obligations, including performance, payment of money, and collection of money. A *performance guaranty* is often required by creditors for real estate construction loans. See California Real Estate Finance Practice: Strategies and Forms §6.17 (Cal CEB 2000) and California Mechanics' Liens and Related Construction Remedies §§2.102-2.103, 8.35 (3d ed Cal CEB 1998) for discussion of this complex subject. A *collection guaranty* differs from a *payment guaranty* in that the former creates liability for the guarantor only after the creditor's collection efforts fail, but the latter creates liability immediately after nonpayment. See CC §§2799-2802. Most commercial guaranties are guaranties of payment, rather than collection, because a lender does not want to spend time, money, and energy in a fruitless attempt to collect from the debtor before it can seek payment from the guarantor. In attempting to satisfy that requirement of a collection guaranty, the lender also risks inadvertently releasing the guarantor or being stayed from pursuing the guarantor during the debtor's bankruptcy.

The general rules of law pertaining to guarantors in California appear in CC §§2787-2856. Certain types of guaranties made in connection with negotiable instruments are covered by Com C §§3116(a), (b), 3305(d), 3419, and 3605. These provisions should be reviewed carefully before drafting a guaranty.

However it is important to distinguish a "guaranty" from an "indemnity" agreement, which may appear to be similar. The primary distinction between a guaranty and an indemnity contract is that a guarantor makes a promise for which he is personally responsible, whereas an indemnitor saves a third party from loss. *Somers v U.S. Fid. & Guar. Co.* (1923) 191 C 542, 547, 217 P 746. This distinction is an important one because the party providing indemnity is not entitled to the same benefits and protections available to a guarantor. *Trust One Mortgage Corp. v Invest Am. Mortgage Corp*. (2005) 134 CA4th 1302, 1309, 37 CR3d 83.

It is also important to distinguish a "guaranty" relationship from an insurance relationship. Unlike a guarantor, the provider of insurance may not be subrogated to all of the insured's rights against third parties. As a compensated insurer, an insurance company's right to recover from third parties is limited by the doctrine of superior equities. In other words, an insurance provider may recover from a third party only if, as between the insurer and the third party, it would be equitable or fair to permit that recovery. *State Farm Gen. Ins. Co. v Wells Fargo Bank, N.A.,* (2006) 143 CA4th 1098, 1108, 49 CR3d 785.

Finally, it is important to distinguish a "guaranty" relationship from one in which a third party would be benefited by performance of a contract by two other parties. Such a third party may be motivated to satisfy the obligations of others even though not contractually obligated to do so. However, as a mere volunteer, such a third party may not have the rights that a guarantor or third party beneficiary would have. *Souza v Westlands Water Dist.* (2006) 135 CA4th 879, 38 CR3d 78. But see *Amwest Surety Ins. Co. v Patriot Homes, Inc.* (2005) 135 CA4th 82, 37 CR3d 195 (bonding company may rely on general indemnity agreement to recover for payments made on bond issued under statutory requirements); *Electrical Electronic Control, Inc. v Los Angeles Unified Sch. Dist.* (2005) 126 CA4th 601, 24 CR3d 316 (subcontractor entitled to recover from school district that failed to enforce bonding requirement for general contractor that was intended to protect subcontractors).

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§22.3 A. Extent of Liability

Absent a contractual agreement that provides otherwise, the liability of a guarantor accrues at the same time as that of the principal, or on default of the principal. *Bloom v Bender* (1957) 48 C2d 793, 799, 313 P2d 568. However, the guarantor's liability is not necessarily extinguished at the same time as that of the principal. In *Bloom*, the court held that the guarantor's obligation on her continuing guaranty was not barred when the statute of limitations had run against the obligation of the principal, because the statute of limitations on the guarantor's obligation had been tolled during a 13-month period when the guarantor was absent from the state.

A guarantor's obligation may not be larger in amount or more burdensome in other respects than the debtor's obligation. CC §2809. Thus, partial satisfaction of the primary obligation reduces the guarantor's obligation to an equal extent (CC §2822), and the guarantor may rely on defenses available to the debtor other than personal disabilities. CC §2810.

In *River Bank Am. v Diller* (1995) 38 CA4th 1400, 45 CR2d 790, individual guarantors of a nonrecourse construction loan challenged the validity of their guaranty under CC §2809 on the grounds that the guaranty imposed on them obligations "larger in amount … [or] in other respects more burdensome" than the nonrecourse obligations undertaken by the principal obligor. The court ruled that the guarantors had effectively waived any defense based on §2809 and therefore did not decide whether the guarantors had a valid argument. It did, however, "briefly outline" the arguments on each side. Counsel who wishes to make this argument should review the court's opinion.

A guarantor is liable for attorney fees and costs if the signed instrument guarantees payment of the primary obligation according to its terms, and the primary obligation provides for payment of attorney fees and costs. *Niederer v Ferreira* (1987) 189 CA3d 1485, 234 CR 779. It is better practice, however, for the creditor's counsel to include the attorney fees provision in the guaranty. See §§16.57-16.61. If the guaranteed obligation is a book account, attorney fees can be recovered from the guarantor only if there is a specific contractual provision in the guaranty. CC §1717.5.

A guaranty may be limited to certain transactions or it may be continuing, relating to all present and future obligations of the debtor. See CC §2814. See also §22.5.

Liability may be limited to a certain dollar amount, limited to a certain principal dollar amount, or unlimited. It may also be limited in duration. See comment to form in §22.18.

One issue for the drafter to consider is whether the amount stated in the guaranty is intended to limit the sum guaranteed or limit the amount of credit that may be extended to the debtor. A guarantor may have valid reasons for limiting not only the amount of his or her liability, but the total indebtedness of the principal debtor as well. One reason could be to prevent the debtor from incurring indebtedness beyond that which it could pay. Another reason could be to try to ensure that the debtor retained some free and clear assets that the guarantor could reach if it had to step in and satisfy the obligation. Unless the guaranty provides otherwise, the amount specified will generally be considered a limitation only on the amount guaranteed. See Anno, *Extension of net credit in excess of specified amount as discharging or releasing guarantor*, 57 ALR2d 1209 (1958).

Effectiveness of the guaranty may be conditioned on some event, such as execution of a guaranty by a coguarantor, or it may be unconditional. Unless stated otherwise, a guaranty is construed to be unconditional. CC §2806.

The independent promise to pay or perform stated in a guaranty may be secured. A guaranty directly secured by real property probably entitles the guarantor to the benefits and protections of the one-action rule and antideficiency statutes. See §§22.25-22.26. A secured guaranty may or may not be limited to the value of the collateral securing it. The language of the guaranty should reflect the parties' intent. Once the primary obligation has matured, the creditor may also rely on any security given by the debtor to the guarantor. CC §2854.

Guaranties are assignable, absent a clear intent to the contrary. Even when a guaranty expressly states that it is not assignable, it effectively can be assigned if the guaranteed obligation is pledged by the beneficiary of the guaranty to secure the beneficiary's own obligation to a third party. The guaranty is a "supporting obligation" under Com C §9102(77), and, as such, under Com C §9308, perfection of a lien on the guaranteed obligation perfects a lien on the guaranty.

An assignment of a debt includes assignment of the guaranty securing the debt; a separate assignment, although desirable, is not necessary. *Champion Home Builders Co. v Sipes* (1990) 219 CA3d 1415, 269 CR 75. An assignee stands in the shoes of its assignor and can assert only the rights the assignor could have enforced. See *U.S. v Garan* (9th Cir 1993) 12 F3d 858 (assignor bank's oral agreement allowing guarantor to revoke guaranty was binding on bank's assignee).

One issue that may arise in the guaranty of a lease is whether the guaranty extends to renewal terms. When a guaranty is a continuing guaranty applying to future obligations, is irrevocable, contains standard waivers of statutory suretyship rights, and expressly provides that the guaranteed lease obligations may be modified without consent of the guarantor; extensions and modifications to a guaranteed lease will not give guarantors a defense to performance. *Central Bldg., LLC v Cooper* (2005) 127 CA4th 1053, 1061, 26 CR3d 212. However, the careful drafter should clearly indicate what the parties intend will happen when the original lease expires, or is extended or modified. Will the guaranty remain in effect for one or more renewal terms? Will it apply if there is a holdover by the tenant debtor? Will it cover an extension of the lease by mutual agreement of the creditor and debtor? Will it remain in effect if the creditor and debtor enter into a new lease for the same premises? While these points could be addressed in the recitals to indicate the parties' intent on the scope of the guaranty, the better course would be to devote a section of the guaranty itself to the issue.

Finally, the extent of liability on a guaranty may be subject to the introduction of parol evidence. In *Pacific State Bank v Greene* (2003) 110 CA4th 375, 1 CR3d 739, the court permitted a guarantor to introduce parol evidence relating to the scope of the guaranty and the parties' intent regarding it even though the court found that the language of the guaranty was clear and unambiguous. The decision could allow a guarantor to introduce parol evidence relating to the scope of the waiver language.

Regardless of efforts to make the documents clear, it is possible that subsequent action by the parties could be interpreted as modifying the underlying guaranteed obligation, and thus modifying the guarantor's liability, notwithstanding language in the guaranty to the contrary. See *Fanucchi & Limi Farms v United Agric. Prods.* (9th Cir 2005) 414 F3d 1075, 1081 (guaranteed obligation held to have been terminated and replaced via novation).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.4 B. Rights of Guarantor and Obligations of Creditor

§22.4 B. Rights of Guarantor and Obligations of Creditor

As with all contracts, there is an implied covenant of good faith and fair dealing in guaranty agreements. This covenant requires the creditor to disclose to the guarantor any facts within its knowledge that would materially increase the risk that the guarantor intends to assume. *American Sec. Bank v Clarno* (1984) 151 CA3d 874, 199 CR 127. A creditor's failure to disclose material information may give a guarantor a defense to the enforcement of the guaranty. See generally Anno, *Creditor's duty of disclosure to surety or guarantor after inception of suretyship or guaranty*, 63 ALR4th 678 (1988). With a continuing guaranty, there may be a duty of disclosure before each new credit extension. See *Sumitomo Bank v Iwasaki* (1968) 70 C2d 81, 73 CR 564.

A guarantor may compel the debtor to perform. CC §2846; CCP §1050. A guarantor may also require the creditor to proceed against the debtor, "or to pursue any other remedy in the creditor's power which the [guarantor] can not pursue, and which would lighten the [guarantor's] burden; and if the creditor neglects to do so, the [guarantor] is discharged to the extent to which [it] is thereby prejudiced." CC §2845. A guarantor may also require the creditor to proceed against the debtor's property securing the primary obligation before proceeding against the guarantor's property securing the obligation. CC §2850.

If the guarantor performs, the debtor must reimburse the guarantor for amounts expended. CC §2847. The guarantor may seek reimbursement by pursuing the creditor's remedies against the debtor (subrogation) unless the debtor has no remaining liability to the creditor as a result of California's antideficiency laws. See §22.25. The guarantor may also seek reimbursement by pursuing the creditor's remedies against cosureties (contribution). CC §§2848-2849. However, the guarantor has no claim for reimbursement against other persons who may have benefited from the guarantor's performance. See *Top Cat Prods. Inc. v Michael's Los Feliz* (2002) 102 CA4th 474, 125 CR2d 553. The applicant for a letter of credit is not entitled to contribution under CC §1432 from guarantors of the obligations to the letter of credit beneficiary even though the obligations are satisfied on drawing under a letter of credit. *Morgan Creek Residential v Kemp* (2007) 153 CA4th 675, 63 CR3d 232. The applicant contractually obligates itself to reimburse the letter of credit issuer on drawing, regardless of the nature of the underlying obligations. For a more detailed discussion, see California Real Estate Finance Practice: Strategies and Forms (Cal CEB 2000).

The guarantor is relieved of liability, except to the extent indemnified by the debtor, if, without the guarantor's consent, the creditor materially alters the primary obligation or impairs or suspends the creditor's rights against the principal. CC §§2819-2821, 2824. See *U.S. on Behalf of Army Athletic Ass'n v Reliance Ins. Co.* (9th Cir 1986) 799 F2d 1382, 1385. Similarly, the guarantor is exonerated and released if the principal obligor is voluntarily released of liability without the guarantor's consent. See *R.P. Richards, Inc. v Chartered Const. Corp.* (2000) 83 CA4th 146, 99 CR2d 425. Such a voluntary release might even occur in a bankruptcy proceeding. See, *e.g.*, *Conner v Conner* (1999) 76 CA4th 646, 90 CR2d 687.

NOTE: Absent an express term in a guaranty permitting modification of the guaranteed obligations, a modification of the underlying obligation generally does not revoke a continuing guaranty, but does modify the guaranty to the extent that the underlying obligation is modified. A guarantor is only discharged if the modification (other than an extension of time) creates a substituted contract or imposes risks on the secondary obligor fundamentally different from those imposed on the guarantor before modification. *Central Bldg., LLC v Cooper* (2005) 127 CA4th 1053, 26 CR3d 212.

The guarantor's consent to these actions may be given in advance in the guaranty agreement. *State Bd. of Equalization v Carleton* (1990) 223 CA3d 1607, 273 CR 436. As a practical matter, even when the guaranty includes such a consent, the prudent creditor will obtain a separate consent from the guarantor before it alters the primary obligation in a way that increases the risk of liability to the guarantor. Because of the fragile nature of a guaranty, most lenders, despite waivers in the guaranty that permit the lender to do otherwise, will also give the guarantor an opportunity to cure defaults of the primary obligation and will notify the guarantor before making an election of remedies with respect to the primary obligation.

In general, the statutory provisions that protect guarantors may be specifically waived in advance by the guarantor in the guaranty, unless the waiver is against public policy. CC §3268. See *WRI Opportunity Loans II, LLC v Cooper (*2007) 154 CA4th 525, 65 CR3d 205 (guarantor may not waive statutory usury defense, because guaranteed obligation was illegal and against public policy). California courts have recognized that the various Civil Code defenses and rights can be waived by a guarantor. See *Pearl v General Motors Acceptance Corp.* (1993) 13 CA4th 1023, 16 CR2d 805 (referring to CC §2815); *Union Bank v Ross* (1976) 54 CA3d 290, 126 CR 646 (referring to CC §§2819 and 2845); *Brunswick Corp. v Hays* (1971) 16 CA3d 134, 93 CR 635 (referring to CC §§2845 and 2849). See also *U.S. v Grayson* (9th Cir 1989) 879 F2d 620 (waiver of right to notice of default by debtor); *Krueger v Bank of America* (1983) 145 CA3d 204, 193 CR 322 (waiver of right to require creditor to first exhaust security and consent to subsequent modification); *Southern Cal. First Nat'l Bank v Olsen* (1974) 41 CA3d 234, 116 CR 4 (waiver of right of exoneration). A waiver of any statute of limitations, for example, is enforceable to the extent permitted by law. *California First Bank v Braden* (1989) 216 CA3d 672, 264 CR 820 (applying CCP §360.5, statute of limitations extended 4 years beyond otherwise applicable date, or 4 years after signing of waiver, whichever was later). See §§22.23-22.29.

The courts have differed, however, on the precise language that is adequate to constitute a waiver of the guarantor's defenses. Therefore, the person drafting the waiver language must do so with care. See §§22.23-22.29. Furthermore, in a situation in which the guarantor is liable because it pledged collateral to secure the principal obligor's debt to the secured party, the guarantor cannot waive in advance its rights under California Com C Div 9. See Com C §9602.

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§22.5 C. Termination of Liability

A guarantor may be exonerated and its liability under the guaranty may be discharged. In addition to discharge as described in CC §§2819-2821, 2824, 2839 (see §22.4), a guarantor under a continuing guaranty may terminate liability for future transactions by revoking the guaranty, unless the guarantor continues to receive consideration. CC §2815. The creditor's knowledge of a guarantor's death acts as a revocation of that guarantor's continuing guaranty. *American City Bank v Tourtelot* (1978) 86 CA3d 585, 150 CR 361. Revocation of the continuing guaranty, however, does not terminate the guarantor's liability for guaranteed obligations that arose or were committed to before the revocation.

If the primary obligation is discharged by operation of law, without any act or omission by the creditor, the guarantor's liability is not affected. CC §2825. Thus, a debtor's bankruptcy does not discharge a guarantor's obligations. *Superior Wholesale Elec. Co. v Cameron* (1968) 264 CA2d 488, 70 CR 636.

If the creditor resorts to arbitration, an award granted only against the debtor is not enforceable against the guarantor. CC §2855. For discussion of arbitration, see chap 16.

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III. REQUISITES AND VALIDITY OF GUARANTY

§22.6 A. Signed Writing

A guaranty must be in writing and signed by the guarantor, unless it is an original obligation of the guarantor. CC §2793. See CC §2794 for examples of what would be deemed "original obligations" of the guarantor.

No particular form of guaranty is required. *Superior Wholesale Elec. Co. v Cameron* (1968) 264 CA2d 488, 70 CR 636. Typical forms of guaranty used by financial institutions are likely to favor the creditor's legal interests, and, by accepting such a form, a guarantor may be giving up more rights than may be necessary. Waivers of notice, waivers of claims and defenses, waivers or extensions of limitations periods, waivers of rights to a jury trial, consents to assignments, waivers of rights in connection with collateral securing the guaranteed obligations, and waivers of rights of subrogation are all extremely common but are subject to negotiation. Each should be analyzed in terms of its applicability to the facts of the transaction and possible consequences to the guarantor. As a practical matter, however, the guarantor may have little room for bargaining, or the cost of negotiating a more favorable guaranty may not be justified in the circumstances. Nevertheless, the attorney representing a guarantor who fails to explain the import of "typical" provisions does the client a great disservice.

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§22.7 B. Consideration

A guaranty must be supported by consideration. The consideration for a guaranty is often identical to the consideration for the principal obligation. If a guaranty is entered into at the same time as the original obligation, consideration is assumed and no further consideration is necessary. CC §2792. See *Rancho Santa Fe Pharmacy, Inc. v Seyfert* (1990) 219 CA3d 875, 268 CR 505; *Niederer v Ferreira* (1987) 189 CA3d 1485, 234 CR 779.

Consideration may be either the contemporaneous or subsequent lending of money, or forbearance from collecting a previously incurred debt. *Donovan v Wechsler* (1970) 11 CA3d 210, 89 CR 669; *Beverly Hills Nat'l Bank v Glynn* (1968) 267 CA2d 859, 73 CR 808; *Superior Wholesale Elec. Co. v Cameron* (1968) 264 CA2d 488, 70 CR 636.

If the guaranty is given after the primary agreement, separate consideration is usually required (CC §2792), unless the guaranty was an intrinsic part of the principal transaction; *i.e.,* the transaction would not have occurred except for the guarantor's promise. *Donovan v Wechsler, supra*. Similarly, if a loan and a later executed guaranty are in reality a single transaction, no other consideration is required. *Beverly Hills Nat'l Bank v Glynn, supra*. When a continuing guaranty is granted for present or future loans, sufficient consideration exists to support enforceability of the guaranty for the loans. *Oakland Bank of Commerce v Washington* (1970) 6 CA3d 793, 86 CR 276.

A guaranty of a negotiable instrument subject to Commercial Code Division 3 may be enforced whether or not the guarantor (the accommodation party) receives consideration for the guaranty. Com C §3419.

Another context in which the issue of consideration may arise is in connection with fraudulent transfers under United States bankruptcy law or under the California Uniform Fraudulent Transfer Act (CC §§3439-3439.12). Under either statute, a transfer of assets or the creation of an obligation such as a guaranty may be voided. Under 11 USC §548, a bankruptcy trustee may avoid a transfer or an obligation as a fraudulent transfer if, among other things, the debtor received less than "a reasonably equivalent value" and was insolvent at the time or met one of several other specified tests of poor financial condition. Consequently, a trustee will scrutinize the nature and extent of consideration given, *e.g.,* for guaranties between related corporations. See Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U Pa L Rev 235 (Dec. 1976).

Similarly, under CC §§3439.04 and 3439.05, any creditor of a party that has executed a guaranty may seek to void the guaranty if (1) the guarantor did not receive reasonably equivalent consideration in connection with the guaranty, and (2) the guarantor was insolvent at the time or made insolvent thereby, or the guarantor was engaged or about to engage in business with unreasonably small capital or believed that it was about to incur debts beyond its ability to pay as they came due.

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§22.8 C. Interpretation

Contracts of guaranty are interpreted according to general rules of contract construction. CC §§1642, 1650, 2837; *Superior Wholesale Elec. Co. v Cameron* (1968) 264 CA2d 488, 70 CR 636. The objective in interpreting these contracts is to ascertain and effectuate the intent of the parties; therefore, that intent should be clearly expressed. See *Levy v Ross* (1969) 269 CA2d 231, 74 CR 622.

When a guaranty agreement incorporates another contract, the two documents are read together and construed fairly and reasonably as a whole according to the intention of the parties. *Central Bldg., LLC v Cooper* (2005) 127 CA4th 1053, 26 CR3d 212. When a bond is given to satisfy a statutory obligation, the relevant statutory provisions are incorporated into the guaranty. *Electrical Electronic Control, Inc. v Los Angeles Unified Sch. Dist.* (2005) 126 CA4th 601, 24 CR3d 316; *Amwest Surety Ins. Co. v Patriot Homes, Inc.* (2005) 135 CA4th 82, 37 CR3d 195.

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IV. SAMPLE GUARANTY AGREEMENT

§22.9 A. Format and Title

No particular form is required for a guaranty. Provisions making up one form of guaranty are set forth in §§22.11-22.33. For other forms, see McConville, *Annotated Form of Guaranty*, 15 Bus L News 9 (Spring 1993); Heitner & Frank, *The Enforceable Guarantee: Illusion or Reality?* 8 Cal Real Prop J 1 (Spring 1990); California Real Estate Finance Practice: Strategies and Forms, chap 6 (Cal CEB 2000).

There is no legal requirement to use a title, but doing so helps to identify the instrument. Common titles are:

- Continuing Guaranty
- Guaranty of Lease
- Limited Guaranty

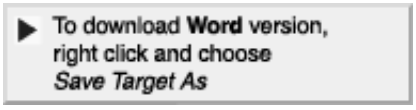
© The Regents of the University of California

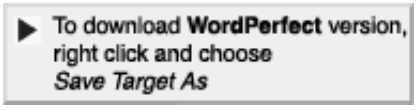
§22.10 B. Introductory Clause

The guaranty should identify the parties, the purpose of the guaranty, and the consideration, which can be accomplished by an introductory clause or, in a more complex document, by separate paragraphs in a recitals section. See §§22.11-22.14, chap 7.

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§22.11 1. Form: Introduction for Use Without Recitals





22.11-1 Introduction for use without recitals

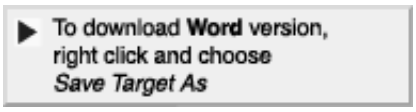
_ _[*Name of guarantor*]_ _ **("Guarantor") is executing this Guaranty as of** _ _[*date*]_ _**, to induce** _ _[*name of creditor*]_ _ **("Creditor") to** _ _[*e.g., sell certain personal property to* _ _[*name*]_ _ *("Debtor") and to extend credit to Debtor in connection with that sale*]_ _**.**

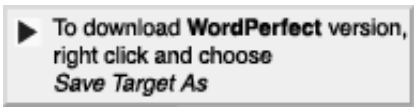
Comment: Introductory clauses for a guaranty are similar to those used in drafting other business agreements. See chap 5.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.12 2. Form: Introduction for Use With Recitals

§22.12 2. Form: Introduction for Use With Recitals





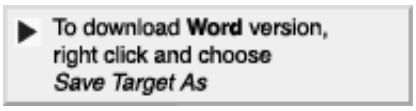
22.12-1 Introduction for use with recitals

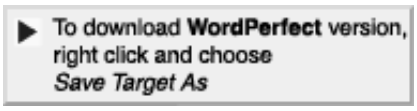
This guaranty ("Guaranty") is made as of _ _[*date*]_ _, by _ _[*name of guarantor*]_ _ ("Guarantor") in favor of _ _[*name of creditor*]_ _ ("Creditor"), with reference to the following facts, which are a material part of this Guaranty:

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C. Recitals

§22.13 1. Form: Recitals for Guaranty of Debt to Bank





22.13-1 Recitals for guaranty of debt to bank

A. Bank has agreed to make a loan ("Loan") to Debtor in the principal sum of $_ _[*amount*]**_ _.**

B. _ _[*Specify benefit to guarantor, e.g., Guarantor is the owner of all issued and outstanding capital stock in Debtor, and has received and will continue to receive from Debtor a significant benefit for undertaking the obligations described in this Guaranty*]**_ _.**

C. In consideration of Bank making the Loan, Guarantor has agreed, at Debtor's request, to unconditionally guarantee _ _[*collection/payment*]**_ _ of any and all indebtedness of Debtor to Bank, as provided in this Guaranty.**

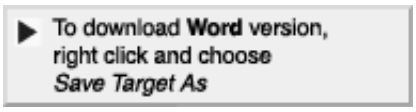
THEREFORE, in consideration of the foregoing and for other valuable consideration, the receipt and sufficiency of which Guarantor acknowledges, Guarantor agrees as follows:

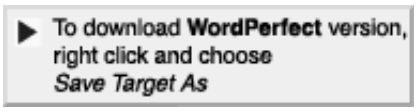
Comment: It is useful to include recitals in the body of the guaranty to establish a factual context for the legal document and assist in identifying the parties' intent and consideration granted. See §§5.17-5.22, 7.3-7.4.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.14 2. Form: Recitals for Guaranty of Lease

§22.14 2. Form: Recitals for Guaranty of Lease





22.14-1 Recitals for guaranty of lease

A. Guarantor is the owner of all issued and outstanding stock of _ _[*name of principal*]_ _ ("Tenant").

B. Guarantor transacts significant business with Tenant and desires to assist Tenant in obtaining from Landlord a lease ("Lease") in the form attached to this Guaranty as Exhibit A.

C. Guarantor has received and will continue to receive a significant benefit from Tenant for undertaking the obligations described in this Guaranty.

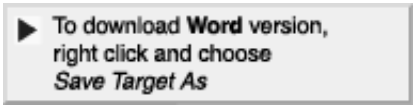
D. Landlord would not execute the Lease except for Guarantor's execution and delivery of this Guaranty to Landlord.

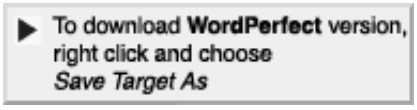
THEREFORE, in consideration of the foregoing and for other valuable consideration, the receipt and sufficiency of which Guarantor acknowledges, Guarantor agrees as follows.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.15 D. Form: Guaranty of Payment

§22.15 D. Form: Guaranty of Payment





22.15-1 Guaranty of payment

___. *Guarantee of Payment.* Guarantor unconditionally guarantees and promises to pay to Creditor, or order, on demand, in lawful money of the United States, any and all Indebtedness of Debtor to Creditor.

[*Add one of the following alternatives*]

[*Alternative 1: Liability limited to specific transaction*]

"Indebtedness" is used in this Guaranty to mean Debtor's indebtedness to Creditor as shown by _ _[*identify indebtedness instrument*]**_ _.**

[*Alternative 2: Liability unlimited*]

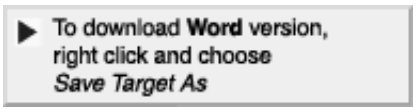
"Indebtedness" is used in this Guaranty in its most comprehensive sense and includes without limitation that unsecured loan in the original principal amount of $_ _[*amount*]**_ _ made by Creditor to Debtor concurrently with the execution of this Guaranty, and any and all advances, debts, obligations, and liabilities of Debtor, _ _**[*or any one or more of them,*]**_ _ made, incurred, or created previously, now, or later, whether voluntary or involuntary and however arising, direct or acquired by Creditor by assignment or succession, due or not due, absolute or contingent, liquidated or unliquidated, or determined or undetermined, whether Debtor may be liable individually or jointly with others, whether recovery is or later becomes barred by any statute of limitations, or whether now or later it is otherwise unenforceable.**

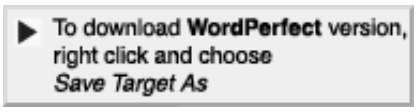
Comment: If the guaranty is limited in amount, the guarantor may want to specify how payments made by the debtor are to be applied. Otherwise, the creditor may be able to apply payments to unguaranteed debt. *Giordano v American Fid. & Cas. Co.* (1950) 97 CA2d 309, 217 P2d 444. See also *Brunswick Corp. v Hays* (1971) 16 CA3d 134, 93 CR 635.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.16 E. Form: Guaranty of Performance

§22.16 E. Form: Guaranty of Performance





22.16-1 Guaranty of performance

___. *Guaranty of Performance.* Guarantor unconditionally guarantees and agrees (a) to perform and comply with all provisions and conditions of _ _[*e.g., the Loan Documents*]**_ _ binding on or otherwise applicable to Debtor and any changes or additions to the same, and all provisions and conditions of any rider or exhibit made a part of _ _**[*e.g., the Loan Documents*]**_ _ now or later existing; and (b) to cause the same to be performed and complied with. "Perform and comply with" are used in this Guaranty in their most comprehensive sense and include without limitation _ _**[*e.g., construction of the Improvements on the Property within the times and in the manner provided by any of the Loan Documents and any Construction Contract now or later in existence*]**_ _.**

Comment: A guaranty may extend to performance as well as to the payment of a monetary obligation. This type of guaranty is commonly required in connection with real estate construction loans. See California Real Estate Finance Practice: Strategies and Forms, chap 6 (Cal CEB 2000).

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F. Liability of Guarantor

§22.17 1. Form: Unlimited Liability

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

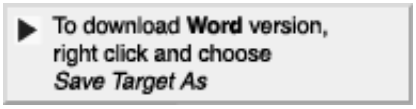
22.17-1 Unlimited liability

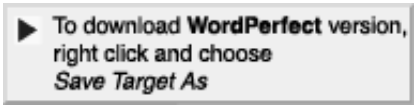
___. *Unlimited Liability.* Guarantor's liability under this Guaranty is unlimited. This is a continuing guaranty relating to any Indebtedness of Debtor to Creditor, including any Indebtedness arising under successive transactions, which may either continue the Indebtedness or from time to time renew it after it has been satisfied. This Guaranty does not apply to any Indebtedness created after actual receipt by Creditor of written notice of revocation of this Guaranty as to future transactions.

Comment: If a guaranty is not limited in time but is continuing, it can be revoked at any time, absent contractual agreement to the contrary. See §22.5. The parties should clearly specify how to give notice, to whom it should be given, and when it will be effective. See chap 17.

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§22.18 2. Form: Limited Liability





22.18-1 Limited liability

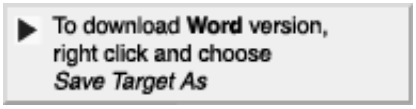
___*. Limited Liability.* Guarantor's liability under this Guaranty is limited to the principal amount of $_ _[*amount*]_ _, interest on that amount, and collection costs, including reasonable attorney fees and costs. Guarantor further agrees, without demand, to immediately reimburse Creditor for all expenses, including attorney fees, incurred in the enforcement of this Guaranty or the collection of the Indebtedness, or in connection with the engagement of counsel by Creditor during a restructuring or "workout" of the Indebtedness.

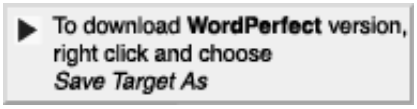
Comment: A guaranty can be limited in amount or duration, or conditional on the occurrence of certain contingencies. If a guaranty is for a limited time, the better practice is to specify the date it will expire. A guaranty "for 120 days," for example, was held in one case not to be a limitation on the guaranty's duration, but rather the period during which credit could be extended in reliance on it. See *Merrimack Valley Nat'l Bank v Baird* (Mass 1977) 363 NE2d 688. In some instances (*e.g.,* multiple guarantors signing the guaranty at different times), it may also be necessary to specify when the guaranty becomes effective.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.19 3. Form: Security

§22.19 3. Form: Security





22.19-1 Security

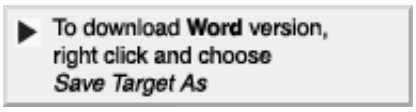
___. *Security.* Guarantor's performance of the obligations in this Guaranty is secured by _ _[*describe security*]**_ _.**

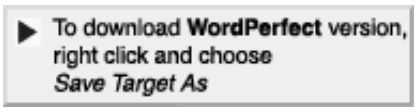
Comment: See California Real Estate Finance Practice: Strategies and Forms, chap 6 (Cal CEB 2000).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.20 G. Form: Rights of Setoff

§22.20 G. Form: Rights of Setoff





22.20-1 Rights of setoff

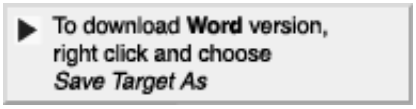
___. *Rights of Setoff.* In addition to all liens on and rights of setoff against Guarantor's money, securities, and other property given to Creditor by law, Creditor has a right of setoff against all of Guarantor's money, securities, and other property now or later in the possession of or on deposit with Creditor, whether held in a general or special account or deposit, for safekeeping, or otherwise. Every security interest and right of setoff may be exercised without demand on or notice to Guarantor. No action or nonaction by Creditor with respect to any security interest or right of setoff will be considered a waiver of either; and every security interest and right of setoff will continue in full force and effect until specifically waived or released by an instrument in writing executed by Creditor.

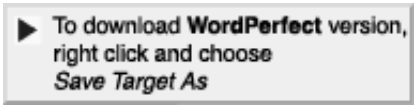
Comment: This type of provision is commonly found in a lender's standard form guaranty, since the lender may already be in possession of property of the guarantor. When a creditor holds "mixed collateral," however, the exercise of rights under such a provision must be considered carefully in light of California's "one form of action" rule. CCP §726. See, *e.g., Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201. See generally Secured Transactions in California Commercial Law Practice §5.12 (2d ed Cal CEB 2001).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.21 H. Form: Subordination

§22.21 H. Form: Subordination



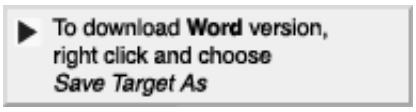


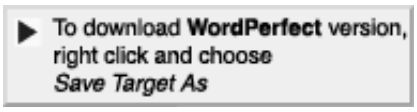
22.21-1 Subordination

___. *Subordination.* Any indebtedness of Debtor now or later owed to Guarantor is subordinated to the Indebtedness; and, if Creditor requests, any indebtedness of Debtor now or later owed to Guarantor will be collected, enforced, and received by Guarantor as trustee for Creditor and paid over to Creditor on account of the Indebtedness, without affecting Guarantor's liability under this Guaranty.

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§22.22 I. Form: Guarantor's Representations and Warranties





22.22-1 Guarantor's representations and warranties

___. Guarantor's Representations and Warranties.

(a) Guarantor represents and warrants that Guarantor has derived or expects to derive a financial advantage from every loan and other extension of credit from Creditor to Debtor, and from every renewal, extension, release of collateral, and other relinquishment of legal rights made or granted, now or in the future, by Creditor to Debtor in connection with the Indebtedness.

(b) Guarantor represents and warrants that Guarantor has copies of, and is fully familiar with, every document executed or delivered to Creditor by Debtor, and represents and warrants that all necessary action, whether corporate or otherwise, has been taken by Debtor to authorize Debtor to execute those documents and to engage in the transactions described in them.

Comment: Additional representations and warranties, such as statements about the guarantor's organization and good standing, its authority to enter into the guaranty, its securing of all necessary consents and approvals, the accuracy of its financial statements, the absence of litigation, and the absence of conflict with other agreements, may also be included. See chap 12.

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J. Waivers

§22.23 1. Drafting Waivers to Conform to CC §2856

For a waiver to be effective, it must be made knowingly and voluntarily. The courts have started from the proposition that waiver documents should be interpreted most strongly against the creditor, and all ambiguities should be interpreted against the creditor. See, *e.g.*, *Pearl v General Motors Acceptance Corp*. (1993) 13 CA4th 1023, 16 CR2d 805. In the absence of an explicit waiver, some courts have held that they would not find a waiver by implication. *Cathay Bank v Lee* (1993) 14 CA4th 1533, 18 CR2d 420; *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64. Other courts have gone further, holding that the guaranty must contain a specific description of the rights being waived (*Torrey Pines Bank v Hoffman* (1991) 231 CA3d 308, 282 CR 354) or that the specific statutory provisions intended to be waived must be expressly identified (*Indusco Mgmt. Corp. v Robertson* (1974) 40 CA3d 456, 114 CR 47; *Mariners Sav. & Loan Ass'n v Neil* (1971) 22 CA3d 232, 99 CR 238). A general waiver of all suretyship defenses has been held not sufficient. *Pearl v General Motors Acceptance Corp., supra*.

In 1994, CC §2856 was enacted, which authorized waivers of a guarantor's various rights and defenses. The purpose of the new law was to establish a standard for waivers that was less stringent than the standard established by the *Cathay Bank* decision. See *River Bank Am. v Diller* (1995) 38 CA4th 1400, 1418, 45 CR2d 790. However, in *Bank of S. Cal. v Dombrow* (1995) 39 CA4th 1457, 46 CR2d 656, opinion withdrawn and ordered not published (Cal, Mar 16, 1996) 96 Cal Daily Op Svc 1922, the court held that the waiver was not sufficiently clear and continued to impose a stringent standard on guarantor waivers.

In 1996, a revised version of CC §2856 was enacted. The language in revised CC §2856 is clear; it appears to set the standard for all waivers of guarantor defenses and to eliminate any higher standards indicated by previous case law. See *River Bank Am. v Diller, supra* ("[I]n apparent response to *Cathay Bank*'s strict holding, the Legislature enacted section 2856."). Unfortunately, few courts have addressed revised CC §2856. Moreover, the reported legislative intent leaves open an opportunity for confusion because it states that: "[s]ubdivisions (a) and (b) of Section 2856 of the Civil Code do not represent a change in, but are merely declarative of, existing law." Stats 1994, ch 1204, §2. It could be argued that this statement of legislative intent weakens the authority of revised CC §2856 by carving out exceptions for prior cases that impose a higher standard for waivers of a guarantor's defenses, and by creating an overlay of equitable principles. See *Cathay Bank v Lee, supra*; *Indusco Mgmt. Corp. v Robertson, supra*. Moreover, by characterizing CC §2856 as declarative of existing law, the legislative history raises a question whether the earlier, more stringent cases have any continuing viability.

As a consequence of these developments, it is reasonable to assume that a waiver drafted with the recommended language of revised CC §2856 should be adequate to waive the guarantor's rights and defenses. If the language recommended in §2856 is not used, however, there could be potential problems with enforceability. For a form employing the language of CC §2856, see §22.25A.

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§22.23A 2. Issues in Drafting Effective Waivers

To help ensure that the waiving party has knowledge of the waiver, the drafting attorney should make sure that it is conspicuous and that its meaning and intent are clear. The waiver should not be buried in the middle of a long run of text, nor should it be ambiguous about what rights are being relinquished. See *Pearl v General Motors Acceptance Corp.* (1993) 13 CA4th 1023, 16 CR2d 805 (no waiver of guarantor's right to revoke continuing guaranty). It is also helpful to include a statement to the effect that the guarantor has had an opportunity to consult with counsel of its choice on the effect of any waiver and other terms of the guaranty.

If specific statutory rights are being waived, it is helpful to identify code sections by number, which will serve as a "red flag" for out-of-state counsel, who may not be familiar with California law.

One waiver issue that sometimes arises when there is personal property security for the guaranteed obligation is the effectiveness of a waiver of notice of sale in the guaranty. Unless collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, the secured party must give to the debtor a notice in writing of the time and place of any public sale or of the time on or after which any private sale or other intended disposition is to be made. For a waiver of that notice of sale to be effective, the guarantor (a "secondary obligor") must sign a statement renouncing or modifying the right to notice after default has occurred. Com C §9624(a).

Another issue relating to waivers arises in the context of a debtor's bankruptcy, when the bankruptcy trustee attempts to recover a preferential transfer. A "preferential transfer" is defined as the debtor's transfer of an interest in property to, or for the benefit of, a creditor on account of an antecedent debt while the debtor was insolvent, made within 90 days before the filing of the debtor's petition for relief in bankruptcy, which results in the creditor's receiving more than it would have if the debtor's assets were liquidated in a Chapter 7 bankruptcy proceeding. 11 USC §547(b).

This 90-day period extends to 1 year when the transfer is to, or for the benefit of, a creditor who is an "insider." 11 USC §547(b)(4)(B). A creditor could also be subjected to the extended preference period applicable to insiders if it holds a guaranty from an individual or an entity that is itself an insider of the debtor. A payment by the debtor to a creditor who has obtained a guaranty is also a transfer for the benefit of the guarantor, since the guarantor's exposure may be lessened by the payment. The guarantor normally has creditor status itself because of its subrogation and reimbursement rights. See *Levit v Ingersoll Rand Fin. Corp.* (*In re Deprizio Constr. Corp.)* (7th Cir 1989) 874 F2d 1186; see form in §22.27.

A creditor who faces this 1-year period of exposure may try to circumvent that risk by having the guarantor waive its subrogation and reimbursement rights so that it no longer has "creditor" status in the bankruptcy. (This type of waiver is called a *Deprizio* waiver, after the court of appeals decision (*Levit v Ingersoll Rand Fin. Corp., supra*) that first considered the preferential transfer issue. See §22.27 for a form of *Deprizio* waiver.) Whether this measure will accomplish the creditor's goals has been a subject of debate and litigation. Arguably, such a waiver eliminates the guarantor's creditor status, making the payment to the creditor unrecoverable beyond the ordinary 90-day preference period. *Hendon v Associated Commercial Corp.* (*In re Fastrans, Inc.)* (Bankr ED Tenn 1992) 142 BR 241. See also *In re Northeastern Contracting Co.* (Bankr D Conn 1995) 187 BR 420; *Hostmann v First Interstate Bank (In re XTI Xonix Technols., Inc.)* (Bankr D Or 1993) 156 BR 821 (anti-*Deprizio* waiver provisions in guaranty are not against public policy). Although the holding in *Deprizio* was partially abrogated by the Bankruptcy Reform Act of 1994, §202 (11 USC §550(c)), it may still be good practice to incorporate the type of waiver language suggested here.

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§22.24 3. Form: Authorizations and Waivers Relating to Actions of Creditor

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22.24-1 Authorizations and waivers relating to actions of creditor

___. Authorizations and Waivers.

(a) Guarantor authorizes Creditor, before or after revocation, without notice or demand, and without affecting Guarantor's liability under this Guaranty, from time to time:

(1) To create new Indebtedness; to renew, extend, accelerate, compromise, and otherwise change the time for payment of the Indebtedness; and to modify any other terms of, any or all of the Indebtedness, including changing the applicable interest rate;

(2) To take and hold security for the payment of this Guaranty or the Indebtedness; to perfect or refrain from perfecting its interest in the security, whether or not the security is required as a condition to the making of the Loan to Debtor; to exchange, enforce, waive, or release (whether intentionally or unintentionally) all or any part of the security; and to purchase all or any part of the security at a public or private sale;

(3) To apply all or any part of the security, and to direct the order or manner of its sale, as Creditor, in its sole discretion, determines;

(4) To settle, release, compromise with and substitute any one or more of the endorsers, Guarantors, and other obligors of this Guaranty or the Indebtedness; and

(5) To assign this Guaranty, in whole or in part.

(b) Guarantor waives any right it may have to require Creditor:

(1) To proceed against Debtor or any other person liable on the Indebtedness;

(2) To proceed against or exhaust any security granted by Debtor or any other person before proceeding against Guarantor or any security granted by Guarantor;

(3) To have the property of Debtor first applied to the discharge of the Indebtedness; and

(4) To pursue any other remedy in Creditor's power.

(c) Guarantor waives all presentments, demands for performance, notices of nonperformance, protests, notices of protest, notices of dishonor, and notices of acceptance of this Guaranty and of the incurring of new or additional Indebtedness or the extension or nonpayment of Indebtedness.

(d) Guarantor assumes responsibility for being and keeping informed of the financial condition of Debtor and of all other circumstances bearing on the risk of nonpayment of the Indebtedness that diligent inquiry would reveal. Creditor has no duty to advise Guarantor of information known to it regarding that condition or any such circumstances. On Creditor's request, Guarantor will promptly provide complete and current financial statements and other financial information about Guarantor as Creditor reasonably requests.

(e) At its election, Creditor may exercise any right it may have against Debtor or any security held by Creditor, including without limitation the right to foreclose on the security by one or more judicial or nonjudicial sales, whether or not every aspect of those sales is commercially reasonable, without affecting or impairing Guarantor's liability under this Guaranty, except to the extent that the Indebtedness is paid.

(f) Guarantor waives any defense arising from the absence, impairment, or loss of any right of reimbursement, contribution, or subrogation, or any other right of Guarantor against Debtor or any security, whether resulting from the election by Creditor or otherwise. Guarantor waives any defense arising from any cause whatsoever, including without limitation the Creditor's act or omission, resulting in the cessation of Debtor's liability to Creditor for the Indebtedness, either in whole or in part.

(g) Guarantor waives, to the fullest extent permitted by law, all rights and benefits:

(1) Under California Civil Code §2809, which provides that a guarantor's obligations may not exceed nor be more burdensome than the principal obligation;

(2) Without limiting the generality of the foregoing or any other provision of this Guaranty, under California Civil Code §§2810, 2815, 2819, 2839, 2845, 2847-2849, 2850, 2899, and 3433, to the extent these provisions, or any of them, have any application to this Guaranty or to Guarantor.

(h) In addition, Guarantor waives, to the fullest extent permitted by law:

(1) Any defense arising as a result of Creditor's election of the application of 11 United States Code §1111(b)(2) in any proceeding instituted under Title 11 of the United States Code; and

(2) Any defense based on any borrowing or grant of a security interest under 11 United States Code §364.

Guarantor acknowledges that _ _[*he/she/it*]_ _ has discussed with legal counsel the effect of the above waivers on rights and remedies _ _[*he/she/it*]_ _ might otherwise have.

Comment: See §22.23.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.25 4. Waiver of Defense From Nonjudicial Foreclosure Sale (Gradsky Waiver)

§22.25 4. Waiver of Defense From Nonjudicial Foreclosure Sale (*Gradsky* Waiver)

When, through a nonjudicial foreclosure, a creditor disposes of real property, and that foreclosure brings less than the amount of the outstanding debt, the creditor cannot recover the deficiency from the debtor. CCP §§580b, 580d. In *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64, the court held that, even though guarantors are not specifically protected by California's antideficiency statute, a creditor who elects to use a nonjudicial foreclosure is estopped from recovering any deficiency from the guarantor as well. Any waiver by the guarantor of the estoppel defense must be *explicit.* See *Cathay Bank v Lee* (1993) 14 CA4th 1533, 18 CR2d 420; *Resolution Trust Corp. v Titan Fin. Corp.* (9th Cir 1994) 22 F3d 923. The language in form §22.26 is intended to meet the standard of explicitness announced in *Cathay Bank*.

Some practitioners suggest that, following the court's reasoning in *Cathay Bank,* all the waivers traditionally used in standard form guaranties could be attacked for lack of "explicitness." Accordingly, counsel might consider a form of waiver that in every case:

- Describes the defense that might be available to the guarantor, setting forth the applicable code citation or judicial decision that establishes the defense;
- States that, in the absence of the waiver in the guaranty, the defense might allow the guarantor to avoid liability under the guaranty; and
- States that the guarantor, with full understanding of the significance of the defense, voluntarily waives the right to assert the defense.

See generally Lurie, *Application of California Code of Civil Procedure Section 580d to a Guaranty Secured by Real Property*, 28 Cal W L Rev 51 (1991).

A guarantor may waive rights of subrogation, rights of reimbursement, and any other rights and defenses available to a guarantor by reason of CC §§2787-2855 or antideficiency laws, including CCP §§580a, 580b, 580d, and 726. CC §2856 (enacted in an effort to clarify the questions raised by *Cathay Bank* and other cases regarding the enforceability of certain waivers in guaranties).

NOTE: Some argue that *Cathay Bank* was largely superseded by CC §2856. See, for example, California Real Estate Finance Practice: Strategies and Forms §6.54 (Cal CEB 2000). Civil Code §2856 authorizes waivers of all suretyship defenses and provides model waiver language regarding a creditor's election of remedies and antideficiency protection. This provision, enacted after the *Cathay Bank* decision, was later repealed and reenacted. The repealed version still applies to guarantors' waivers executed before January 1, 1997. CC §2856(f). The current version was effective January 1, 1997.

There is no clear answer to the question of how "explicit" an effective waiver of a guarantor's rights must be. *River Bank Am. v Diller* (1995) 38 CA4th 1400, 45 CR2d 790 relied on CC §2856 to conclude that *Cathay Bank*'s "explicitness" requirement does not apply to a waiver of CC §2809. It stated that *Cathay Bank* focused on the narrow issue of whether there was a sufficient waiver of the *Gradsky* defense, and did not purport to set out a waiver standard applicable to all surety defenses. It further reasoned that the standard for enforceable waivers provided by the legislature in §2856 is a lesser standard than that articulated in *Cathay Bank*, emphasizing that the provisions of CC §2856 "do not represent a change in, but are merely declarative of, existing law." Stats 1994, ch 1204, §2; see *WRI Opportunity Loans II, LLC v Cooper* (2007) 154 CA4th 525, 545, 65 CR3d 205 (following *River Bank Am.*).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.25A 5. Form: Waiver Language from CC §2856

§22.25A 5. Form: Waiver Language from CC §2856

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22.25A-1 Waiver language from CC §2856

___. *Waiver of Rights and Defenses.* Guarantor waives all rights and defenses that Guarantor may have because Debtor's debt is secured by real property. This means, among other things:

(a) Creditor may collect from Guarantor without first foreclosing on any real or personal property collateral pledged by Debtor; and

(b) If Creditor forecloses on any real property collateral pledged by Debtor:

(1) The amount of the debt may be reduced only by the price for which the collateral is sold at the foreclosure sale, even if the collateral is worth more than the sale price; and

(2) Creditor may collect from Guarantor even if Creditor, by foreclosing on the real property collateral, has destroyed any right Guarantor may have to collect from Debtor.

This is an unconditional and irrevocable waiver of any rights and defenses that Guarantor may have because Debtor's debt is secured by real property. These rights and defenses include, but are not limited to, any rights or defenses based on California Code of Civil Procedure §§580a, 580b, 580d, or 726.

Guarantor waives all rights and defenses arising out of an election of remedies by Creditor, even though that election of remedies, such as a nonjudicial foreclosure with respect to security for a guaranteed obligation, has destroyed Guarantor's rights of subrogation and reimbursement against the principal by the operation of Code of Civil Procedure §580d or otherwise.

Comment: This language is from the current version of CC §2856. For a detailed discussion of §2856, see California Real Estate Finance Practice: Strategies and Forms §§6.53-6.56 (Cal CEB 2000).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.26 6. Form: Gradsky Waiver

§22.26 6. Form: *Gradsky* Waiver

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22.26-1 *Gradsky* waiver

___. *Gradsky Waiver.* If any indebtedness of Debtor to Creditor is secured by a deed of trust or other interest in real property, Guarantor expressly waives any defenses or benefits available to Guarantor as a result of the exercise of nonjudicial or judicial remedies against Debtor or Debtor's real or personal property, and expressly waives any defenses or benefits arising from any impairment of Guarantor's right of subrogation against Debtor or Debtor's real or personal property, and further expressly waives, to the full extent permitted by law, any and all rights that Guarantor may have under each of California Code of Civil Procedure §§580a, 580b, 725a, and 726.

If Creditor elects to conduct a trustee's sale and to foreclose nonjudicially on any deed of trust securing any debt owed by Debtor or any guarantor, Guarantor's subrogation rights may be destroyed. The preceding sentence means that, even if Guarantor were to honor this Guaranty, Guarantor would be prevented from recovering reimbursement from Debtor because that reimbursement could be construed to be the recovery of a deficiency against Debtor. Guarantor further acknowledges that, under judicial interpretations of California Code of Civil Procedure §580d, if it were not for this paragraph, Guarantor would have the right to assert that as a result of the foreclosure Creditor would be estopped to enforce this Guaranty against Guarantor.

Guarantor hereby voluntarily waives the right to assert that defense in any action or proceeding that Creditor may commence to enforce this Guaranty.

Comment: Some creditors add to this form language stating that the guarantor acknowledges that the creditor is relying on the *Gradsky* waiver (*Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64) in making the loan to the debtor and that the waiver is a material part of the consideration the creditor is receiving for making the loan. It may also be desirable to highlight the waiver provision in the guaranty or have the guarantor separately initial the provision.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.27 7. Form: Deprizio Waiver

§22.27 7. Form: *Deprizio* Waiver

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22.27-1 *Deprizio* waiver

___. *Deprizio Waiver.* Guarantor is a director, officer, shareholder, or person in control of Debtor, or a relative of that person, and as such, may be deemed to be an "insider" as defined in 11 United States Code §101. Guarantor expressly waives and agrees not to assert any claim (as defined in §101) that Guarantor has or may have against Debtor for any payment or transfer that Guarantor is obligated to make to Creditor under this Guaranty or under any other agreement with a creditor of Debtor. Guarantor's obligations under this Guaranty include all amounts paid to Creditor by Debtor that are later recovered from Creditor in a legal proceeding.

Comment: See discussion in §22.23.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.28 8. Form: No Subrogation

§22.28 8. Form: No Subrogation

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22.28-1 No subrogation

___. *No Subrogation.* Until the Indebtedness has been paid in full, including any part of the Indebtedness that exceeds Guarantor's liability under this Guaranty, Guarantor does not have, and waives to the fullest extent permitted by law, (a) any right of subrogation to any right that Creditor now has or may have later against Debtor in connection with the Indebtedness and (b) any benefit of, and any right to participate in, any security now or later held by Creditor for the Indebtedness.

Comment: A guarantor is discharged if the creditor releases the primary debtor, unless either the guarantor agrees to remain liable or the creditor reserves its rights against the guarantor in the release. CC §2819; Restatement (Third) of Suretyship and Guaranty §39 (1996). When the creditor releases the primary debtor without a reservation of rights, it destroys the guarantor's right of subrogation, which would otherwise allow it to proceed against the debtor when the guarantor satisfies the obligation guaranteed. CC §2847. Through this form, the creditor seeks to avoid discharge of the guarantor by having it expressly waive its right of subrogation. Note that the discharge rule does not apply to negotiable instruments. Com C §3605(b). See chap 20.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.29 9. Form: Joint and Several Obligation

§22.29 9. Form: Joint and Several Obligation

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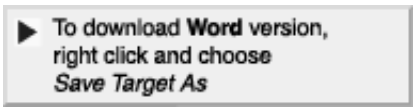
22.29-1 Joint and several obligation

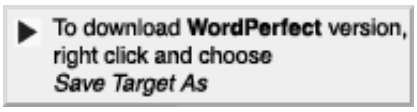
___. *Joint and Several Obligation.* The obligations under this Guaranty are joint and several, and are independent of Debtor's obligations. A separate action may be brought and prosecuted against Guarantor, whether or not action is brought against Debtor or Debtor is joined in the action.

Comment: If there is more than one guarantor for the obligation, the guaranty should specify whether the guarantors' liability is joint, or joint and several, and whether a release of one will act as a release of the remaining guarantor(s). If separate guaranties are used, the liability will generally be several and the release of one will not affect the others. *U.S. v Jewell* (8th Cir 1984) 726 F2d 398. See §17.25 for further discussion of joint and several liability.

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§22.30 K. Form: Authority of Signatory





22.30-1 Authority of signatory

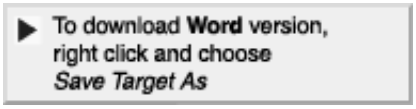
___. *Authority of Signatory.* If any Guarantor or Debtor is a corporation or a partnership, Creditor is not required to inquire into the powers of Guarantor, Debtor, or of the officers, directors, partners, or agents acting or purporting to act on their behalf. Any indebtedness created in reliance on the professed exercise of those powers is guaranteed under this Guaranty.

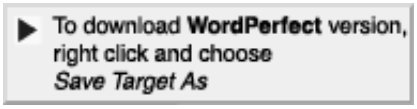
Comment: Only the guarantor need sign the guaranty. See chap 18 for further discussion of execution of agreements. See also Anno, *Admissibility of parol evidence to show whether guaranty of corporation's obligations was signed in officer's representative or individual capacity*, 70 ALR3d 1276 (1976).

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§22.31 L. Form: Construction





22.31-1 Construction

___. *Construction.* If more than one Debtor is named in this Guaranty, or if this Guaranty is executed by more than one Guarantor, the word "Debtor" and the word "Guarantor" mean all and any one or more of them. Words in this Guaranty used in the singular are to be considered to be used in the plural if so required by the context.

Comment: For further discussion of the rules of construction, see chap 17.

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§22.32 M. General Provisions

For discussion of additional "boilerplate" provisions that may be included in a guaranty, see chap 17.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/22 Guaranties/§22.33 V. FORM: SAMPLE CONTINUING GUARANTY

§22.33 V. FORM: SAMPLE CONTINUING GUARANTY

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22.33-1 Continuing guaranty

GENERAL CONTINUING GUARANTY

1. *Consideration and Guarantee.* In consideration of any loans or advances by Creditor, a California corporation, to or for the benefit of Debtor, the forbearance of Creditor to sue on any of Debtor's past-due debt, and for other valuable consideration, the undersigned Guarantors jointly and severally guarantee to Creditor, its successors and assigns, the prompt payment of any and all Indebtedness according to the terms creating the Indebtedness, which Debtor may now or at any time owe to Creditor to the extent of, but not exceeding at any one time, the principal sum of $100,000, together with interest and collection costs, including reasonable attorney fees.

2. *Powers of Creditor.* Creditor is given full power to make advances beyond the above-mentioned principal sum; to cancel any part of the Indebtedness, or to alter, renew, or extend it; and to decrease or increase the amount of principal or interest of that Indebtedness as Creditor and Debtor may expressly or impliedly agree. Creditor may increase, decrease, release, substitute, or alter any collateral or property securing the Indebtedness or any part of it, and otherwise to deal with Debtor or any endorser or coguarantor as Creditor may elect, without in any way diminishing, releasing, or discharging Guarantors' liability. This liability is continuing and will only be affected by payment to Creditor of the full amount of all Indebtedness that may now or at any time be owed by Debtor to Creditor, as long as no payments made by or on behalf of Guarantors to Creditor are held to discharge or diminish the continuing liability of Guarantors under this Guaranty, unless and until written notice is given to Creditor that those payments are at that time being made to liquidate the liability. The liability of the undersigned Guarantors, and each of them, is neither in consideration of nor contingent on the liability of anyone else under this Guaranty or any similar instrument, and the release of the Guarantors, and each of them, from liability does not release or otherwise affect the continuing liability of any other signer of this Guaranty.

3. *Wavier of Notice.* Notice of acceptance of this Guaranty as well as all demands, presentments, notices of protest, and notices of every kind or nature, including those of any action or nonaction by Debtor, Creditor, or anyone else, are fully waived by Guarantors. On any default of Debtor, Creditor may, at its option, proceed directly and at once, without notice, against Guarantors to collect and recover the full amount of the liability, or any part of it, without proceeding against Debtor or anyone else, or foreclosing on, selling, or otherwise disposing of or collecting or applying any property, real or personal, that it may then have as security for that Indebtedness. Guarantors waive the right to require Creditor to proceed against Debtor or to pursue any other remedy, waive the right to have the property of Debtor first applied to the discharge of the Indebtedness, and waive the pleading of any statute of limitations as a defense to the obligation under this Guaranty. Guarantors understand the consequences of all waivers in this Guaranty. Guarantors assume responsibility for being and keeping themselves informed of the financial condition of Debtor and of all other circumstances bearing on the risk of nonpayment of the Indebtedness that diligent inquiry would reveal. Guarantors acknowledge that without a request for information from Guarantors, Creditor has no duty to advise Guarantors of information known to it regarding Debtor's condition or circumstance.

4. *Reimbursement for Costs of Enforcement.* Guarantors further agree, without demand, to immediately reimburse Creditor for all costs and expenses, including attorney fees, incurred in enforcing this Guaranty or collecting the Indebtedness, or in connection with or resulting from the engagement of counsel by Creditor during a restructuring or "workout" of the Indebtedness.

5. *Debts Covered by Guaranty.* The word "Indebtedness" as used in this Guaranty is intended to include not only debts voluntarily contracted, principal, and interest, but also every debt, obligation, or liability however arising and whether the same be due or owing, absolute or contingent, determined or inchoate; and this

Guaranty extends to and cover all renewals and extensions of any claims or demands guaranteed under this Guaranty. If more than one Debtor is named in this Guaranty, all its provisions, including the maximum sum guaranteed, applies to each Debtor.

6. *Waiver of Defenses.* If any Indebtedness of Debtor to Creditor is secured by a deed of trust or other interest in real property, Guarantors expressly waive any defenses or benefits available to Guarantors as a result of the exercise of nonjudicial or judicial remedies against Debtor or Debtor's real or personal property, and expressly waive any defenses or benefits arising from any impairment of Guarantors' right of subrogation against Debtor or Debtor's real or personal property, and further expressly waive, to the full extent permitted by law, all rights that Guarantors may have under each of California Code of Civil Procedure §§580a, 580b, 725a, and 726. If Creditor elects to conduct a trustee's sale and to foreclose nonjudicially on any deed of trust securing any debt owed by Debtor or any guarantor, Guarantors' subrogation rights may be destroyed. The preceding sentence means that, even if Guarantors were to honor this Guaranty, they would be prevented from recovering reimbursement from Debtor, because that reimbursement could be construed to be the recovery of a deficiency against Debtor. Guarantors further acknowledge that under judicial interpretations of §580d, if it were not for this paragraph, Guarantors would have the right to assert that, as a result of the foreclosure, Creditor would be estopped to enforce this Guaranty against them. Guarantors voluntarily waive the right to assert that defense in any action or proceeding that Creditor may commence to enforce this Guaranty.

7. *Waiver of Claims.* The undersigned is a director, officer, shareholder, or person in control of Debtor, or a relative of that person, and as such, may be deemed to be an "insider" as defined in 11 United States Code §101. The undersigned expressly waives and agrees not to assert any claim (as defined in §101) that he or she may now or later have against Debtor for any payment or transfer that the undersigned is obligated to make to Creditor under this Guaranty or under any other agreement with a creditor of Debtor. The undersigned's obligations under this Guaranty include all amounts paid to Creditor by Debtor that are later recovered from Creditor in a legal proceeding.

8. *Guaranty as Assignable.* This Guaranty is assignable with any one of several or all of the Indebtedness and principal obligations that it guarantees, and when so assigned, Guarantors will be bound as above to the transferees.

9. *Provision of Financial Statements.* On Creditor's request, Guarantor will promptly provide complete and current financial statements and other financial information about Guarantor as Creditor reasonably requests.

10. *Entire Agreement.* This Guaranty contains the entire guaranty agreement between Guarantors and Creditor, supersedes any other guaranty agreement between Guarantors and Creditor, and its provisions may be modified, altered, or amended only by written agreement signed by Guarantors and Creditor. This Guaranty is governed by the laws of the State of California.

11. *Married Signatories.* Any married person who signs this Guaranty hereby expressly agrees that recourse may be had against that person's separate property for all of that person's obligations or liabilities under this Guaranty.

Comment: This form is provided for illustrative purposes only. It is a continuing guaranty, secured by the guarantors' real property. The creditor is a financing company, and the debtor is a delinquent borrower. The guarantors are the owner of the borrower and a sister company of the borrower.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/23 Powers of Attorney/Chapter Outline

23

Powers of Attorney

Edith R. Warkentine
Sandra B. Price

I. INTRODUCTION AND CHECKLIST: POWERS OF ATTORNEY §23.1

II. DEFINITION AND APPLICABLE LAW §23.2

III. FEATURES OF POWERS OF ATTORNEY
- A. General Power of Attorney versus Special Power of Attorney §23.3
- B. Effective Dates of Powers of Attorney
  - 1. Durable Power of Attorney §23.4
  - 2. Springing Power of Attorney §23.5
- C. Statutory Power of Attorney §23.6
- D. Power of Attorney Coupled With an Interest §23.7
- E. Form: Sample Power of Attorney Coupled With an Interest §23.8

IV. REQUISITES AND VALIDITY §23.9

V. ATTORNEYS-IN-FACT
- A. Qualifications §23.10
- B. Authority and Duties §23.11
- C. Standard of Care §23.12
- D. Compensation §23.13
- E. Multiple and Successor Attorneys-in-Fact §23.14
- F. Reliance on Power of Attorney by Third Parties §23.15

VI. MODIFICATION AND REVOCATION §23.16

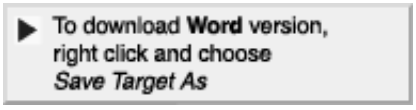
VII. TERMINATION §23.17

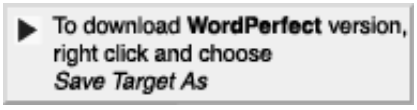
VIII. POWER OF ATTORNEY INSTRUMENT
- A. Statutory Short Form Power of Attorney §23.18
- B. Form: Statutory Short Form Power of Attorney §23.19
- C. Form: Special Power of Attorney (Sale of Real Property) §23.20
- D. Signature by Attorney-in-Fact §23.21
- E. Form: Signature by Attorney-in-Fact §23.22
- F. Acknowledgment §23.23
- G. Form: Revocation of Power of Attorney §23.24
- H. Form: Notice of Revocation of Power of Attorney §23.25

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/23 Powers of Attorney/§23.1 I. INTRODUCTION AND CHECKLIST: POWERS OF ATTORNEY

§23.1 I. INTRODUCTION AND CHECKLIST: POWERS OF ATTORNEY





It may be that parties to a business contract are temporarily or permanently unavailable, either at the drafting and execution stage or at a later point in time. In such instances, a power of attorney may be used to give another person authority to act on behalf of the unavailable party. A power of attorney may also be used when a party simply wants another to act in his or her place for reasons other than unavailability. This chapter discusses the definition and scope of a power of attorney so that counsel can (1) determine whether a power of attorney is valid if offered by another party, or (2) consider how best to draft a power of attorney for counsel's own client.

The information in this chapter is organized as follows:

- Appointment of attorney-in-fact (see §§23.10-23.11)
- Multiple attorneys-in-fact (see §23.14)
- Successor attorneys-in-fact (see §23.14)
- Statutory short form power of attorney; special instructions (see §§23.18-23.19)
- Special power of attorney (see §§23.4, 23.20)
- Term (see §§23.16-23.17)
- Springing power of attorney: effective on specified date or happening of specified event (see §23.6)
- Irrevocable/coupled with an interest (see §§23.7-23.8)
- Compensation (see §23.13)
- Modification (see §23.16)
- Revocation (see §§23.16, 23.24-23.25)
- Signature and acknowledgment (see §§23.21-23.23)
- Recording (see §§23.10, 23.25)

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§23.2 II. DEFINITION AND APPLICABLE LAW

A power of attorney is a document that grants to a party, called the agent or attorney-in-fact, the legal power to act on behalf of the granting party, called the principal. Prob C §§4014(a), 4022, 4026. The power of attorney creates an agency relationship. See *Rosenberg v C.W. Clarke Co.* (1962) 200 CA2d 178, 19 CR 191. An agent is "one who represents another, called the principal, in dealings with third persons." CC §2295.

California has a comprehensive Power of Attorney Law (see Prob C §§4000-4545), which, although located in the Probate Code, governs powers of attorney used in ordinary business contexts. The Power of Attorney Law applies to the following, regardless of when executed (Prob C §4050(a)):

- Durable powers of attorney other than durable powers of attorney for health care (see §23.5);
- Statutory form powers of attorney (see §§23.18-23.19); and
- Any other power of attorney that incorporates or refers to the Power of Attorney Law.

The Power of Attorney Law does *not* apply to powers of attorney coupled with an interest (see §§23.7-23.8), reciprocal or interinsurance exchanges and their contracts, subscribers, attorneys-in-fact, agents, and representatives, or to proxies given by an attorney-in-fact to another person to exercise voting rights. Prob C §4050(b).

Moreover, the Power of Attorney Law does not apply to powers of attorney for health care. Powers of attorney for health care are governed by the Health Care Decisions Law (Prob C §§4600-4805).

The Power of Attorney Law is not intended to affect the validity of any instrument to which it does not specifically apply. Prob C §4050(c). Except when the Power of Attorney Law provides a specific rule, the law of agency applies to powers of attorney, including Civil Code provisions that govern the agency relationship. Prob C §4051. See generally CC §§2295-2357.

The principal may limit the application of any provision of the Power of Attorney Law by an express statement in the power of attorney or simply by providing an inconsistent rule in the power of attorney, except for the following (Prob C §4101(a)-(b)):

- Warnings or notices required to be included in a power of attorney;
- Operative dates of statutory enactments or amendments;
- Execution formalities;
- Qualifications of attorneys-in-fact;
- Qualifications of witnesses; and
- Protections of third parties from liability.

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III. FEATURES OF POWERS OF ATTORNEY

§23.3 A. General Power of Attorney versus Special Power of Attorney

With reference to the scope of powers given to the attorney in fact, powers of attorney may be general or special. A power of attorney is a general power unless it is specifically limited by the principal. CC §2318, Prob C §§4261-4262. A general power of attorney authorizes the attorney-in-fact to act for the principal in all matters and to deal in any lawful manner with the principal's property.

A special (or limited) power of attorney limits the agent's authority to specific situations or actions and will likely be more appropriate than a general power of appointment in a business context. CC §§2315, 2318; Prob C §4262. It authorizes the attorney-in-fact to do no more than necessary to the limited powers delegated. *Rosenberg v C.W. Clarke Co.* (1962) 200 CA2d 178, 19 CR 191. For example, it might limit the agent's authority to the execution of specific documents, such as a loan agreement in a set dollar amount from a designated lender. Even under a special power of attorney, however, an attorney-in-fact has general authority in his or her dealings with third parties, unless they have actual or constructive knowledge that the attorney-in-fact's authority is limited. CC §2318.

A general power of attorney may have unanticipated estate or gift tax consequences if not drafted carefully. For example, if A has the unrestricted power to convey B's property to anyone (including A), then, for estate tax purposes, A will be deemed to be the owner of such property under IRC §2041. A special power of attorney that properly limits or restricts an agent's powers will prevent this consequence. See California Powers of Attorney and Health Care Directives, chap 6 (Cal CEB 2008).

A client will often request that a power of attorney be prepared if he or she will be unavailable for a specific period of time. If the client is aware of a specific matter that will require attention during his or her absence, a special power of attorney would likely be more appropriate than a general power of attorney. In such cases, it is prudent to have the third party who will be asked to honor the power of attorney review the form before the client's absence begins.

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B. Effective Dates of Powers of Attorney

§23.4 1. Durable Power of Attorney

A durable power of attorney is one that continues through the incapacity of the principal. It *must* contain the following words or words showing a similar intent (Prob C §4124):

This power of attorney will not be affected by the subsequent incapacity of the principal.

or:

This power of attorney will become effective on the incapacity of the principal.

Without these words, the agent's power ceases if the principal becomes incapacitated. Counsel should advise its client of this "durable" feature and of its appropriateness relative to the particular purpose for which the power of attorney is being used.

WARNING: General durable powers of attorney for financial management are frequently prepared as part of an estate plan (to address the problems that arise in dealing with assets when the principal becomes incapacitated) at the same time that a client's will or revocable living trust are prepared. Counsel in a business context should question his or her client about whether such a durable power of attorney exists and, if so, should review it so that its terms and the terms of the power of attorney for a specific business purpose are coordinated. Such general estate planning powers of attorney are not discussed in this chapter. For further information on such powers of attorney, see California Powers of Attorney and Health Care Directives, chaps 4-5 (Cal CEB 2008).

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§23.5 2. Springing Power of Attorney

A springing power of attorney becomes effective at a specified future time or on the occurrence of a specified event or contingency (such as the principal's incapacity). Prob C §4030. The principal may designate one or more people (including the attorney-in-fact) to conclusively determine, by written declaration under penalty of perjury, whether the contingency has occurred. Prob C §4129(a). The contingency and designation may, but need not, be included in a statutory short form power of attorney as special instructions. Prob C §4405. The power of attorney may provide other methods of ascertaining whether the contingency has occurred. Prob C §4129(d). A springing power of attorney may be durable or nondurable. Prob C §4030.

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§23.6 C. Statutory Power of Attorney

California has adopted the Uniform Statutory Form Power of Attorney Act (Prob C §§4400-4465), which provides a "check-the-box" approach to preparing powers of attorney. Statutory powers of attorney can be either general or special, durable or nondurable. By executing a Statutory Form Power of Attorney (see §§23.18-23.19) with respect to a particular chosen subject as set forth in Prob C §4401 (*e.g.,* "stock and bond transactions" or "real property transactions"), the powers given to the attorney-in-fact include the following powers (Prob C §4450; CC §2304):

- To contract with anyone, on terms agreeable to the attorney-in-fact, to accomplish the purpose of a transaction, and perform, rescind, reform, release, or modify the contract, or any other contract made by or on behalf of the principal;
- To execute, acknowledge, seal, and deliver a deed, revocation, mortgage, lease, notice, check, release, or other instrument the attorney-in-fact considers desirable to accomplish a purpose of a transaction;
- To prosecute, defend, submit to arbitration, settle, and compromise any claim existing in favor of or against the principal, or intervene in litigation relating to the claim; and
- To prepare, execute, and file any record, report, or other document the attorney-in-fact considers desirable to safeguard or promote the principal's interest under a statute or governmental regulation.

The statutory power of attorney is not the only acceptable form, however. Powers of attorney may be custom drafted and will be valid as long as they meet all requirements. See Prob C §§4121-4122, discussed in §23.9.

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§23.7 D. Power of Attorney Coupled With an Interest

Generally, a power of attorney is created for the benefit of the principal. If a power of attorney is "coupled with an interest," however, it is created for the attorney-in-fact's benefit. The attorney-in-fact, rather than the principal, controls the term of the agency, and it cannot be revoked or otherwise terminated by the principal.

A power of attorney is coupled with an interest if:

- It is made for the benefit of the agent rather than the principal;
- It is given to secure the performance of a duty to the agent or to protect a title interest; and
- It is given at the time the duty or title is created or for new consideration.

Lombardo v Santa Monica Y.M.C.A. (1985) 169 CA3d 529, 215 CR 224; *Becket v Welton Becket & Assoc.* (1974) 39 CA3d 815, 114 CR 531.

An example of a power of attorney coupled with an interest is a power of attorney given to a secured party in a security agreement, in which the secured party (agent) has both an interest and a power (to sell) created at the same time and given to protect the secured party's security interest. See §23.8.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/23 Powers of Attorney/§23.8 E. Form: Sample Power of Attorney Coupled With an Interest

§23.8 E. Form: Sample Power of Attorney Coupled With an Interest

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

23.8-1 Sample power of attorney coupled with an interest

Debtor hereby irrevocably appoints Secured Party as its attorney-in-fact coupled with an interest to do (but Secured Party will not be obligated to and will incur no liability to Debtor or any third party for failure to do) any act that Debtor is obligated by this Security Agreement to do, and to exercise such rights and powers as Debtor might exercise with respect to the Collateral.

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§23.9 IV. REQUISITES AND VALIDITY

A power of attorney governed by the Power of Attorney Law (see §23.2) must satisfy the following requirements (Prob C §§4121-4122):

- It must contain the date of its execution;
- It must be signed by the principal or by some other adult in the principal's presence and at the principal's direction; and
- It must either be acknowledged before a notary public or signed by at least two adult witnesses who are not the attorney-in-fact.

The statutory power of attorney includes provisions that satisfy all the requirements above. Prob C §4401; see §§23.18-23.19. A power of attorney *not* governed by the Probate Code (*e.g.,* a special power of attorney that does not refer to or incorporate any part of the Power of Attorney Law in the Probate Code) generally need not be acknowledged or witnessed to be valid. However, the drafter should be careful about omitting an acknowledgment, because the subject or purpose of the power of attorney may require it. For instance, if the purpose of a power of attorney is to authorize the attorney-in-fact to execute a mortgage, it must be acknowledged and recorded. CC §2933. Because acknowledgment is a prerequisite to recording a power of attorney (Govt C §27287), and a proper acknowledgment provides prima facie evidence of the facts recited and the genuineness of each signature (Evid C §1451; CC §1190), it is recommended that all powers of attorney be acknowledged. See §23.23. The presence or absence of an acknowledgment may also have consequences when a third party relies on the power of attorney. See §23.15.

Certain governmental agencies dictate the form of power of attorney that they will accept, and this form must be on file before the agency will deal with the attorney-in-fact. See, *e.g.,* FTB Form 3520, required by the California Franchise Tax Board, and IRS Form 2848, required by the Internal Revenue Service, for representation of others in tax matters before those agencies.

A power of attorney is properly used by a corporation or partnership to appoint an attorney-in-fact. The practitioner should note that a corporate *officer* who is an agent of the corporation should not use a power of attorney in an effort to appoint a substitute agent. Such a delegation of authority should be made by the corporation either through another power of attorney or through a corporate resolution.

The validity of a proxy is governed by special rules relating to proxies and not by rules for powers of attorney. See CC §2356(d); Corp C §§604, 705.

An individual serving in a fiduciary capacity generally cannot delegate his or her fiduciary obligations to an agent under a power of attorney. A fiduciary for these purposes includes a director of a corporation, an executor, a trustee, a conservator, and a custodian under the California Uniform Transfers to Minors Act (Prob C §§3900-3925). See Corp C §300. See also California Powers of Attorney and Health Care Directives §4.34 (Cal CEB 2008).

PRACTICE TIP: For special powers of attorney related to particular acts or specific property, counsel should confirm that the property is actually owned by the individual and not by the trustee of the individual's revocable trust. For estate planning purposes, it is not unusual for a client to have transferred title of his or her assets to the trustees of his or her revocable trust. For example, a power of attorney authorizing the attorney-in-fact to complete the sale of the principal's residence while the principal is on vacation will likely not be effective if the principal no longer owns the property because title was conveyed to a trustee.

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V. ATTORNEYS-IN-FACT

§23.10 A. Qualifications

Anyone who has the capacity to contract may grant a power of attorney or act as an attorney-in-fact. CC §2296; Prob C §4200. Minors are expressly precluded from granting powers of attorney. Fam C §6701.

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§23.11 B. Authority and Duties

The attorney-in-fact has the authority that the principal actually or ostensibly confers. CC §2315. "Actual authority" is that which the principal intentionally confers on the attorney-in-fact, or which the principal either intentionally or by lack of ordinary care allows the attorney-in-fact to believe it possesses. CC §2316. "Ostensible authority" is that which a principal either intentionally or by lack of ordinary care allows a third party to believe that the attorney-in-fact possesses. CC §2317.

Powers of attorney are strictly construed, and the attorney-in-fact's authority is limited to powers either directly granted by the instrument or necessary and proper to their exercise. See *Jay v Dollarhide* (1970) 3 CA3d 1001, 84 CR 538, disapproved on other grounds in *Morris v Thogmartin* (1973) 29 CA3d 922, 930, 105 CR 919 (when power of attorney to convey land did not contain description of land, description could not be added later); *Shields v Shields* (1962) 200 CA2d 99, 19 CR 129 (power of attorney granting power to sell, exchange, grant, or convey property did not give agent authority to make gift of property). Accordingly, the powers bestowed under the power of attorney must be adequately described. A power of attorney may, however, grant authority to the attorney-in-fact by incorporating powers by reference to a statute. Prob C §4263(a).

A principal may not authorize an attorney-in-fact to perform any act to which the principal is bound to give his or her personal attention. CC §2304.

If a principal grants inconsistent authority to one or more attorneys-in-fact in two or more powers of attorney, the authority last granted controls to the extent of the inconsistency. This rule is not subject to limitation in the power of attorney. Prob C §4130.

An attorney-in-fact has a duty to act solely in the principal's interest and to avoid conflicts of interest. Prob C §4232(a); CC §2306. To the extent reasonably practicable under the circumstances, the attorney-in-fact has a duty to keep in regular contact with the principal, and to follow the principal's instructions. Prob C §4234(a).

The attorney-in-fact must keep records of all transactions entered into on the principal's behalf. Prob C §4236(a).

Except as described below, an attorney-in-fact has no duty to exercise the authority granted in the power of attorney. Prob C §4230(a).

- Acting for the principal in one or more transactions does not obligate an attorney-in-fact to act for the principal in a subsequent transaction, but the attorney-in-fact has a duty to complete a transaction that it has begun. Prob C §4230(b).
- If an attorney-in-fact has expressly agreed in writing to act for the principal, it has a duty to comply with the agreement. That agreement is enforceable against the attorney-in-fact as a fiduciary regardless of whether there is any consideration to support a contractual obligation. Prob C §4230(c).

An attorney-in-fact may revocably delegate authority to perform mechanical acts to one or more persons qualified to exercise the authority delegated. The attorney-in-fact remains responsible to the principal for the exercise or nonexercise of the delegated authority. Prob C §4205(a)-(b).

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§23.12 C. Standard of Care

In dealing with the principal's property, the attorney-in-fact must observe the standard of care that would be observed by a prudent person dealing with the property of another. Prob C §4231(a). If an attorney-in-fact is not compensated (see §23.13), it is not liable for a loss to the principal's property unless the loss results from the attorney-in-fact's bad faith, intentional wrongdoing, or gross negligence. Prob C §4231(b).

An attorney-in-fact who has special skills or expertise or who was designated because it claimed to have special skills or expertise must observe the standard of care that would be observed by others with similar skills or expertise. Prob C §4231(c).

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§23.13 D. Compensation

An attorney-in-fact is entitled to reasonable compensation for services rendered to the principal and to reimbursement for reasonable expenses incurred while acting as attorney-in-fact. Prob C §4204. The parties may provide otherwise, however, in the power of attorney. Prob C §4101(a)-(b).

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§23.14 E. Multiple and Successor Attorneys-in-Fact

A principal may designate more than one attorney-in-fact in one or more powers of attorney. Prob C §4202(a). Authority granted to two or more attorneys-in-fact is exercisable only by their unanimous action (Prob C §4202(b)) unless otherwise authorized in the power of attorney (see Prob C §4101(a)).

If a vacancy occurs, the remaining attorneys-in-fact may exercise the authority conferred as if they are the only attorneys-in-fact. Prob C §4202(c). When an attorney-in-fact is unavailable because of absence, illness, or other temporary incapacity, the other attorneys-in-fact may exercise the authority under the power of attorney as if they are the only attorneys-in-fact, when that is necessary to accomplish the purposes of the power of attorney or to avoid irreparable injury to the principal's interests. Prob C §4202(d).

An attorney-in-fact is not liable for the actions of other attorneys-in-fact unless it participates in, knowingly acquiesces in, or conceals a breach of fiduciary duty committed by another attorney-in-fact. Prob C §4202(e).

A principal may designate one or more successor attorneys-in-fact in the power of attorney, to act if the authority of a predecessor attorney-in-fact terminates. Prob C §4203(a). See §23.17 on termination. The principal may also grant authority to another person, including the attorney-in-fact, to designate at any time one or more successor attorneys-in-fact. Prob C §4203(b).

A successor attorney-in-fact is not liable for the actions of a predecessor attorney-in-fact. Prob C §4203(c).

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§23.15 F. Reliance on Power of Attorney by Third Parties

A third party who relies in good faith on a power of attorney will not be liable to the principal if the document is acknowledged or signed by two witnesses, appears valid on its face, and is presented to the third party by the attorney-in-fact. Prob C §4303. This is true even if the power of attorney has terminated by revocation, by the principal's death or incapacity, or by revocation or modification of the attorney-in-fact's authority to act, as long as the third party was not aware of those events. Prob C §§4150(b), 4151(b), 4153(b); CC §2356(b).

If a power of attorney relating to real estate is signed with the principal's name, notarized, and delivered by the principal's attorney-in-fact, the third party may rely on the validity of the document. *Security Pac. Fin. Corp. v Nelson (In re Nelson)* (9th Cir 1985) 761 F2d 1320.

If the instrument is a springing power of attorney (see §23.5), a third party may rely on a written declaration of the person designated to determine whether the event or contingency has occurred, without liability to the principal or anyone else, regardless of whether the event or contingency making the power effective has actually occurred. Prob C §4129(b).

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§23.16 VI. MODIFICATION AND REVOCATION

A power of attorney may be revoked at any time unless it is a power coupled with an interest (see §23.7). Revocation may be accomplished in writing, or in the manner designated in the power of attorney. Prob C §§4151, 4153. Because a power of attorney is a relatively simple instrument, it is preferable to revoke it and create a new one rather than to modify an existing power of attorney to change the powers granted or substitute a new attorney-in-fact. Nevertheless, a power of attorney may also be modified in accordance with its terms or by a separate instrument executed in the same manner as the power of attorney. Prob C §4150(a). See §23.9.

If a subsequent power of attorney will be used, some practitioners include the revocation in the later document (*e.g.* "I hereby revoke the power of attorney I executed on (date) and intend that this instrument supersede and replace it in all respects"). See §23.24.

PRACTICE TIP: If the original power of attorney was recorded, the revocation or modification should also be recorded. Similarly, any person or entity provided with the original or a copy of the power of attorney should receive the original or a copy of the revocation or modification. See §§23.24-23.25.

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§23.17 VII. TERMINATION

A power of attorney may terminate in several ways:

- In accordance with the terms of the power of attorney. Prob C §4152(a)(1).
- The subject of the agency is extinguished or its purpose fulfilled. Prob C §4152(a)(2).
- The attorney-in-fact's authority is revoked. Prob C §4152(a)(3).
- The principal dies (except as to specific authority permitted by statute to be exercised after the principal's death). Prob C §4152(a)(4).
- The attorney-in-fact is removed. Prob C §4152(a)(5).
- The attorney-in-fact resigns. Prob C §4152(a)(6).
- The attorney-in-fact becomes incapacitated (except that a temporary incapacity suspends the attorney-in-fact's authority only during the period of the incapacity). Prob C §4152(a)(7).
- The attorney-in-fact is the spouse of the principal and the marriage is dissolved or annulled. Prob C §4152(8).
- The attorney-in-fact dies. Prob C §4152(a)(9).

A petition to revoke the authority of an attorney-in-fact for cause may be filed by the attorney-in-fact or the principal as well as other interested parties. Prob C §§4540, 4541. A principal who wants to prevent such a court determination may limit the right to petition by so stating in the power of attorney, and such a provision will be honored if the principal is represented by counsel and understands the nature and effect of the power of attorney. Prob C §4503.

The attorney-in-fact may resign by notice to the principal (or the principal's conservator, if one has been appointed) on written agreement of a successor who is designated in the power of attorney or under its terms, or in a court order. Prob C §4207(a). The right to resign cannot be limited by the power of attorney. Prob C §4207(b).

The authority of an attorney-in-fact under a *nondurable* power of attorney is terminated by the principal's incapacity. This rule cannot be limited by the power of attorney. Prob C §4155(a), (c).

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VIII. POWER OF ATTORNEY INSTRUMENT

§23.18 A. Statutory Short Form Power of Attorney

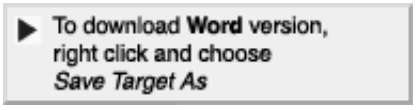
The statutory form below is reprinted from Prob C §4401. A detailed description of the powers granted to the attorney-in-fact for each of the categories (A) through (M) is given in Prob C §§4450-4463. Because of space limitations, they are not duplicated here. Counsel should carefully review these powers before they are adopted wholesale.

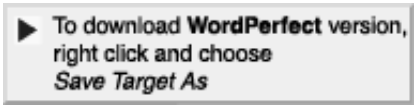
The Power of Attorney Law does not affect the validity of any statutory power of attorney prepared in conformance with former Civil Code provisions repealed by it. Prob C §4409.

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§23.19 B. Form: Statutory Short Form Power of Attorney





23.19-1 Statutory short form power of attorney

UNIFORM STATUTORY FORM POWER OF ATTORNEY
(California Probate Code section 4401)

NOTICE: THE POWERS GRANTED BY THIS DOCUMENT ARE BROAD AND SWEEPING. THEY ARE EXPLAINED IN THE UNIFORM STATUTORY FORM POWER OF ATTORNEY ACT (CALIFORNIA PROBATE CODE SECTIONS 4400-4465). IF YOU HAVE ANY QUESTIONS ABOUT THESE POWERS, OBTAIN COMPETENT LEGAL ADVICE. THIS DOCUMENT DOES NOT AUTHORIZE ANYONE TO MAKE MEDICAL AND OTHER HEALTH-CARE DECISIONS FOR YOU. YOU MAY REVOKE THIS POWER OF ATTORNEY IF YOU LATER WISH TO DO SO.

I, _ _[*name and address of principal*]_ _**, appoint** _ _[*name and address of the person appointed, or of each person appointed if more than one*]_ _ **as my agent (attorney-in-fact) to act for me in any lawful way with respect to the following initialed subjects:**

TO GRANT ALL OF THE FOLLOWING POWERS, INITIAL THE LINE IN FRONT OF (N) AND IGNORE THE LINES IN FRONT OF THE OTHER POWERS.

TO GRANT ONE OR MORE, BUT FEWER THAN ALL, OF THE FOLLOWING POWERS, INITIAL THE LINE IN FRONT OF EACH POWER YOU ARE GRANTING.

TO WITHHOLD A POWER, DO NOT INITIAL THE LINE IN FRONT OF IT. YOU MAY, BUT NEED NOT, CROSS OUT EACH POWER WITHHELD.

INITIAL

____(A) Real property transactions.

____(B) Tangible personal property transactions.

____(C) Stock and bond transactions.

____(D) Commodity and option transactions.

____(E) Banking and other financial institution transactions.

____(F) Business operating transactions.

____(G) Insurance and annuity transactions.

____(H) Estate, trust, and other beneficiary transactions.

____(I) Claims and litigation.

____(J) Personal and family maintenance.

____(K) Benefits from social security, Medicare, Medicaid, or other governmental programs, or civil or military service.

____(L) Retirement plan transactions.

____(M) Tax matters.

____(N) ALL OF THE POWERS LISTED ABOVE.

YOU NEED NOT INITIAL ANY OTHER LINES IF YOU INITIAL LINE (N).

SPECIAL INSTRUCTIONS: ON THE FOLLOWING LINES YOU MAY GIVE SPECIAL INSTRUCTIONS LIMITING OR EXTENDING THE POWERS GRANTED TO YOUR AGENT.

_____

_____

_____

_____

_____

UNLESS YOU DIRECT OTHERWISE ABOVE, THIS POWER OF ATTORNEY IS EFFECTIVE IMMEDIATELY AND WILL CONTINUE UNTIL IT IS REVOKED.

This power of attorney will continue to be effective even though I become incapacitated.

STRIKE THE PRECEDING SENTENCE IF YOU DO NOT WANT THIS POWER OF ATTORNEY TO CONTINUE IF YOU BECOME INCAPACITATED.

EXERCISE OF POWER OF ATTORNEY WHERE MORE THAN ONE AGENT DESIGNATED

If I have designated more than one agent, the agents are to act _____.

IF YOU APPOINTED MORE THAN ONE AGENT AND YOU WANT EACH AGENT TO BE ABLE TO ACT ALONE WITHOUT THE OTHER AGENT JOINING, WRITE THE WORD "SEPARATELY" IN THE BLANK SPACE ABOVE. IF YOU DO NOT INSERT ANY WORD IN THE BLANK SPACE, OR IF YOU INSERT THE WORD "JOINTLY," THEN ALL OF YOUR AGENTS MUST ACT OR SIGN TOGETHER.

I agree that any third party who receives a copy of this document may act under it. Revocation of the power of attorney is not effective as to a third party until the third party has actual knowledge of the revocation. I agree to indemnify the third party for any claims that arise against the third party because of reliance on this power of attorney.

Signed this _____ day of _____, _____

_____
(principal's signature)

_____
(social security number)

State of _____ County of _____

BY ACCEPTING OR ACTING UNDER THE APPOINTMENT, THE AGENT ASSUMES THE FIDUCIARY AND OTHER LEGAL RESPONSIBILITIES OF AN AGENT.

CERTIFICATE OF ACKNOWLEDGMENT

OF NOTARY PUBLIC

On _____ before me, (here insert name and title of the officer) personally appeared _____, who personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument, and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies) and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

__[*Signature of officer*]__ [*Officer's seal*]

Comment: A statutory form power of attorney sufficient if it complies substantially with the above. It need not include the provisions relating to designation of a co-agent in order to substantially comply. Prob C §4402(a). If the line in front of (N) of the statutory form is initialed, an initial on the line in front of any other power does not limit the powers granted by line (N). Prob C §4403. The certificate of acknowledgment of notary public must comply with CC §1189. Prob C §4401.

Because of the sweeping powers granted in this form, the attorney should consider whether a special power of attorney, drafted for a particular set of circumstances, might be preferable. For a form of a durable power of attorney, which continues in effect despite the disability or incapacity of the principal, see California Powers of Attorney and Health Care Directives (Cal CEB 2008).

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/23 Powers of Attorney/§23.20 C. Form: Special Power of Attorney (Sale of Real Property)

§23.20 C. Form: Special Power of Attorney (Sale of Real Property)

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23.20-1 Special power of attorney for sale of real property

SPECIAL POWER OF ATTORNEY FOR SALE OF REAL PROPERTY

I, _ _[*name and address of principal*]_ _, appoint _ _[*name and address of the person appointed*]_ _ as my agent (attorney-in-fact) to act in my place for the purpose of _ _[*specify, e.g., selling the parcel of real property described below*]_ _. To further that purpose, my attorney-in-fact has the following powers:

To bargain, sell, grant, and convey my real property located at _ _[*address*]_ _, more particularly described as _ _[*insert legal description*]_ _, for the price and on the terms and conditions my attorney-in-fact deems proper.

To enter into any contract for the sale of the above-described property, to collect and receive the proceeds of sale, and to execute, acknowledge, and deliver in my name any deed or conveyance, with whatever conditions or covenants as my attorney-in-fact may consider necessary or proper to transfer the above-described property or any interest in it.

I further grant to my attorney-in-fact full authority to take whatever actions are reasonably necessary to exercise the foregoing powers, including the powers of substitution and revocation.

[*Add if power is granted for a limited term:*]

This power of attorney is granted for a period of _ _[*e.g., 6 months*]_ _. It becomes effective on _ _[*date*]_ _, and terminates on _ _[*date*]_ _.

Comment: The power of attorney should be acknowledged. See §23.9. For discussion of special power of attorney, see discussion in §23.4.

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§23.21 D. Signature by Attorney-in-Fact

A party designated as attorney-in-fact may sign legal documents for the principal, but a deed signed by an attorney-in-fact is effective only if the attorney-in-fact signs *both* the principal's name and his or her own name. CC §1095.

When requested to engage in transactions with an attorney-in-fact, a third party may require the attorney-in-fact to provide identification, specimens of the signatures of the principal and the attorney-in-fact, and any other information reasonably necessary to identify the principal and the attorney-in-fact. Prob C §4302.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/23 Powers of Attorney/§23.22 E. Form: Signature by Attorney-in-Fact

§23.22 E. Form: Signature by Attorney-in-Fact

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23.22-1 Signature by attorney-in-fact

Date: _ _ _ _ _ _

_ _[*Attorney-in-fact signs principal's name*]_ _
Name: _ _[*Typed name of principal*]_ _

By: __[*Signature of attorney-in-fact*]__
Name: _ _[*Typed name*]_ _
Under Power of Attorney dated _ _[*date*]_ _

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/23 Powers of Attorney/§23.23 F. Acknowledgment

§23.23 F. Acknowledgment

The acknowledgment form to be used when an instrument is signed by an attorney-in-fact is the same as that used for other instruments. CC §1189. See §§18.34-18.37 for discussion of acknowledgments.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/23 Powers of Attorney/§23.24 G. Form: Revocation of Power of Attorney

§23.24 G. Form: Revocation of Power of Attorney

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23.24-1 Revocation of power of attorney

REVOCATION OF POWER OF ATTORNEY

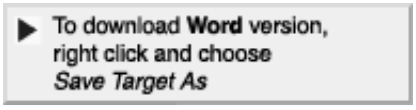
I hereby revoke all authority granted to _ _[*name of attorney-in-fact*]_ _ **under that power of attorney dated** _ _[*date*]_ _**, effective immediately.**

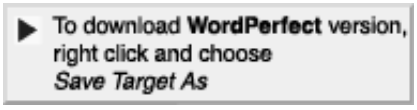
Dated: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

Comment: See discussion in §23.16.

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§23.25 H. Form: Notice of Revocation of Power of Attorney





23.25-1 Notice of revocation of power of attorney

NOTICE OF REVOCATION OF POWER OF ATTORNEY

I, _ _[*name of principal*]_ _, of _ _[*address*]_ _, executed a power of attorney dated _ _[*date*]_ _, appointing _ _[*name of attorney-in-fact*]_ _ as my lawful attorney-in-fact, with full power to act for me and in my name. This power of attorney was duly recorded on _ _[*date*]_ _, in Book _ _ _, at Page _ _ _, of the official records of the County of _ _ _ _ _ _, California.

I hereby revoke and withdraw the power of attorney granted to _ _[*name of attorney-in-fact*]_ _ described above, effective immediately.

Dated: _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

Comment: This revocation should be acknowledged (see §23.9); to revoke a power of attorney to convey or execute instruments affecting real property that has been recorded, a written revocation must be executed, acknowledged, and recorded in the same office in which the power of attorney was recorded. CC §1216. An unrecorded revocation, however, is still valid as between the principal and attorney-in-fact and those who have actual notice of the revocation. CC §§1217, 2356(b). See §23.15. If the power of attorney being revoked affects real property but has not been recorded, it is still a good idea to record the revocation in the county where the real property is located in the event the power of attorney is subsequently recorded. Revocations of powers of attorney that do not affect real property need not be recorded, unless the document requires that it be recorded.

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24

Software License Agreements

Clara Ruyan Martin

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B. Form: Date and Signature Line §24.51

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§24.1 I. CHECKLIST: SOFTWARE LICENSE AGREEMENTS

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- Different uses of software license agreements (see §24.2)
- Grants licensee certain rights to use code
- Right to use software to operate website
- Right to sublicense rights to end users of website
- Right to download and distribute software
- May permit collaboration between companies that requires joint license
- Strategic issues in drafting software licenses
- Exclusive licenses (see §§24.3-24.5)
- Nonexclusive licenses (see §24.6)
- Scope of license (see §24.7)
- Payment structures (see §§24.8-24.9)
- Mechanics of drafting exclusive licenses
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- Performance milestones (see §24.12)
- Minimum royalties (see §24.13)
- Bankruptcy considerations (see §§24.15-24.24)
- Sample license agreement (see §§24.25-24.51)

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§24.2 II. BASIC FORMS OF ACQUIRING RIGHT TO USE SOFTWARE

There are two basic ways to acquire the right to use software. The first is to purchase the source code itself. Because it vests complete ownership in the purchaser, this model can be limiting for software vendors because it does not permit broader distribution of the product. This chapter addresses the second way to acquire use rights: by license. A software license is a contract granting the licensee certain rights to use the code; ownership, however, is retained by the licensor. The license structure is very flexible, allowing the parties to expand or limit the scope of the license to suit their objectives.

Strategic and drafting considerations in the preparation of software licenses are discussed in §§24.3-24.14. The effect of bankruptcy laws on software licenses and drafting tips to address these issues are discussed in §§24.15-24.24.

A form of software license agreement is set forth in §§24.25-24.51. This basic license may be combined with other elements such as software development, a source code escrow, and training, maintenance, and hosting services. See generally Internet Law and Practice in California (Cal CEB 2004).

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III. STRATEGIC ISSUES IN DRAFTING SOFTWARE LICENSES

A. Exclusive Licenses

§24.3 1. Limited Use

Software licenses may be exclusive or nonexclusive. Under an exclusive license, only the licensee is permitted to exercise the rights granted by the license. Once an exclusive license is granted, the licensor may neither grant additional licenses nor itself exercise the rights granted. Exclusive licenses can be limited to certain markets (so that the licensee has exclusivity in a certain geographic market or a specific industry) or to specified types of uses (so that the licensee has exclusive rights, *e.g.,* to train others in the software or to act as a distributor or an installer). See §24.10.

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§24.4 2. Advantages for Licensees

An exclusive license can be very valuable to a licensee. Licensees often seek exclusivity in the following situations:

- Licensees pay licensors to develop specialized software and want to keep their competition from accessing innovations or improvements funded by the licensee. Exclusivity is used in this context as a means of protecting competitive advantage.
- Licensees perform functions for the licensor, such as software distribution or end user support and training services. Licensees in this situation may require exclusivity as a condition of their willingness to invest time and resources in building the business.
- An exclusive license may be appropriate in connection with distribution when a licensee of an online business wishes to be the sole source for products or services distributed online.

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§24.5 3. Risks for Licensors

Because it is valuable to the licensee, an exclusive license often merits significantly higher royalty fees for the licensor. Granting licenses on an exclusive basis is risky for the licensor, however. In an exclusive license, the licensor limits its opportunity to derive revenue from the subject matter of the license to only one source. When a licensor grants an exclusive license, it is effectively "putting all its eggs in one basket." If the licensee is not successful, or if the licensee abandons the licensed technology in favor of another project, the licensor will be without revenue and unable to relicense to a third party for the term of the license. A licensor that enters into a long-term exclusive license should therefore consider structuring the license to protect against such risks.

To help limit the risks to licensors, exclusive licenses often include performance milestones such as revenue targets that, if not met, trigger either the loss of exclusivity or the loss of the license. See §§24.11-24.13. Consideration for exclusive licenses may take the form of an advance payment, a royalty payable over the term of the license, or both. On drafting considerations for exclusive licenses, see §§24.10-24.14.

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§24.6 B. Nonexclusive Licenses

Nonexclusive licenses allow the licensor to grant the same or similar rights over and over again to as many different parties as the licensor chooses. The nonexclusive license is the vehicle for commercial software distribution. A licensor grants each of its end users a nonexclusive license to install and use its software product, and can do so for an unlimited number of end users. A classic form of nonexclusive license is a "shrink-wrap" license that accompanies commercial off-the-shelf software. See §18A.3. Consideration for a nonexclusive license of widely distributed software is typically a single payment in advance. See §24.8.

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C. Scope of License

§24.7 1. Scope of Rights Granted

The scope of rights to be granted in a nonexclusive software license is an important consideration. It is not always necessary to grant licensees all of the owner's rights to use and exploit the software. For example, an end user may not need or seek the right to modify the software or to copy and distribute it to third parties commercially. Those additional rights may be more valuable and should come with a higher price and a different payment structure, such as a royalty.

When representing a licensee, practitioners should consider whether the following rights should be granted in order for the licensee to achieve its objectives:

- Reproduction (making copies);
- Distribution or reselling;
- Public display;
- Making modifications or improvements;
- Creating derivative works;
- Using the license on behalf of others (not merely for the licensee's own internal use), such as in the capacity of a service bureau;
- Hosting the software for third parties; or
- Possessing rights to the source code (typically necessary to make modifications).

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§24.7A 2. Number of End Users

Often, an important element in determining the scope of a software license is the number of end users who will be able to access and use the software. Various structures are commonly used to address this issue. Although vendors have tended to develop their own terminology for their licensing structures, and the same terms may mean different things to different vendors, examples of common structures include the following:

- **Named user license**. Under this structure, each individual user is specifically listed in the license agreement and the license permits use only by the persons named. If an organization with 500 employees desires to license a software product under the named user license method for use by its employees, the license would refer to each of the 500 employees by name and be limited to use by those named individuals. This approach can have negative consequences, however: If provision is not made for swapping out a user who leaves the company, a new license for the user's replacement would have to be purchased.
- **Per seat license**. This structure provides a license for a specified number of end users, or "seats," but actual users are not named. Therefore, if a 500-employee organization desires to license software for use by all of its employees, it would purchase a 500-seat license and cover its needs.

PRACTICE TIP: In negotiating a per seat license, counsel should consider making provision for additional seats at a prenegotiated price so that negotiations do not need to be reopened each time a new employee joins the organization.

- **Maximum concurrent use license**. If end users will use the software occasionally, not continuously, to do their jobs, the software may be a candidate for a concurrent use license. Under this structure, the parties agree on a maximum number of users who can access the software program at the same time. Monitoring software, either internal or external to the software program, serves as a gatekeeper so that when the maximum user count is reached, additional users are not permitted access to the program until space is available. If an organization with 500 users estimates that only 20 percent of its employees will be using the software at any given time, it can set a 100-maximum concurrent user threshold. If 100 users are using the program, then the 101st user would be required to wait until a user is finished and logs off before he can use the software. This structure can result in cost savings because fewer licenses may be needed to achieve the same operational result.
- **Site license**. Here a license is granted with respect to a specific geographic location or building, usually in the context of an organization that has multiple locations. Sometimes a site license applies to all users located at the site, but more often a maximum capped number of users applies.
- **Enterprise license**. An enterprise license is used when an organization consists of one or more related entities, perhaps at multiple sites, and wants to be able to spread its licensed users across all locations within the organization. Sometimes enterprise licenses apply to all users within an enterprise, but more often a maximum capped number of users applies.
- **Per machine license**. Typically used for software used to administrate and maintain servers and other equipment, this structure assigns the license to a specific computing device whose serial number or other identifying information is listed in the license.

Courts tend to interpret these license scoping provisions narrowly. In *Wall Data Inc. v Los Angeles County Sheriff's Dep't* (9th Cir 2006) 447 F3d 769, the United States Court of Appeals for the Ninth Circuit ruled that making and installing copies of software in excess of the number of copies permitted under the applicable license constitutes copyright infringement. In *Wall Data*, the Los Angeles County Sheriff's Department, preparing for the opening of a new jail, purchased approximately 3700 licenses to Wall Data's software. In order to expedite the rollout of the new computers needed for the jail, rather than manually installing programs onto the computers, the department created a "master" hard drive configuration and used a hard disk imaging methodology to rapidly copy the master configuration onto all of its computers. Ultimately, it installed the Wall Data software on approximately 6000 of its computers. The

department claimed that it limited the number of users who could access and use the software to the number of authorized licenses it had purchased. Rejecting the department's fair use and other arguments, the court found that the making of the unauthorized copies constituted an infringement of Wall Data's copyright.

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D. Payment Structures

§24.8 1. Basis for Fee

License fees are generally viewed as consideration for entering into the license. A licensor may choose from different payment structures for a license agreement, including:

- A flat fee payable at the commencement of a license, on renewal, or both; or
- A flat fee payable in installments.

If the license is an end-user license, use fees can be structured either as a flat fee (*e.g.,* one amount covering an entire business unit up to a maximum number of users or a maximum number of computers accessing the software) or on a per-user or per-computer basis. See §24.30.

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§24.9 2. Royalty Payments

If the license is for distribution or resale of a product, royalty payments are typically required. A royalty is usually expressed as a percentage of the licensee's gross or net revenues, based on past sales, and is payable periodically.

One area for negotiation in reaching agreement on a royalty structure is the calculation of the royalty base, (*i.e.,* the base amount to which the royalty percentage is applied), which is subject to negotiation. See §§24.31-24.34. The licensee's gross revenues from sales of the software may serve as the royalty base, but the licensor must consider whether gross revenues include items such as sales taxes on which a royalty should not be paid. Further, the licensee's gross sales figures may not reflect returns, which are normally deducted from the royalty base. Another approach is to calculate the royalty base uses the licensee's net profits from sales of the software. Most licensors do not use this approach, because it often involves internal overhead charges such as administrative services and staffing costs that may be subject to abuse by the licensee, although it is possible to mitigate these concerns by imposing caps on the allowable charges for administrative overhead. More commonly, however, licensors apply lower royalty percentages based on gross sales figures.

PRACTICE TIP: The licensee's gross revenues from sales of the software may serve as the royalty base, but the licensor must consider whether gross revenues include items such as sales taxes or returns, which should not be included in the royalty base.

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IV. DRAFTING EXCLUSIVE LICENSES

§24.10 A. Restrictions on Scope or Field of Use

When granting an exclusive license of intellectual property or technology, the licensor must consider whether the agreement should include limitations on the scope or field of use of the licensed property. See §24.28. If the licensed technology has multiple nonconflicting applications and the intended licensee is only capable of exploiting one of them, then the scope of the license should perhaps be limited to that particular field of use.

EXAMPLE: Software that can determine the shortest route between two points on a map may have multiple applications in consumer products, freight handling, defense, and the oil and gas industries. If the licensee's business provides online map generation targeted at consumers, the licensor should consider limiting the field of use to that specific purpose to preserve the ability to relicense the technology on an exclusive basis in other industries.

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§24.11 B. Mitigating Risks to Licensor

A licensor risks a total loss of revenue and the inability to relicense if the licensee is unsuccessful or if the licensee abandons the licensed technology in favor of another project. Long-term exclusive licenses should include mechanisms to protect against these risks, including those discussed in §§24.12-24.13.

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§24.12 1. Performance Milestones

One type of protection for exclusive licensors is to include performance milestones in the license agreement. The licensor can monitor the licensee's progress using agreed-upon criteria to indicate that the licensee is properly developing the market for the licensed technology. Many different types of measures can be used, depending on the circumstances. Common examples are the achievement of research and development milestones, minimum sales thresholds, or annual marketing expenditures. Any criterion chosen should be objective and easily measurable.

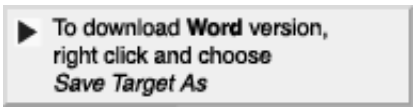
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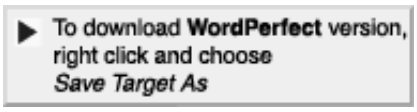
§24.13 2. Guaranteed Royalties

Another type of protection for exclusive licensors is a minimum guaranteed annual royalty. There are many types of minimum royalty structures, such as a flat fee per year or an amount that escalates or declines over time. The right approach depends on the applicable market and the circumstances of the license. If annual royalty payments do not reach the minimum level in any period, the license agreement could provide that the licensee must choose either to remit payment for the difference or to convert its license to a nonexclusive license. In this way, the licensor is guaranteed a certain level of revenue from its license.

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§24.14 C. Form: Exclusivity Clause





24.14-1 Exclusivity clause

___. *Exclusivity Requirement.* The license rights granted to Licensee by this Agreement are exclusive, provided that Licensee complies with the following requirements (the "Exclusivity Requirements"):

(a) Meets the requirements of the Performance Milestones attached as Exhibit A on or before the required deadline for each such Performance Milestone as set forth on Exhibit A; and

(b) Pays to Licensor the annual minimum royalty set forth in Exhibit B on or before the due dates set forth in Exhibit B.

24.14-2 Loss of exclusivity

___. *Loss of Exclusivity.* If Licensee fails to perform an Exclusivity Requirement when due, Licensor shall provide Licensee with written notice of such failure and 30 days to cure. If such failure is not cured within the 30-day period, the license rights granted by this Agreement will become nonexclusive.

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§24.15 V. BANKRUPTCY CONSIDERATIONS

Businesses that build infrastructure and systems based on software licensed from third parties avoid the research and development costs involved in creating the software, but they are also dependent on the stability of their licensor and the licensor's business. If the licensor files for bankruptcy, the licensee risks losing its investment in the code and incurring the cost of replacing the software or developing a replacement on its own. The following discussion provides an overview of bankruptcy-related issues in software licensing to assist the practitioner in understanding the risks and benefits available under the Bankruptcy Code (11 USC §§101-1532) and to anticipate them in the license drafting process. If either party to a software license files a bankruptcy case, the other party should seek the advice of experienced bankruptcy counsel.

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§24.16 A. Consequences of Bankruptcy on Software License Agreements

When a petition for relief is filed under the Bankruptcy Code, all legal or equitable interests of the debtor become the property of the bankruptcy estate. 11 USC §541(a)(1). If the debtor has an interest in a license of intellectual property, that interest becomes property of the bankruptcy estate. The bankruptcy trustee (or the debtor in possession, if the case is under Chapter 11) may then assume, assume and assign, or reject the license as an executory contract. 11 USC §365(a).

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§24.17 1. Software Licenses as Executory Contracts

The term "executory contract" is not defined in the Bankruptcy Code. However, the legislative history to 11 USC §365(a) indicates that a contract should be "executory" when "performance remains due to some extent on both sides." HR Rep No. 95-595 at 347 (1977); S Rep No. 95-989 at 58 (1978). Another definition of an "executory contract" often used by courts is the "Countryman" definition (see Countryman, *Executory Contracts in Bankruptcy, Part I*, 57 Minn L Rev 439, 446 (1973)):

> [An executory contract is] a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.

Software licenses are usually classified as executory contracts. Both the licensor and the licensee have obligations that continue until the termination of the license, such as payment, royalty reporting, indemnification, training, and confidentiality. *Fenix Cattle Co. v Silver (In re Select-A-Seat)* (9th Cir 1980) 625 F2d 290, 292. In *Select-A-Seat,* the court held a software license agreement to be executory based partly on the fact that the licensor had a continuing obligation not to license the software to a third party. A mere obligation to make payments is insufficient to render a contract an executory contract under the Bankruptcy Code. Software licenses, however, typically contain covenants, warranties, and other ongoing obligations in addition to the obligation to pay license fees and royalties. *Lubrizol Enters., Inc. v Richmond Metal Finishers, Inc.* (4th Cir 1985) 756 F2d 1043, 1046, cert denied (1986) 475 US 1057.

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§24.18 2. Debtor-Licensor's Choices: Assumption or Rejection of License

The debtor-licensor has a choice of "assuming" the license (*i.e.*, keeping it in effect) or "rejecting" the license (*i.e.*, terminating it). To assume a license the licensor must (11 USC §365(b)(1)):

- Cure, or provide adequate assurance that it will promptly cure, any default;
- Compensate any third party for any pecuniary loss caused by a default; and
- Provide adequate assurance of future performance.

Once the license is assumed, the licensor may either hold the license or assign it to a third party for value. If the licensor rejects the license, the licensee is left with an unsecured claim for breach of contract as if the breach had occurred immediately before the bankruptcy filing.

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§24.19 3. Licensee's Options if Debtor-Licensor Rejects License

Congress believed it was necessary to provide the licensee of a bankrupt licensor additional protections because rejection of an intellectual property license could have a detrimental effect on a licensee's business. Bankruptcy Code §365(n) gives software licensees some protection by allowing them to retain their rights in the subject matter of the license (except rights in trademarks and certain other intellectual property) despite the licensor's rejection of the license agreement.

If the debtor-licensor rejects the license agreement, the licensee may treat the license as terminated or elect to retain some of the rights under the license.

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§24.20 a. Treating License as Terminated

If the rejection of the license constitutes a breach that would entitle the licensee to terminate the license agreement, the licensee can elect to treat the license as terminated and then pursue a damage claim against the licensor. 11 USC §365(n)(1)(A). This option presents difficulties for the licensee because it is often hard to measure monetary damages resulting from the rejection of the license. Moreover, the licensee typically would prefer, instead of damages, to have continued access to the intellectual property it bargained for to be able to continue to use it in its business. 11 USC §365(n).

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§24.21 b. Retention of Rights

The licensee may elect to retain certain rights under the license as those rights existed immediately before the bankruptcy, including the right to enforce an exclusivity clause. Some of the rights contained in the original license agreement—for example, the right to specific performance under nonbankruptcy law—may not be retained. 11 USC §365(n)(1)(B).

The retained rights continue for the duration of the agreement's initial term and any lawful extensions of it. 11 USC §365(n)(1)(B). In return, the licensee must make all royalty payments due under the license for the duration of the license, and must waive any rights of setoff and any administrative claims in the bankruptcy arising from the debtor's nonperformance of the license.

Section 365(n)(1)(B) does not provide the licensee with any rights to the subject intellectual property other than those in existence as of the date of the bankruptcy filing. Therefore, it is arguable that the licensee does not have rights to future modifications or enhancements.

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§24.22 4. Debtor-Licensor's Obligations to Perform

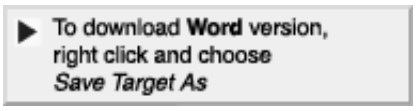
The bankruptcy trustee or debtor-in-possession is usually not required to perform the licensor's obligations under an executory contract pending its decision to assume or reject the contract. This is because the contract is not enforceable against the bankruptcy estate until it has been assumed. *NLRB v Bildisco & Bildisco* (1984) 465 US 513, 532, 79 L Ed 2d 482, 499, 104 S Ct 1188. The licensee has the right, however, to request that the licensor continue to perform. 11 USC §365(n)(4). Once the licensee makes such a request in writing, the trustee or debtor-in-possession must either (1) continue to perform the licensor's obligations under the license, or (2) turn over to the licensee the intellectual property subject to the license. 11 USC §365(n)(4)(A).

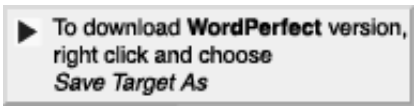
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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/24 Software License Agreements/ B. Drafting Considerations/§24.23 1. Form: License Treated as Executory Contract

B. Drafting Considerations

§24.23 1. Form: License Treated as Executory Contract





24.23-1 License as executory contract

___. *License as Executory Contract.* To the extent this Agreement is determined to be an executory contract under 11 United State Code §365, it is an intellectual property license within the meaning of 11 United States Code §365(n).

Comment: Inserting certain provisions in the licensing agreement may assist the licensee in obtaining the benefits of 11 USC §365(n), such as the provision in this form.

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§24.24 2. Other Provisions to Protect Licensee

To provide a clearer path toward termination of the license on rejection by a licensor in bankruptcy, the license agreement should:

- Identify the ongoing obligations of each of the parties to the license and provide that failure to perform them constitutes a material breach of the license;
- Include as an "event of default" the licensor's rejection of the license agreement under 11 USC §365(n);
- Include as an "event of default" the licensor's breach or failure to perform any of its obligations, covenants, or agreements under the license agreement; and
- State that the licensee has a right to terminate the license agreement upon the licensor's default.

In addition, the license fee can be structured so that it will be reduced if future improvements are no longer provided. If the debtor-licensor rejects the license and the licensee elects to retain its rights, the licensor will no longer be required to provide improvements and the license fee should be reduced automatically. Further, because it may be difficult to value the licensee's damages if a license is terminated, the agreement should include a liquidated damages clause to assist in the determination of monetary damages in a bankruptcy setting if the license is rejected. A significant liquidated damages amount may also serve to discourage the debtor-in-possession or the trustee from rejecting the contract.

Under 11 USC §365(n), a licensee that retains its rights under the license must continue to make all royalty payments. There is a risk that if the licensor is performing additional services (such as training and maintenance) and the fees for those services are bundled with the license fee, the licensee may end up paying more than it should for the retained license. If the fees are bundled, it may be difficult to argue that the fees should be reduced if the licensor's services are reduced. Therefore, it is advisable to provide for separate fees for each additional service the licensor agrees to perform, so that if certain services will no longer be performed after bankruptcy, payment for those services can easily be segregated and discontinued.

If the license is rejected, the licensee may need to hire third party vendors to provide support and maintenance services previously furnished by the licensor. The license agreement should permit the licensee to give any such third parties access to and use of the software. To facilitate this type of provision, the licensee should also have access to the source code for the purpose of making modifications and maintaining the software.

WARNING: Certain contract clauses that are triggered by the bankruptcy or insolvency of a party may be unenforceable as so-called ipso facto clauses under Bankruptcy Code §365(e). That section provides that no rights or obligations under an executory contract may be terminated or modified after a bankruptcy filing solely because of a contract provision that is conditioned on the debtor's bankruptcy, insolvency, or financial condition.

A source code escrow agreement may be used to mitigate the risk that future improvements may no longer be available to the licensee under 11 USC §365(n). Because agreements that are "supplements" to an intellectual property license agreement are covered by §365(n), the escrow agreement should state that it is a supplement to the underlying license agreement. For discussion of source code escrows, see Internet Law and Practice in California, chap 15 (Cal CEB 2004).

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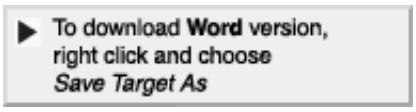
VI. SOFTWARE LICENSE AGREEMENT

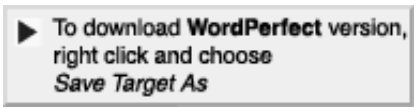
§24.25 A. Introduction

The software license agreement in §§24.26-24.51 contemplates that the licensee will use the code for its internal purposes and also distribute the code to sublicensees. The license is nonexclusive and royalty-bearing (see §§24.6, 24.13), and the licensee is not permitted to make any modifications to the software. For a software end user license intended to be accessed online (a "click-wrap" agreement), see §§18A.16-18A.26. On special considerations in drafting exclusive licenses, see §§24.3-24.5.

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§24.26 1. Form: Introductory Clause





24.26-1 Introductory clause

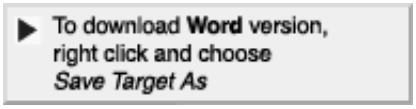
SOFTWARE LICENSE AGREEMENT

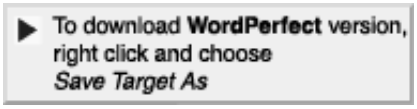
This SOFTWARE LICENSE AGREEMENT (this "Agreement") is between _ _[*name of licensor*]_ _ ("Licensor"), and _ _[*name of licensee*]_ _ located at _ _[*address of licensee*]_ _ ("Licensee"), as of _ _[*date*]_ _ (the "Effective Date"), with reference to the following facts:

Comment: Consider whether entities affiliated with the licensee, such as parent or subsidiary corporations, should be included in the term "Licensee."

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§24.27 2. Form: Recitals





24.27-1 Recitals

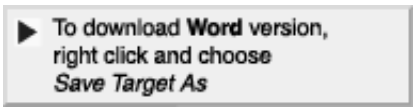
A. Licensor is the sole owner of all rights, title, and interest in and to the proprietary software product(s) generally known as _ _[*name of software*]_ _, described in detail in Exhibit A, which is attached to this Agreement and incorporated into it by this reference (the "Licensed Software"), as well as any and all related documentation, user manuals, and related material (collectively, the "Licensed Documentation").

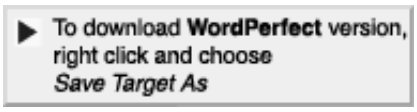
B. Licensee desires a nonexclusive license to the Licensed Software and the Licensed Documentation so that Licensee will have the right to use and distribute the Licensed Software and Licensed Documentation to third parties in accordance with the terms of this Agreement.

The parties therefore agree as follows:

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§24.28 3. Form: Grant of License





24.28-1 Grant of license

1. *Grant Of License*. Licensor grants to Licensee for the term of this Agreement a worldwide, nonexclusive license to the object code version of the Licensed Software and the Licensed Documentation, for the following purposes and on the terms set forth in this Agreement.

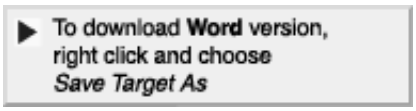
Comment: This section enumerates the specific rights granted to the licensee. Licensees should pay particular attention to this section and compare the rights they need with the rights granted. License grants should set forth elements such as:

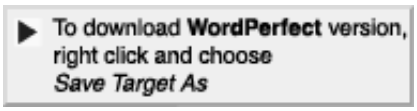
- The geographic scope of the license (worldwide or otherwise);
- Whether the licensee is limited to use of the code for its internal purposes or is permitted to provide services using the code to others;
- Whether the license is transferable and sublicensable;
- Whether the license is irrevocable and perpetual; and
- Whether the license is exclusive or nonexclusive.

Licensees should be aware that no rights beyond those specifically listed are granted. If the licensee determines at a later time that additional rights are needed, the addition of those rights will likely come, if at all, at a price.

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§24.29 4. Form: Terms





24.29-1 Terms

2. *Terms*.

(a) *Use By Licensee*. Licensee may install, use, reproduce, and display the Licensed Software and Licensed Documentation for its internal purposes in support of this Agreement, including internal training of Licensee employees in the use and operation of the Licensed Software.

(b) *Marketing And Demonstration*. Licensee may display the Licensed Software in order to demonstrate, market, and promote the Licensed Software.

(c) *Sublicensing And Distribution*. Licensee may reproduce, resell, sublicense, and distribute the Licensed Software, the Licensed Documentation, and any alterations to them, their derivative works, or related materials provided by Licensor to Licensee under this Agreement.

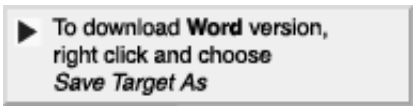
(d) *Ownership; Restrictions*. Subject to the rights granted to Licensee under this Agreement, all right, title, and interest in and to the Licensed Software and Licensed Documentation are and shall remain at all times the sole and exclusive property of Licensor. Licensor may use, sell, assign, transfer, and license copies of and rights in the Licensed Software and Licensed Documentation to third parties in Licensor's discretion free from any claim of Licensee. In addition, Licensee agrees that it shall not, without the express written consent of Licensor, decompile, disassemble, or reverse engineer the Licensed Software, or modify, enhance, or otherwise change or supplement the Licensed Documentation, in whole or in part.

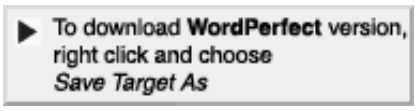
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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/24 Software License Agreements/ 5. Payments/§24.30 a. Form: Initial Fees and Renewal Fees

5. Payments

§24.30 a. Form: Initial Fees and Renewal Fees





24.30-1 Initial fees and renewal fees

3. *Payments*. In consideration of the rights granted under this Agreement, Licensee shall pay Licensor as follows:

3.1. *License Fees*.

(a) For the initial 1-year term of this Agreement below, Licensee will pay Licensor $_ _[*amount*]_ _ (the "Initial Fee"). Licensee shall pay Licensor 50 percent of the Initial Fee on the execution of this Agreement, with the remaining 50 percent of the Initial Fee to be paid on acceptance by Licensee of the Licensed Software and Licensed Documentation.

(b) For each Renewal Term, Licensee shall pay to Licensor $_ _[*amount*]_ _ at least 30 days before commencement of the renewal term (each such payment a "Renewal Fee," and, together with the Initial Fee and any other Renewal Fees, collectively, the "License Fees"). The payment of the Renewal Fee is a condition precedent to the renewal of the Term.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/24 Software License Agreements/ b. Royalties/§24.31 (1) Form: Percentage of Revenue

b. Royalties

§24.31 (1) Form: Percentage of Revenue

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24.31-1 Percentage of revenue

3.2. *Royalties*.

(a) Licensee shall pay Licensor a royalty of _ _[*number*]_ _ percent of Adjusted Gross Sales Revenue. Licensee shall pay Licensor a royalty of _ _[*number*]_ _ percent of revenues received from sublicensees of the Licensed Software and Licensed Documentation.

Comment: If the licensee has the right to sublicense, there should be two royalty calculations: one for the revenues the licensee receives from direct sales of the software to its own customers, and another for the revenues the licensee may receive from its subdistributors.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/24 Software License Agreements/§24.32 (2) Form: Definition of Adjusted Gross Sales Revenue

§24.32 (2) Form: Definition of Adjusted Gross Sales Revenue

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To download **WordPerfect** version, right click and choose *Save Target As*

24.32-1 Adjusted gross sales revenue

(b) "Adjusted Gross Sales Revenue" means all revenues actually received by Licensee from the sale of Products, less only the following specific items related to the manufacture or sale of such Products: discounts; packing, shipping, transportation, and insurance costs; taxes, tariffs, and duties; refunds, returns, or offsets; and sales commissions.

Royalties shall be payable to Licensor only to the extent the Licensed Software is used in the manufacture of, or incorporated into, the Product. If any third party or Licensee proprietary technology is also incorporated in or used to manufacture a Product ("Mixed Products"), the royalty due shall be reduced proportionately by assigning the Licensed Software a percentage of the Product's core technological elements, and by multiplying the Adjusted Gross Sales Revenue by that percentage to determine the base for calculating the royalty due.

Comment: Sometimes the licensed software is bundled with other code or products. The language in the second paragraph of this form is intended to provide a mechanism for calculating the royalty base from the revenues received from this "mixed" product.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/24 Software License Agreements/§24.33 (3) Form: Payment Schedule

§24.33 (3) Form: Payment Schedule

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24.33-1 Payment schedule

(c) Royalties shall be paid quarterly in arrears within 60 days after the end of each calendar quarter. The Licensee's obligation to pay royalties shall survive the expiration or earlier termination of this Agreement.

Comment: If the licensee will incur significant start-up costs that benefit the licensor, the licensor should consider deferring the first royalty payment until licensee has recouped some or all of its start-up investment in the project.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/24 Software License Agreements/§24.34 (4) Form: Basis for Calculations

§24.34 (4) Form: Basis for Calculations

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24.34-1 Basis for calculations

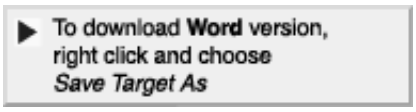
(d) Royalty payments shall be accompanied by a report indicating the method and basis of calculation of the payment; however, Licensee shall be under no obligation to provide customer names or contact information in the royalty report.

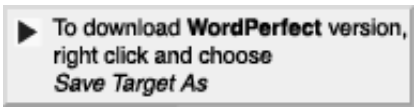
Comment: Consider attaching a sample royalty report as an exhibit to the license agreement to clarify in advance the type of reporting that is required.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/24 Software License Agreements/§24.35 c. Form: Late Payments

§24.35 c. Form: Late Payments





24.35-1 Late payments

3.3. *Late Payments*. Interest shall accrue on any amount due and payable under this Agreement and remaining unpaid for more than 30 days (the "Principal Amount") at a rate per annum which shall from day to day be equal to the lesser of the following:

(a) _ _[*Number*]_ _ percent per year, computed on the basis of a year of 360 days and for the actual number of days elapsed (including the first day but excluding the last day) until payment of the Principal Amount, or

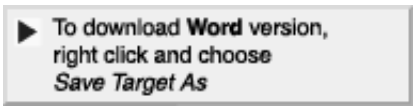
(b) The maximum rate of interest permitted from day to day under applicable law.

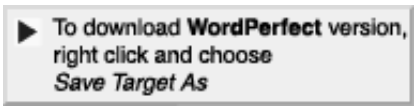
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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/24 Software License Agreements/§24.36 a. Form: Delivery and Acceptance

6. Licensor Responsibilities

§24.36 a. Form: Delivery and Acceptance





24.36-1 Delivery and acceptance

4. *Licensor Responsibilities*.

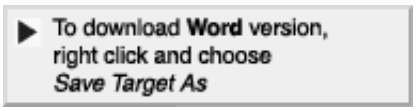
4.1. *Materials*.

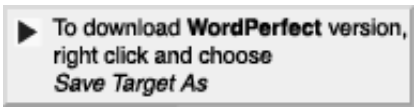
(a) Licensor shall deliver to Licensee within 15 days after the Effective Date of this Agreement the Licensed Software and the Licensed Documentation in a form suitable for Licensee's reproduction and use under this Agreement. If Licensee has not notified Licensor of any deficiencies in the Licensed Software or the Licensed Documentation within _ _[*number*]_ _ days after delivery, Licensee will be deemed to have accepted the Licensed Software and the Licensed Documentation for purposes of this Agreement.

Comment: If the agreement pertains to custom software, the acceptance process will likely be more complicated, involving specifically negotiated acceptance testing procedures, allocation of testing responsibility, and procedures for remediation of errors.

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§24.37 b. Form: Alterations and Updates





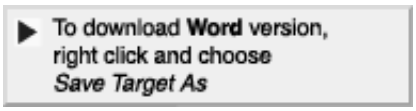
24.37-1 Alterations and updates

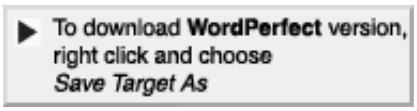
(b) Throughout the term of this Agreement, if Licensor makes any alterations, modifications, improvements, or other changes to the Licensed Software or Licensed Documentation (collectively, "Alterations"), Licensor shall promptly deliver to Licensee complete copies of the Licensed Software and Licensed Documentation, as updated or altered, on completion of such Alterations, and in any event no later than the time Licensor begins using the updated or altered Licensed Software or Licensed Documentation in its own operations, or delivers them to any third party.

Comment: The licensor may wish to limit this clause to exclude any obligation to deliver alterations that were specifically developed for a customer and are not subject to general commercial distribution.

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§24.38 c. Form: Marketing Materials





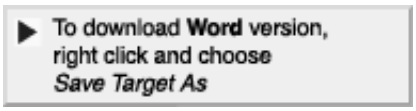
24.38-1 Marketing materials

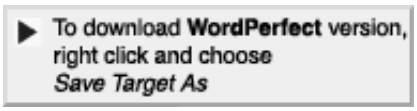
(c) Licensee may produce advertising or marketing materials, brochures, or other literature relating to the Licensed Software. Licensee also may translate into other languages the Licensed Documentation, any Licensor-supplied sales and marketing materials, or any portions of them. Any such translations and related works shall be the property of Licensee.

Comment: The licensor may wish to amend this clause to provide that it will receive an unrestricted license back, covering all such translated materials. In that situation, the licensee may request partial reimbursement of its translation costs. The licensor should consider whether it will require prior approval of any such advertising or marketing materials. Prior approval may be covered in the section on use of trademarks.

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§24.39 7. Form: Training



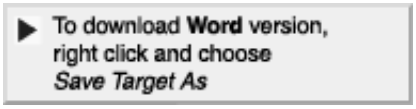


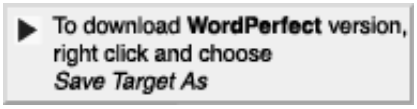
24.39-1 Training

4.2. *Training*. Licensor shall provide to Licensee within _ _[*number*]_ _ days after the Effective Date technical training for Licensee's employees in the installation and use of the Licensed Software and Licensed Documentation. The training shall take place at Licensee's facility located at _ _[*address*]_ _ and shall comprise _ _[*number*]_ _ full-time days of instructor training. To the extent Licensee requires additional technical training, such training shall be provided at Licensor's customary and reasonable hourly rates. A mutually agreeable date, together with a course outline and the permitted number of attendees, shall be set forth in a separate letter from Licensor to Licensee. The course outline and all training materials used in connection with such training shall be titled "Licensed Documentation."

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§24.40 8. Form: Trademarks





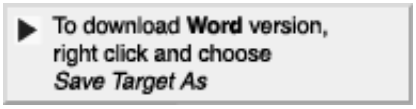
24.40-1 Trademarks

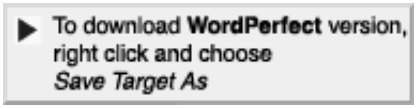
4.3. *Trademarks*. Licensee may use, reproduce, and distribute Licensor's trademarks and service marks, if any, in connection with the performance of Licensee's rights and obligations under this Agreement. Any such use or goodwill received from it shall accrue to Licensor, who shall remain the sole owner of the trademarks and service marks. Whenever Licensee uses a name, mark, or logo licensed under this Agreement, it shall print or display the following statement: "The _ _[*name, mark, or logo*]_ _ is used solely by permission of _ _[*name of licensor*]_ _," and print a registered trademark symbol or trademark symbol, whichever is appropriate in Licensor's sole discretion. Licensee shall provide Licensor with a copy of all materials bearing Licensor's trademark or service mark. The trademark rights granted by Licensor under this Agreement are nonassignable. Any attempted transfer or assignment of such limited license shall terminate the license without further action from Licensor. Licensee shall not remove or destroy any proprietary markings placed on or contained within the Licensed Software or Licensed Documentation. At the expiration or earlier termination of this Agreement, all rights to use Licensor's trademarks and service marks shall cease unless Licensor provides its written approval to each such use.

Comment: Consider whether marketing and other materials prepared by the licensee and bearing the licensor's trademarks should require prior approval of the licensor. Also consider whether the licensor should develop a style guide for licensees to comply with in using the licensor's trademarks.

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§24.41 9. Form: Title





24.41-1 Title

5. *Title*. Licensor represents and warrants that it owns all right, title, and interest in and to the Licensed Software and Licensed Documentation. Licensor warrants that the Licensed Software and Licensed Documentation furnished or to be furnished to Licensee do not and shall not infringe on or violate any patent, copyright, trade secret, or any other proprietary right of any third party. In the event of a claim by any third party, including the third party licensors of Licensor, against Licensee or any Licensee customer ("Customer"), Licensee shall promptly notify Licensor and, notwithstanding any disclaimer or limitation of liability to the contrary, Licensor shall defend the claim, in Licensee's or Customer's name, but at Licensor's sole expense, and shall indemnify Licensee or Customer against any loss, cost, expense (including reasonable attorney fees and costs) or liability arising out of the claim, whether or not the claim is successful.

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10. Warranty

§24.42 a. Form: Extent of Liability

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

24.42-1 Extent of liability

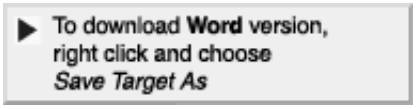
6. *Warranty*.

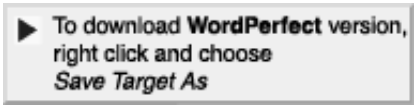
6.1. *Extent Of Liability*. Licensor warrants that, for a period of _ _[*number*]_ _ days after the date of Licensee's receipt of Licensed Software (the "Warranty Period"), the Licensed Software will conform to the performance standards and specifications set forth in the Licensed Documentation if properly installed and used in the operating environment specified in such Documentation. Licensor does not warrant that the functions contained in the Licensed Software will meet Licensee's requirements or will operate in the combination that Licensee selects for use, or that the operation of the Licensed Software will be uninterrupted or error free, or that all defects in the Licensed Software will be corrected by Licensor. Licensor's responsibility under this warranty shall be limited to correcting the portion of the Licensed Software that fails to perform substantially in accordance with the specifications or, at the option of Licensor, refunding the applicable license fees, in which event Licensee shall return all copies of the Licensed Software and related Documentation. Licensor shall have no liability under the foregoing warranty if (a) Licensee decompiles, reverse engineers, or modifies the Licensed Software without Licensor's prior written consent, (b) Licensee fails to give Licensor written notice of the claimed breach of warranty, or (c) the failure to perform is caused in whole or in part by persons other than Licensor or by products, equipment, or computer programs not furnished by Licensor. EXCEPT AS OTHERWISE SPECIFICALLY PROVIDED IN THIS AGREEMENT, LICENSOR MAKES NO OTHER WARRANTIES, EXPRESS, IMPLIED, OR STATUTORY, INCLUDING ANY IMPLIED WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE.

Comment: The warranty period in this form runs from the licensee's receipt of the software. It may, however, be more appropriate for the warranty period to run from acceptance or installation of the software. The licensee's interest is to have the warranty period run as long as possible. The licensee may also wish to impose an outside deadline for repair of defective software.

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§24.43 b. Form: Viruses



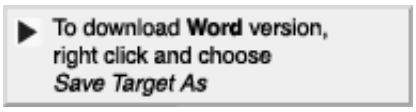


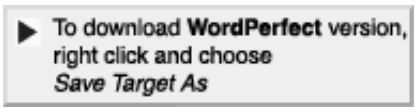
24.43-1 Viruses

6.2. *Viruses*. Licensor warrants that, to the best of its knowledge, the Licensed Software when physically delivered under this Agreement does not contain programming code or instruction(s) constructed with the ability to damage, interfere with, or otherwise adversely affect computer programs, data files, or hardware (collectively "Viruses"). Licensor also warrants that it has exercised its best efforts to ensure that Viruses have not been introduced into the Licensed Software while the Licensed Software was in its possession. Further, Licensor warrants that the Licensed Software shall not contain any disabling code that will activate on a predetermined date or that can be remotely activated by Licensor without Licensee's prior written consent. If it is determined that such a Virus or disabling code exists, Licensor shall, at Licensee's option, immediately replace any portion(s) of the Licensed Software or Licensed Documentation that cannot be corrected or cured within a reasonable period of time or shall immediately reestablish the affected portion(s) of the Licensed Software or Licensed Documentation to be functionally equivalent to their performance before the introduction of the Virus or disabling code. Licensor shall further ensure that all Customers promptly obtain copies of any updated materials provided under this section. If neither of the foregoing alternatives is reasonably available to Licensor, then Licensee may terminate this Agreement immediately on written notice to Licensor, and Licensor shall refund to Licensee any License Fees paid for the Licensed Software and Licensed Documentation.

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§24.44 11. Form: Indemnity





24.44-1 Indemnity

7. *Indemnity*.

7.1. *Intellectual Property Indemnity*. In the event that an action is filed in a court of competent jurisdiction alleging that Licensed Software used within the scope of the License granted under this Agreement infringes any copyright, patent, trade secret, or similar proprietary right of any third party ("Infringement Action"), Licensor shall indemnify, defend, and hold Licensee harmless from and against such Infringement Action and any and all costs, damages, penalties, and expenses, including reasonable attorney fees, finally awarded in actions attributable to such claim, provided that (a) Licensee notifies Licensor in writing of the existence of such Infringement Action within 10 days after Licensee receives notice of it, (b) Licensor has sole control of the defense of the Infringement Action and all related settlement negotiations, and (c) Licensee provides all reasonable assistance and cooperation in such defense. Notwithstanding the foregoing, Licensor shall have no liability on account of any Infringement Action based on (1) the combination, operation, or use of the Licensed Software with equipment, data, or programming not supplied by Licensor or (2) the use of Licensed Software that has been modified or altered without prior written consent of Licensor. Should the Licensed Software become, or in Licensor's opinion be likely to become, the subject of a claim of infringement, Licensor shall either (at Licensor's election) procure for Licensee and its Customers the right to continue to use the Licensed Software, or replace, or otherwise modify, the Licensed Software to make it noninfringing, provided that there is no material change in the functionality of the Licensed Software. The indemnification provided in this section constitutes the entire liability of Licensor with respect to an Infringement Action.

24.44-2 Licensor indemnification

7.2. *Licensor Indemnification*. Licensee shall indemnify, defend, and hold Licensor harmless from and against any and all demands, claims, or suits by any third party and any and all costs, damages, penalties, and expenses, including reasonable attorney fees, arising out of or in connection with the use of the Licensed Software and Licensed Documentation by Licensee, its employees, agents, or invitees, except to the extent any such demand, claim, or suit arises out of or in connection with Licensor's breach of its obligations under this Agreement.

24.44-3 Cross indemnity

7.3. *Cross Indemnity*. If any negligent act or omission of a party or its employees, agents, or representatives causes or results in loss or damage to, or destruction of property of, the other party or third parties, or death or injury to any persons, then that party shall indemnify, defend, and hold the other party harmless from and against any and all claims, actions, damages, demands, liabilities, costs, and expenses, including reasonable attorney fees, resulting from it.

24.44-4 Limitation of liability

7.4. *Limitation Of Liability*. In no event shall Licensor be liable to Licensee or any third party, under this Agreement or through the use of the Licensed Software or Documentation, for any amounts representing loss of profits, loss of data, loss of business, or indirect, consequential, or punitive damages of Licensee or such third party. Except as set forth in this Agreement, Licensor's liability in contract, tort, or otherwise for direct damages to Licensee or any third party arising from this Agreement or the use of the Licensed Software is limited to credit for the amount of the applicable fees and royalties payable to Licensor under this Agreement.

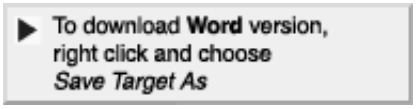
24.44-5 Survival

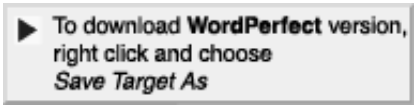
7.5. *Survival*. The provisions of this section shall survive the expiration or earlier termination of this Agreement.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/24 Software License Agreements/§24.45 12. Form: Taxes

§24.45 12. Form: Taxes



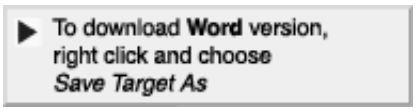


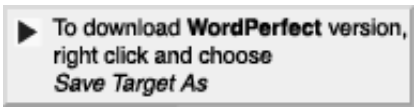
24.45-1 Taxes

8. *Taxes*. All taxes and charges of any kind imposed by any national, federal, state, or local government concerning the products, services, or other items covered by this Agreement, or their sale or use, or measured by the gross receipts to Licensee under this Agreement, shall be collected and paid by Licensee, exclusive of franchise taxes and taxes based on Licensor's income, which shall be paid by Licensor. The provisions of this section shall survive the expiration or earlier termination of this Agreement.

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§24.46 13. Form: Escrow of Source Code





24.46-1 Source code escrow

9. *Escrow Of Source Code*. The parties agree to enter into a standard source code escrow agreement for the Licensed Software ("Escrow Agreement") on reasonably satisfactory terms between themselves and a reputable escrow agent agreed on by the parties. The terms of the Escrow Agreement shall include standard terms of deposit by Licensor, including a requirement that Licensor must deposit with the escrow agent source code and any other information necessary to maintain and update the Licensed Software and Licensed Documentation. The Escrow Agreement shall also include standard release terms, including terms for release of the deposited materials on occurrence of any of the following: (a) Licensor's inability to cure after 30 days a material breach of its obligations under this Agreement; (b) Licensor's ceasing to conduct its operations pertaining to the Licensed Software in the normal course of business; (c) Licensor's legal or equitable insolvency, including failure to meet its obligations as they mature; (d) the bringing by or against Licensor of any proceedings under any bankruptcy or insolvency law; or (e) the appointment or application for appointment of a receiver or the like for Licensor.

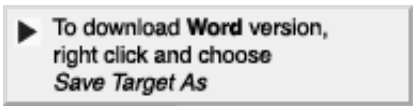
Comment: A source code escrow may not be appropriate or economically justifiable in all circumstances. However, if the licensor is a new and unproven business, then an escrow should give the licensee some insurance against business risks inherent in a new enterprise. Further, if the licensee is undertaking maintenance obligations with its customers or needs to retain the right to continue to modify the software should the licensor no longer be able to do so, then an escrow may be warranted. In lieu of the reference to the agreement, a source code escrow agreement could be attached as an exhibit to the license agreement to be executed concurrently with the license.

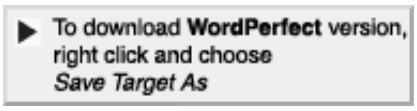
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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/24 Software License Agreements/ 14. Term and Termination/§24.47 a. Form: Term

14. Term and Termination

§24.47 a. Form: Term





24.47-1 Initial term, renewal, and cancellation

10. *Term And Termination*.

10.1. *Term*.

(a) The initial term of this Agreement shall be for a period of _ _[*number*]_ _ years from the Effective Date, unless sooner terminated in accordance with this section.

(b) This Agreement automatically renews for successive 1-year renewal terms as long as Licensee has paid the required Renewal Fee. However, through the second 1-year renewal term of this Agreement, either party may terminate the Agreement by providing the other party with written notice of cancellation at least 90 days before the expiration of the then-current term.

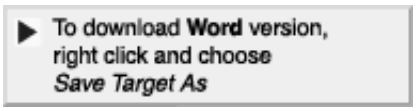
(c) After completion of the second renewal term, this Agreement shall automatically renew for successive 1-year renewal terms. However, either party shall be entitled to terminate this Agreement by providing the other party with written notice of cancellation at least 30 days before the expiration of the then-current term.

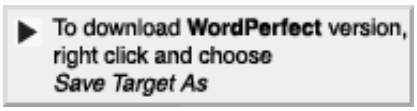
24.47-2 Termination for material breach

10.2. *Termination For Material Breach*. Either party may terminate this Agreement (without prejudice to Licensee's rights to obtain source code under the Escrow Agreement) if the other party materially breaches any provision of this Agreement and the breach is not cured within 30 days after receipt of written notice from the nonbreaching party describing the breach in detail.

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§24.48 b. Form: Effect of Termination





24.48-1 Return of materials

11. *Effect Of Termination.*

11.1. *Return Of Materials*. On any termination of this Agreement that does not cause the release of materials deposited pursuant to the Escrow Agreement, Licensee agrees to return to Licensor within 30 days all copies of the Licensed Software and Licensed Documentation in Licensee's possession, and to erase or otherwise remove all such items from Licensee computers and storage devices. Licensee agrees to assume all responsibility and attendant costs in returning the Licensed Software and Licensed Documentation.

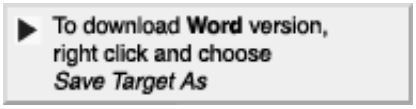
24.48-2 Rights of third parties

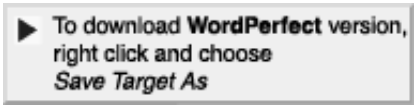
11.2. *Rights Of Third Parties*. The parties agree that the rights of third parties, including any Customers existing at the date this Agreement terminates, shall not be prejudiced by any termination of this Agreement and the Customer's right to continue using the Licensed Software and the Licensed Documentation shall survive notwithstanding any such termination.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/24 Software License Agreements/§24.49 15. Form: Assignment

§24.49 15. Form: Assignment





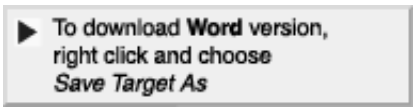
24.49-1 Assignment

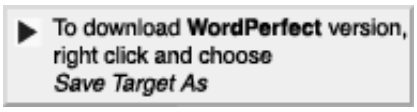
12. *Assignment*. Licensee may not assign or delegate any or all of its rights, obligations, and duties under this Agreement without the prior written consent of Licensor, which may be withheld in Licensor's sole discretion. Nothing contained in this Agreement, whether express or implied, is intended to confer on any person or entity other than the parties to it and their successors in interest and permitted assigns, any rights or remedies under this Agreement.

Comment: Consider whether this agreement should be assignable by the licensee to a direct or indirect parent, subsidiary, or other affiliate of the licensee without the consent of the licensor.

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§24.50 16. Form: General Provisions





24.50-1 Authority

13. *General Provisions*.

13.1. *Authority*. Each party represents and warrants that it is a legal business entity duly organized and validly existing in good standing under the laws of the jurisdiction of its formation, and that it has full power and authority to enter into and perform this Agreement. Each party also represents and warrants that the person signing this Agreement on its behalf has been properly authorized and empowered to do so.

24.50-2 Notices

13.2. *Notices*. All notices under this Agreement shall be given in writing by delivery by a commercially recognized overnight carrier to the addresses set forth on the first page. Either party may from time to time change its address for notification purposes by giving the other prior written notice of the new address and the date when it will become effective.

24.50-3 Remedies

13.3. *Remedies*. No remedy conferred on Licensee by any of the specific provisions of this Agreement is intended to be exclusive of any other remedy, and each and every remedy shall be cumulative and shall be in addition to every other remedy given under this Agreement or existing at law or in equity or by statute or otherwise. The election of one or more remedies by Licensee shall not constitute a waiver of the right to pursue other available remedies.

24.50-4 Force majeure

13.4. *Force Majeure*. If the performance of this Agreement or any obligation under it by any party is prevented, restricted, or interfered with by reason of fire or other casualty or accident, acts of God, severe weather conditions, strikes or labor disputes, war or other violence, any law, order, proclamation, regulation, ordinance, demand, or requirement of any governmental agency or any other act or condition whatsoever beyond the reasonable control of the party, the party whose performance is so affected, on giving prompt notice to the other party, shall be excused from performance. If the force majeure condition continues for 90 days, then the party whose performance is not affected by the condition may, at its option and without liability to the other party, terminate this Agreement.

24.50-5 Relationship

13.5. *Relationship.* The relationship of the parties under this Agreement is one of independent contractors and no agency, partnership, joint venture, or similar relationship is created by it. Except as specifically authorized, neither party shall have any authority to assume or create obligations on the other party's behalf. Neither party shall take any action that has the effect of creating the appearance of its having such authority.

24.50-6 Waiver

13.6. *Waiver*. Licensee's waiver or modification of, or failure to insist on, any of the provisions of this Agreement shall not void, waive, or modify any of the other provisions or be construed as a waiver or relinquishment of Licensee's right to performance in the future of any such provision.

24.50-7 Severability

13.7. *Severability*. If any provision of this Agreement is declared or found to be illegal, unenforceable, or void by a court of competent jurisdiction, then both parties shall be relieved of all obligations arising under the provision, but only to the extent that the provision is illegal, unenforceable, or void. The parties intend that this Agreement shall be deemed amended by modifying the provision to the extent necessary to make it legal and enforceable while preserving its intent or, if that is not possible, by substituting another provision that is legal and enforceable and achieves the same objective. If the remainder of this Agreement shall not be affected by such declaration or finding and is capable of substantial performance, then each provision not so affected shall be enforced to the extent permitted by law.

24.50-8 Successors

13.8. *Successors*. This Agreement shall inure to the benefit of and be binding on the heirs, legal representatives, successors, and permitted assigns of the parties.

24.50-9 Headings

13.9. *Headings.* Headings used in this Agreement are for reference purposes only and neither limit nor amplify the terms of the Agreement.

24.50-10 Governing law

13.10. *Governing Law.* This Agreement shall be governed by and construed according to the laws of California as they are applied to contracts made and to be performed entirely in California, but without reference to California's rules regarding conflicts of laws. All actions under this Agreement shall be brought in a federal or state court of competent jurisdiction in _ _[*city or county*]_ _, California, and in no other jurisdiction.

24.50-11 Survival

13.11. *Survival Of Certain Provisions*. Termination or expiration of this Agreement for any reason shall not release either party from any liabilities or obligations set forth in this Agreement that (a) the parties have expressly agreed shall survive any such termination or expiration or (b) remain to be performed or by their nature would be intended to be applicable following any such termination or expiration. The provisions of this section shall survive the expiration or earlier termination of this Agreement.

24.50-12 Entire agreement

13.12. *Entire Agreement*. This Agreement, together with its exhibits, constitutes the entire understanding and agreement between the parties with respect to the subject matter of the Agreement and supersedes any and all prior oral or written communications with respect to it, all of which are merged into it. Except as specifically provided for, this Agreement may not be altered, amended, or modified except by an instrument in writing signed by a duly authorized representative of each party.

24.50-13 Confidentiality

13.13. *Confidentiality*. The parties have executed a separate Nondisclosure Agreement, a form of which is attached as Exhibit B, concurrently with the execution of this Agreement and as a condition precedent to the effectiveness of the Agreement.

24.50-14 Announcements and disclosures

13.14. *Media Releases*. All media releases, public announcements, and public disclosures by Licensee or its employees or agents related to this Agreement or its subject matter, including promotional or marketing material, but not including any announcement intended solely for internal distribution by Licensee or any disclosure required by legal, accounting, or regulatory requirements beyond the reasonable control of Licensee, shall be coordinated with and approved by Licensor in writing before publication.

24.50-15 Hiring limitations

13.15. *Hiring Of Employees*. Licensee agrees that, beginning as of the Effective Date, during the term of this Agreement and for a period of _ _[*number*]_ _ years after it, neither it nor any of its affiliates shall, except with

the prior written consent of the Licensor, offer employment to or employ any person employed within the preceding 12 months by Licensor who came in contact with a person who was directly or indirectly involved in the performance of services or provision or receipt of products under this Agreement.

24.50-16 Compliance with laws

13.16. *Compliance With Laws.* Licensee agrees to comply with all applicable federal, state, and local statutes, ordinances, rules, and regulations, including the rules and regulations under the United States Export Administration Act and the United States Foreign Corrupt Trade Practices Act. Without in any way limiting the foregoing, (a) Licensee shall not export or otherwise remove any Licensed Software or Licensed Documentation from the United States, either directly or indirectly, without the consent of Licensor and without first obtaining any licenses or approvals required from the United States Department of Commerce and any other applicable agency of the United States Government, and (b) Licensee agrees that neither it, nor any officer, director, employee, or agent of it (1) shall pay or be instructed to pay or give anything of value, either directly or indirectly, to an official of any foreign government or any foreign political party for the purpose of influencing an act or decision in that person's official capacity, or inducing that person to use his or her influence with the foreign government to assist Licensee in obtaining or retaining business for or with, or directing business to, any person, or (2) is at present or shall at any time during the term of this Agreement become an official, officer, or representative of a foreign country.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/24 Software License Agreements/§24.51 B. Form: Date and Signature Line

§24.51 B. Form: Date and Signature Line

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▶ To download **WordPerfect** version, right click and choose *Save Target As*

24.51-1 Signatures

IN WITNESS WHEREOF, the parties have executed this Agreement as of the Effective Date.

Date: _ _ _ _ _ _

_ _[*NAME OF LICENSEE*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _

_ _[*NAME OF LICENSOR*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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Appendix A

General Partnership Agreement Organizational Outline

NOTE: This outline identifies components of a general partnership agreement. Counsel may want to delete or add certain provisions to give effect to the parties' intent.

Heading: Parties and Date

Recitals

1. Partnership name

2. Places of business

3. Term of partnership

4. Definitions

5. Purpose

6. Powers

7. Statutory Filings

a. Fictitious business name statement

b. Address and agent for service

c. Statement of partnership real property

8. Capital

a. Initial capital contributions

b. Tax treatment of contributed property

c. Failure to make initial contribution

d. Deferred contributions

e. Additional capital

f. Withdrawals of capital

g. Interest on capital contributions

h. Loans to partnership at commencement

i. Future loans to partnership

9. Division of profits and losses

10. Distributions to partners

a. Annual distributions

b. Proceeds from sale of capital assets

c. Partners' drawing accounts

d. Limits on distributions

11. Accounting procedures

a. Fiscal year

b. Accounting method

c. Increases, reductions, and adjustments to capital accounts

d. Determination of profit or loss

e. Partnership books

f. Annual report to partners

12. Partnership management

a. Decisionmaking by voting or by managing partner

b. Acts requiring majority consent

c. Handling funds

13. Partners' outside activities

14. Salaries

15. Changes in membership

a. New partners

b. Partner's death, disability, or voluntary withdrawal

c. Noncompetition

d. Expulsion of partner

e. Retirement of partner

f. Bankruptcy or insolvency of partner

16. Transfer of partnership interests

a. Transferability

b. Marriage dissolution

c. Right of first refusal

d. Valuation of interest

e. Payment of purchase price

17. Distributions on liquidation

18. Indemnification

19. Remedies

a. Available remedies

b. Remedies cumulative

20. General Provisions

a. Amendments

b. Governing law

c. Notices

d. No waiver

e. Entire agreement

f. Severability

g. Successors and assigns

h. Cross-references

i. Headings

j. Exhibits

k. Gender and number

l. Construction

m. Further action

n. Time of the essence

o. No election

p. Counterparts

21. Execution

22. Spousal consent

In addition to the discussions and forms in this book, see Advising California Partnerships (3d ed Cal CEB 1999) for forms for each topic listed above and further discussion.

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Appendix B

Limited Partnership Agreement Organizational Outline

NOTE: This outline identifies components of a limited partnership agreement. Counsel may want to delete or add certain provisions to give effect to the intent of the parties.

Heading: Parties and Date

Recitals

1. Partnership name

2. Places of business

3. Definitions

4. Certificate of limited partnership

5. Purpose

6. Admission of limited partners

7. Original capital contribution in escrow

8. Initial limited partner

9. Term

a. Commencement of term

b. Dissolution

c. Continuation

d. Authority to wind up

10. Capital

a. Initial capital contributions

b. Additional contributions

c. Delinquent contributions

d. Additional limited partners

e. General partner as limited partner

11. Accounting procedures

a. Capital account

b. Reserves

c. Distributions and allocations

12. Payments to general partner and affiliates

a. Limits

b. Acquisition fees

c. Property management fees

d. Partnership management fees

e. Commissions

f. Distributions to general partner

g. Payment on removal

13. Partnership expenses

14. Partnership books and records

a. Maintaining books and records

b. Reports to partners

c. Inspection rights

d. Tax returns and fiscal year

e. Tax matters partner

f. Annual audit

15. Transfer of partnership interest

a. Assignment by limited partner

b. Involuntary transfers

c. Prohibited assignments

d. Substitute limited partner

e. Assignment by general partner

(1) Assignee's capital

(2) Tax election

f. Right of first refusal

16. Partnership management

a. General partner's power and authority

b. Limitations on general partner's authority

c. General partner's time obligations

d. Indemnification

e. Reliance on agents

f. Investment opportunities

g. Audit committee

h. Budget

i. Agreements with general partner or affiliate

17. Limited partners' rights

a. No management or control

b. Voting rights

c. Limitations of limited partners' powers

d. Meetings

e. Voting procedures

f. Action without meeting

g. Waiver of meeting and voting rights

18. General partner ceasing to be general partner

a. Withdrawal, removal, bankruptcy, or dissolution

b. Partnership liability

c. Successor and predecessor general partners

d. Continuation of partnership

19. Special power of attorney

20. Put/call procedure

21. Limited partner's death or incapacity

22. Reorganization

a. Approval of reorganization by limited partners

b. Incorporation of partnership

c. Merger

d. Valuation of surviving interests

23. Remedies

a. Available remedies

b. Remedies cumulative

24. General Provisions

a. Amendments

b. Arbitration

c. Attorney fees

d. Governing law

e. Notices

f. Waivers

g. Entire agreement

h. Severability

i. Successors and assigns

j. Cross-references

k. Headings

l. Exhibits

m. Gender and number

n. Construction

o. Further action

p. Time of the essence

q. No election

r. Counterparts

s. Covenant of capacity to sign

t. Group ownership of partnership interests

u. Business in other states

v. No election

25. Execution

26. Spousal consent

In addition to the discussions and forms in this book, see Advising California Partnerships (3d ed Cal CEB 1999) for forms for each topic listed above and further discussion.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/Appendix C Purchase and Sale of Stock Agreement Organizational Outline

Appendix C

Purchase and Sale of Stock Agreement Organizational Outline

NOTE: This outline identifies components of a typical stock purchase and sale agreement. Counsel may want to delete certain pro-seller or pro-buyer provisions, based on the client's position in the transaction. Similarly, additional provisions may be necessary to fully tailor the agreement to the facts of the transaction.

Heading: Parties and Date

Recitals

1. Purchase and sale of shares

a. Tax-free reorganization

b. Transfer of shares

c. Consideration

d. Conditional consideration

e. Payment for noncompetition covenant

f. Holdback provisions

2. Seller's representations and warranties

a. Organization, standing, and qualification

b. Authority

c. Capital structure

d. Title to shares

e. Subsidiaries

f. Financial statements

g. Absence of specified changes

h. Absence of undisclosed liabilities

i. Tax returns and audits

j. Description of assets

(1) Real property: Zoning and hazardous materials

(2) Tangible assets

(3) Intangible assets

k. Title to assets

l. Customers and sales

m. Insurance policies

n. Other contracts

o. Compliance with laws

p. No pending litigation

q. No contrary bylaw agreement or statute

r. Interest in customers, suppliers, and competitors

s. Corporate documents

t. Personnel

(1) Identification and compensation

(2) Employment contracts and benefits

(3) Authority for financial transactions

u. Information for buyer's shareholders

v. Full disclosure

3. Buyer's representations and warranties

a. Organization, standing, and qualification

b. Authority

c. Financial information (if deferred consideration)

4. Seller's obligations before closing

a. Buyer's access to premises and information

b. Conduct of business in normal course

c. Preservation of business and relationships

d. Corporate matters

e. Maintenance of insurance

f. Employees and compensation

g. No new transactions

h. Dividends, distributions, and acquisitions of stock

i. Payment of liabilities and waiver of claims

j. Existing agreements

k. Third party consents

l. Documentation of procedures and trade secrets

5. Buyer's obligations before closing

a. Use of confidential information

b. Cooperation in securing third party consents

6. Conditions precedent to buyer's performance

a. Continued accuracy of seller's representations and warranties

b. Seller's performance

c. No material adverse change

d. Seller's certification

e. Opinion of seller's counsel

f. Absence of litigation

g. Letter regarding changes

h. Corporate approval

i. Deeds and title policies

j. Franchise Tax Board clearance

k. Employment Development Department release

l. FIRPTA withholding

m. Consents

n. Employment agreement

o. Resignations

p. Other letter agreements

q. Buyer's approval of documentation

7. Conditions precedent to seller's performance

a. Continued accuracy of buyer's representations and warranties

b. Buyer's performance

c. Opinion of buyer's counsel

d. Buyer's corporate approval

e. Qualification with California Commissioner of Corporations

f. Listing of buyer's stock

g. Investment undertaking

h. Absence of litigation

8. Closing

a. Time and place of closing

b. Seller's obligations at closing

c. Buyer's obligations at closing

9. Seller's obligations after closing

a. Guaranty of accounts receivable

b. Seller's indemnity

c. Noncompetition

10. Buyer's obligations after closing

a. Continuation of employee benefits

b. Buyer's indemnity

11. Publicity

12. Costs, fees, and expenses

13. No third party beneficiaries

14. Termination

a. Conditions permitting termination

b. Defaults permitting termination

15. Survival of representations and obligations

16. Remedies

a. Available remedies

b. Remedies cumulative

17. General Provisions

a. Amendments

b. Arbitration

c. Attorney fees

d. Governing law

e. Notices

f. Waivers

g. Entire agreement

h. Severability

i. Successors and assigns

j. Cross-references

k. Headings

l. Exhibits

m. Gender and number

n. Construction

o. Further action

p. Time of the essence

q. Counterparts

r. Joint and several liability

18. Execution

In addition to the discussions and forms in this book, see Sales and Mergers of California Businesses, chap 10 (Cal CEB 2002) for forms for each topic listed above and further discussion.

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Source: Business Law/Drafting Business Contracts: Principles, Techniques and Forms/Appendix D Purchase and Sale of Asset Agreement Organizational Outline

Appendix D

Purchase and Sale of Asset Agreement Organizational Outline

NOTE: This outline identifies components of a typical asset purchase and sale agreement. Counsel may want to delete certain pro-seller or pro-buyer provisions, based on the client's position in the transaction. Similarly, additional provisions may be necessary to fully tailor the agreement to the facts of the transaction.

Heading: Parties and Date

Recitals

1. Purchase and sale of assets

a. Tax-free reorganization

b. Transfer of assets

c. Consideration

d. Conditional consideration

e. Assumption of liabilities

f. Holdback provisions

2. Purchase price and allocation

3. Excise and property taxes

4. Seller's representations and warranties

a. Organization, standing, and qualification

b. Authority

c. Capital structure

d. Title to shares

e. Subsidiaries

f. Financial statements

g. Absence of specific changes

h. Claims and liabilities

i. Tax returns and audits

j. Description of assets

(1) Real property: Zoning and hazardous materials

(2) Tangible assets

(3) Intangible assets

k. Title to assets

l. Customers and sales

m. Insurance policies

n. Other contracts

o. Compliance with laws

p. No pending litigation

q. No contrary bylaw agreement or statute

r. Interest in customers, suppliers, and competitors

s. Corporate documents

t. Personnel

(1) Identification and compensation

(2) Employment contract and benefits

(3) Authority for financial transactions

u. Information for buyer's shareholders

v. Full disclosure

5. Buyer's representations and warranties

a. Organization, standing, and qualification

b. Authority

c. Financial information (if deferred consideration)

6. Seller's obligations before closing

a. Buyer's access to premises and information

b. Conduct of business in normal course

c. Preservation of business and relationships

d. Corporate matters

e. Maintenance of insurance

f. Employees and compensation

g. No new transactions

h. Dividends, distributions, and acquisitions of stock

i. Payment of liabilities and waiver of claims

j. Existing agreements

k. Third party consents

l. Documentation of procedures and trade secrets

m. Corporate and shareholder approvals

7. Buyer's obligations before closing

a. Use of confidential information

b. Cooperation in securing third party consents

c. Resale certificate

d. Bulk sales law

e. Tax rulings

8. Conditions precedent to buyer's performance

a. Continued accuracy of seller's representations and warranties

b. Seller's performance

c. No material adverse change

d. Seller's certification

e. Opinion of seller's counsel

f. Absence of litigation

g. Letter regarding changes

h. Corporate approval

i. Deeds and title policies

j. Franchise Tax Board clearance

k. Employment Development Department release

l. Sales and use tax on prior sales

m. FIRPTA withholding

n. Consents

o. Employment agreement

p. Approval of documentation

9. Conditions precedent to seller's performance

a. Continued accuracy of buyer's representations and warranties

b. Buyer's performance

c. Opinion of buyer's counsel

d. Buyer's corporate approval

e. Qualification with California Commissioner of Corporations

f. Listing of buyer's stock

g. Absence of litigation

10. Closing

a. Time and place of closing

b. Seller's obligations at closing

c. Buyer's obligations at closing

11. Seller's obligations after closing

a. Guaranty of accounts receivable

b. Seller's indemnity

c. Shareholder's competition

d. Change of corporation's name

e. Dissolution of selling corporation

12. Buyer's indemnity

13. Publicity

14. Costs, fees, and expenses

15. No third party consents

16. Termination

a. Conditions permitting termination

b. Defaults permitting termination

17. Survival of representations and obligations

18. Remedies

a. Available remedies

b. Remedies cumulative

19. General Provisions

a. Amendments

b. Arbitration

c. Attorney fees

d. Governing law

e. Notices

f. Waivers

g. Entire agreement

h. Severability

i. Successors and assigns

j. Cross-references

k. Headings

l. Exhibits

m. Gender and number

n. Construction

o. Further action

p. Time of the essence

q. Counterparts

r. Joint and several liability

20. Execution

In addition to the discussions and forms in this book, see Sales and Mergers of California Businesses, chap 11 (Cal CEB 2002) for forms for each topic listed above and further discussion.

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Appendix E

Agreement for Sale of Goods Organizational Outline

NOTE: This outline identifies the components of a sales agreement under the Uniform Commercial Code. Counsel may want to add or delete certain provisions, depending on the type of transaction. Because Division 2 of the Commercial Code governs the sale of all kinds of goods, no single checklist or form could ever anticipate the multitude of variables that attorney may encounter in the drafting process.

Heading: Parties and Date

Recitals

1. Parties

a. Legal names (and state of incorporation)

b. Trade names

2. Addresses

a. Chief executive offices

b. Location where notices may be delivered

3. Goods sold

a. Description

b. Quantity

c. If quantity consists of buyer's requirements or seller's output for a specified period, minimum or maximum quantity or allowable variations from estimated quantity

d. Manufacturing terms:

(1) Seller's duty to manufacture goods according to specifications

(2) Delivery of plans or patterns

(3) Confidentiality, patent rights, trademarks

e. Time for identification of goods to the contract:

(1) When seller puts goods in possession of carrier for delivery

(2) When buyer receives seller's notice that goods are ready for shipment

(3) When buyer receives goods

4. Price

a. Determination of price

(1) Agreed on later by the parties

(2) Determined by one of the parties

(3) Determined by reference to competitors, the market, or some other standard

(4) Determination of price is a condition precedent to the contract's existence

b. Per unit

c. Total

d. Charges included in price, *e.g.,* packaging, shipping, insurance, taxes

e. Price discounts

f. Price adjustments for increases in costs of, *e.g.,* materials, transportation

g. Price protection

5. Delivery terms

a. Time for delivery; latest date for delivery

b. Tender of payment is a condition for delivery

c. Single delivery or delivery in lots

d. Size and number of deliveries at seller's option, with all goods to be delivered by given date

e. Delivery of all or part of goods as buyer may demand from time to time within specified period

f. Delivery terms: F.O.B., F.A.S., C.I.F., C. & F., Ex ship, C.O.D.; modifications of these terms

g. Delivery of goods in possession of third party; whether seller may tender delivery through nonnegotiable document of title or written direction to third party to deliver

h. Purchased goods to be stored by seller (keep in mind seller's creditors)

i. Seller's packaging duties

j. Carrier to be used

k. Other shipping instructions; effect of delay or failure to furnish instructions

l. Effect of delay in shipment

m. Specify when title passes: on identification, execution of contract, shipment of goods, delivery at destination, payment, or delivery of document of title

n. Specify when buyer acquires a special property in the goods

o. Effect of partial or complete destruction of goods:

(1) Seller is not excused and must tender substitute goods

(2) Seller is not excused but has additional time to deliver

(3) Seller is excused unless destruction is due to seller's own negligence

p. Force majeure provision

q. Time when risk of loss passes; effect of breach on risk of loss

r. Procurement of insurance; consequences of failure to procure

s. "No arrival, no sale" term, if appropriate; duty of seller and risk of loss under such a term

t. Notification of shipment

u. Delivery of documents of title

v. Seller's reservation of security interest when goods shipped on credit

x. Whether substituted methods of delivery will be acceptable

y. Sale on approval

(1) Terms concerning goods' acceptance and return

(2) Agreement regarding risk of loss and passage of title

z. Sale or return: terms of goods' return; seller's commitment to repurchase unsold goods

6. Payment

a. Manner of payment

b. Payment on tender of goods or documents

c. Whether tender of delivery is a condition for payment

d. Credit terms

e. Interest on overdue payments

f. Payment with each installment

g. Prohibition of substituted manner of payment, if substitution will not be acceptable

h. Payment by letter of credit

(1) Irrevocable unless otherwise specified

(2) Bank specified or approved by seller

(3) Credit confirmed

(4) Time by which credit must be established

(5) Amount that letter of credit must cover

i. Seller's reservation of security interest in goods until paid

7. Warranties

a. Express

(1) Limitations on authority of seller's agents to make warranties

(2) Specifications for goods incorporated

(3) Exclusion or modification of express warranties

b. Disclaimer or modification of implied warranties of merchantability and fitness for particular purpose

c. Disclaimer or modification of implied warranties through course of performance, course of dealing, or usage of trade

d. Sale of goods "as is" and "with all faults"

e. Warranty of title

f. Warranty against infringement; right to control infringement litigation

g. Exclusion or modification of warranties of title and against infringement

h. Full warranty versus limited warranty under Magnuson-Moss Warranty—Federal Trade Commission Improvement Act

i. Availability of informal dispute settlement mechanism

j. Warranties are cumulative unless parties specify otherwise

8. Buyer's acceptance or rejection of goods

a. Manner of acceptance

b. Partial acceptance; minimum amount required to be accepted

c. Inspection by buyer:

(1) Time, place, and manner (whether third party may inspect)

(2) Whether acceptance of goods or payment is a condition for inspection

(3) Intent of parties regarding exclusiveness of place or manner of inspection

(4) Whether contract will be voided if there is a failure of the agreed method of inspection

d. Notice of rejection: time, grounds

e. Rejection only if nonconformity substantial, noncurable

f. Buyer's responsibilities regarding rejected goods, *e.g.,* resell, reship, notify seller and await instructions

g. Installment contract or unitary contract

h. Definition of substantial impairment of installment and whole contract

i. Acceptance of past-due installment is not waiver

j. Whether buyer is restricted from revoking acceptance

9. Seller's performance

a. Seller's right to cure defects and make adjustments or repairs

b. Seller's right to make accommodation shipment

c. Substituted performance

d. Seller's right to resell goods; notice of sale; manner of resale

10. Other terms of performance

a. Grounds for demanding assurances of performance, *e.g.,* delivery is late by more than a specified number of days, buyer is delinquent in payment by more than a specified number of days

b. Type of assurance to be furnished when assurance must be given, *e.g.,* posting of performance bond, deposit in escrow

c. Specific events that will excuse performance

d. Requirement of notice of claimed excused performance

e. Exclusive dealing terms

f. Definition of "best efforts" in fulfilling exclusive dealing obligations

g. Buyer's representation of solvency

11. Remedies

a. Notice of breach; time for giving notice, manner of notice, receipt

b. Shortened limitations period

c. Remedy limitations:

(1) Repair or replacement

(2) Exclusion of incidental or consequential damages

(3) Liquidated damages

d. Whether remedies are exclusive or cumulative

e. Attorney fees

f. Choice of law

g. Venue for actions

h. Arbitration of disputes

12. General provisions

a. Time-of-the-essence provision

b. Limitation on or exclusion of application of course of performance, course of dealing, and usage of trade

c. Waiver of contract terms in writing only

d. Modification of contract in writing only

e. Assignment of rights and delegation of duties: permitted (with or without consent), restricted, or prohibited

f. Severability of unconscionable or unenforceable provisions

g. Duration and renewal of contract

h. Grounds for termination of contract; notice required

i. Merger or integration clause

j. Proper authorizations given for execution

In addition to the discussions and forms in this book, see California UCC Sales and Leases (Cal CEB 2002) for forms for each topic listed above and for further discussion.

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Internet Resources for California Businesses

A. Government Sites—Federal

Americans with Disabilities Act	http://www.ada.gov Information and technical assistance on the ADA by the U.S. Department of Justice.
Board of Governors of the Federal Reserve System	http://www.federalreserve.gov/ Home page with informational links about the "Fed," monetary policy, banking regulation, economic data, and other topics.
Bureau of Industry and Security (BIS), U.S. Department of Commerce	http://www.bis.doc.gov/about/index.htm Federal agency that administers the U.S. export control and treaty compliance system, including the Export Administration Regulations (EAR).
BusinessLaw.gov	http://www.business.gov/ Home page, operated by the U.S. Small Business Administration, with links to legal and regulatory information, and plain English guides for starting a business, handling finances, managing employees, and other topics.
CIA, The World Factbook	https://www.cia.gov/library/publications/the-world-factbook/ U.S. government profiles of countries and territories around the world.
Equal Employment Opportunity Commission (EEOC)	http://www.eeoc.gov/ EEOC site with basic introduction to employers' rights and responsibilities under the federal equal employment opportunity laws.
Federal agencies (through Library of Congress site)	http://www.loc.gov/rr/news/fedgov.html A Library of Congress resource page with links to most federal agencies.
Federal Citizen Information Center (FCIC)	http://www.pueblo.gsa.gov/ Part of the U.S. General Service Administration, the FCIC's Small Business Links offer information for persons planning or owning small businesses, including information on procurement, taxes, woman- and minority-owned businesses, human resources, and financial and legal issues.
Federal Deposit Insurance Corporation (FDIC)	http://www.fdic.gov/ Home page with links to statistical data, pertinent regulations, and FAQs.
Federal Register	http://www.gpoaccess.gov/fr/index.html Main page, with search functions, for the Federal Register—the official daily publication for federal agency rules, proposed rules, and notices as well as executive orders. Specific Federal Register pages can be retrieved at http://www.gpoaccess.gov/fr/retrieve.html
Federal Reserve Bank of San Francisco	http://www.frbsf.org/ Home page. The current FRBSF discount rate, used to determine the usury ceiling in California, is posted at http://www.frbsf.org/banking/data/discount/index.html
Federal Trade Commission	http://www.ftc.gov/ftc/business.shtm Home page for businesses, with links to business publications, advertising guidance, fair packaging and labeling, antitrust law guide, and other topics. Information concerning the Hart-Scott-Rodino pre-merger notification requirements is at http://www.ftc.gov/bc/hsr/introguides/introguides.htm.

USA.gov	http://www.usa.gov/Business/Business_Gateway.shtml The official web portal of the U.S. government, with links to information on contracting with the U.S. government, export licenses, business financial assistance, and many other topics.
Internal Revenue Service	http://www.irs.gov/ Home page; access to downloadable IRS forms and publications.
Occupational Safety and Health Administration (OSHA)	http://www.osha.gov/ Home page.
Office of Federal Contract Compliance Programs (OFCCP)	http://www.dol.gov/esa/ofccp/index.htm Home page with statutory, regulatory, and compliance information regarding nondiscrimination requirements for federal contractors.
Office of the Comptroller of the Currency (OCC)	http://www.occ.treas.gov/ Home page with links to reports and other resources for banking industry professionals as well as public information about the national banking system.
Office of the U.S. Trade Representative	http://www.ustr.gov/index.html Home page.
Securities and Exchange Commission (SEC)	http://www.sec.gov/ Home page with links to information for small businesses; online access to proposed and final rules, SEC releases, policy statements, and other commission notices and information; searchable database of all electronic company filings since 1994.
SEC Edgar	http://www.sec.gov/edgar.shtml SEC Edgar main page, with access to electronic filings and forms.
Small Business Administration	http://www.sba.gov/ Home page with extensive links to federal and other resources for small businesses.
Social Security Administration	http://www.ssa.gov/ Home page. SSA forms are available online at http://www.ssa.gov/online/forms.html.
THOMAS	http://thomas.loc.gov/home/thomas.html Website of the Library of Congress providing federal legislative information.
U.S. Citizenship and Immigration Services	http://www.uscis.gov/portal/site/uscis Home page with links to immigration laws and forms.
U.S. Copyright Office	http://www.copyright.gov/ Home page with links to copyright registration and other information. The agency's new Electronic Copyright Office (eCO) is at http://www.copyright.gov/eco/index.html
U.S. Department of Commerce	http://www.commerce.gov/ Home page.
U.S. Department of Justice, Antitrust Division	http://www.usdoj.gov/atr/public/guidelines/guidelin.htm Link to Antitrust Division Guidelines and Policy Statements.
U.S. Department of Labor	http://www.dol.gov/ Home page with links to statutory and regulatory information, labor statistics, small business regulatory compliance assistance, and other information.

U.S. Department of Labor, Dictionary of Occupational Titles (DOT)	http://www.oalj.dol.gov/libdot.htm Dictionary of job titles and standardized job descriptions; useful for job placement, occupational research, career guidance, labor-market information, curriculum development, and long-range job planning. Last updated in 1991, the DOT has now been replaced by O*NET Online, http://online.onetcenter.org/.
U.S. Department of State	http://www.state.gov/ Home page with links to international commercial laws and guides.
U.S. Environmental Protection Agency	http://www.epa.gov/ Home page.
U.S. Government Printing Office	http://www.gpo.gov/ Home page with links to products and services, including online searchable copies of the United States Code and the Code of Federal Regulations.
U.S. International Trade Commission	http://www.usitc.gov/ Home page with rules, regulations, reports, and other information, including an extensive list of links to international trade resources.
U.S. Patent and Trademark Office	http://www.uspto.gov/ Home page with downloadable forms and information on patent applications and trademark registrations.

B. International Sites

Private International Law Database: Trade/Business Transactions Law, U.S. Department of State	http://www.state.gov/www/global/legal_affairs/transaction_law.html Access to treaties in force for the United States, other international instruments, and information on current negotiations and projects concerning private international law. Updated through January 1, 2001. For treaty actions since President Bush took office, see http://www.state.gov/s/l/treaty/c3428.htm.
CURIA	http://curia.europa.eu Home page of the courts of the European Communities, with texts governing procedures and searchable case law.
Electronic Embassy Website	http://www.embassy.org/ Information on all foreign embassies in Washington, D.C.
EUR-Lex	http://eur-lex.europa.eu/en/index.htm Website providing direct free access to European Union law. Among other things, it includes the Official Journal of the European Union, treaties, legislation, case law and legislative proposals.
European Franchise Federation (EFF)	http://www.eff-franchise.com/ Non-profit international organization that promotes the interests and development of franchising in Europe.
Hague Conference on Private International Law (HCCH)	http://hcch.e-vision.nl/index_en.php?act=text.display&tid=1 Home page.
International Trademark Association (INTA)	http://www.inta.org INTA is an international nonprofit membership association dedicated to the support and advancement of trademarks and related intellectual property.
North American Free Trade Agreement (NAFTA)	http://www.nafta-sec-alena.org/ Home page with link to text of NAFTA.

Secretariat	
United Nations Commission on International Trade Law (UNCITRAL)	http://www.uncitral.org/ Home page with links to UNICITRAL texts, including conventions, model laws, guides to enactment, legislative guides, legislative recommendations, and model contract rules. In particular, this website includes the text of the United Nations Convention on Contracts for the International Sale of Goods (CISG).
CISG Database at Pace University School of Law, Pace Law Library, Institute of International Commercial Law	http://cisgw3.law.pace.edu/ Site dedicated to U.N. Convention on Contracts for the International Sale of Goods (CISG), with annotated text of CISG, CISG in different languages, cases organized by countries, and related CISG material.
International Institute for the Unification of Private Law (UNIDROIT)	http://www.unidroit.org/english/home.htm Home page.
Canadian System for Electronic Document Analysis and Retrieval (SEDAR)	http://www.sedar.com/ Home page of the Canadian equivalent to the SEC's EDGAR. Provides access to corporate filings of Canadian companies with Canada's securities regulatory authorities.
World Intellectual Property Organization (WIPO)	http://www.wipo.int/portal/index.html.en A specialized agency of the United Nations, dedicated to developing a balanced and accessible international intellectual property system.
World Trade Organization (WTO)	http://www.wto.org/ Global international organization dealing with the rules of trade between nations.

C. Government Sites—California

California Department of Corporations (DOC), Franchise Regulation	http://www.corp.ca.gov/SRD/franchise.asp Access to information and forms concerning franchise registration.
California Department of Corporations (DOC), Securities Regulation Division	http://www.corp.ca.gov/SRD/default.asp Access to forms, departmental publications, Commissioner's releases, opinions and notices concerning the California blue sky laws.
Cal-EASI	http://www.corp.ca.gov/CalEASI/caleasi.asp California Department of Corporations website providing access to securities and franchise filings.
California Department of Fair Employment and Housing	http://www.dfeh.ca.gov/ Home page.
California Department of Insurance, Workers' Compensation Information	http://www.dir.ca.gov/workers'_comp.html Access to information on workers' compensation insurance.
California Division of Occupational Safety and Health	http://www.dir.ca.gov/dosh Access to information concerning the Cal-OSHA program.

(DOSH)	
California Employment Development Department (EDD)	http://www.edd.ca.gov Home page; information concerning job placement and referrals, unemployment insurance, disability insurance, employment and training, labor-market information, payroll taxes, and other topics.
California Franchise Tax Board (FTB)	http://www.ftb.ca.gov/ Home page with links to downloadable state tax forms and publications.
California Law Revision Commission	http://www.clrc.ca.gov/ Home page.
Official California Legislative Information	http://www.leginfo.ca.gov/index.html Full text of bills, resolutions, and constitutional amendments, as well as their status, history, votes, analyses, and veto messages.
California Legislative Resource	http://calbar.ca.gov/state/calbar/calbar_generic.jsp?cid=10137&id=10452 Webpage maintained by the State Bar of California with many helpful links regarding California's legislative process, pending bills, legislative calendar, committees, and other topics.
State Bar of California Bill Tracking Service	http://www.calbar.ca.gov/calbar/legislation/State%20Bar%20Bill%20Tracking-Sections.html Centralized legislative monitoring and tracking service listing bills of potential interest to members of the State Bar's sections and their committees.
CalGOLD	http://www.calgold.ca.gov/ The CalGOLD website provides links and contact information for California businesses concerning business permits, licenses, and registrations required by federal, regional, state, and local agencies. Information is searchable according to type of business.
California Office of Privacy Protection	http://www.oispp.ca.gov/consumer_privacy/default.asp State agency dedicated to promoting and protecting the privacy rights of consumers.
California state agencies	http://www.ca.gov/ State of California site with links to California agencies, departments, and commissions.
California State Association of Counties	http://www.csac.counties.org/ Home page with links to all California counties.
California State Board of Equalization	http://www.boe.ca.gov/ Home page with access to information about sales and use taxes, sellers' permits, forms, and publications.
California Secretary of State: California Business Portal:	http://www.ss.ca.gov/business/business.htm Home page.
Forms:	http://www.ss.ca.gov/business/bpd_forms.htm Directory of forms and samples for different business filings, including UCC forms; some in fill-in format.
Business Filings:	
Corporations	http://www.ss.ca.gov/business/corp/corporate.htm Corporations main page with links to filing tips to meet statutory minimum requirements, name availability, FAQs, and more.
Limited Liability Companies (LLCs)	http://www.ss.ca.gov/business/llc/llc.htm

	LLC main page with links to forms and fees, name availability, FAQs, and more.
Limited Partnerships	http://www.ss.ca.gov/business/lp/lp.htm Limited partnerships main page with links to forms and fees, name availability, FAQs, and more.
General Partnerships	http://www.ss.ca.gov/business/gp/gp.htm General partnerships main page with links to forms and fees, name availability, FAQs, and more.
Limited Liability Partnerships	http://www.ss.ca.gov/business/llp/llp.htm Limited liability partnership main page with links to forms and fees, name availability, FAQs, and more.
Trademarks and Service Marks	http://www.ss.ca.gov/business/ts/ts.htm Trademarks and service marks main page with links to forms and fees, name availability, FAQs, private service companies, and more.
Miscellaneous Filings	http://www.ss.ca.gov/business/other/bp_other.htm Links to filing requirements for unincorporated common interest development associations, unincorporated associations, unincorporated nonprofit associations, foreign lending institutions, and foreign partnerships.
California Business Search	http://kepler.ss.ca.gov/list.html Fill-in boxes to check records online for corporations, limited partnerships, and limited liability companies.
Starting a Business	http://www.ss.ca.gov/business/resources.htm A step-by-step guide for starting a business in California; available in English or Spanish.
e-file Statement of Information	https://businessfilings.ss.ca.gov/ Fill-in boxes to file a Statement of Information for a corporation online.
Notary Public	http://www.ss.ca.gov/business/notary/notary.htm Notary public main page, with links to topics such as obtaining a notary public commission, handbook, authentications, apostille or certification, forms, and fees.
Uniform Commercial Code	http://www.ss.ca.gov/business/ucc/ucc.htm UCC main page with links to financing statement forms, amendment forms, requests for information, revised Article 9 (as of July 1, 2001), and FAQs.
International Business Relations Program	http://www.ss.ca.gov/business/ibrp/ibrp.htm Main page in English or Spanish with international resources and business tips; intended to assist foreign corporations with various filing procedures.
Business Program Division, Legislation	http://www.ss.ca.gov/business/bpd_newleg.htm Summaries and links to new state laws affecting businesses.

D. Private Agency Sites

ABA Section of Business Law	http://www.abanet.org/buslaw/home.html Home page with links to publications and other resources for business lawyers.
Active Capital	http://activecapital.org/ Site dedicated to helping individual accredited investors, SBICs, and institutional venture capitalists find small, growing companies through a secure Internet database, and providing ongoing training and research for entrepreneurs and small investors.

AllBusiness	http://www.allbusiness.com Small business portal, with links to forms, directories, and resources on many topics.
American Arbitration Association	http://www.adr.org/ Home page with links to rules and procedures.
Annual Reports.com	http://www.annualreports.com/ Free service offering links to annual reports of public companies.
BenefitsLink	http://www.benefitslink.com Compliance information and tools for employee benefit plan sponsors, service-providers, and participants.
Better Business Bureau	http://www.bbb.org/ Home page.
The Biz-Tech Network by Brint Institute, LLC	http://www.brint.com/ Portal with a meta-index of business, management, and information technology topics; it also provides search capabilities and full text articles on related issues.
Business.com	http://www.business.com/ Business search engine and directory intended to help users find companies, products, services, and other business-related information; some features are fee-based.
Business Law Section of the State Bar of California	http://www.calbar.ca.gov/state/calbar/calbar_sections_generic.jsp?sCategoryPath=/Home/Attorney%20Resources/Sections/Business%20Law Home page with links to standing committees, programs, and publications.
Business Week Online	http://www.businessweek.com/ Articles, links, and opportunity to subscribe to free newsletter.
CNN Money	http://money.cnn.com/ General business news website offered by CNN and Fortune, Money and Business 2.0 magazines.
Corporate Finance Sourcebook	http://www.financesourcebook.com/ Link for ordering popular guidebook published by National Register Publishing. The guidebook features over 1500 top investment sources and 1700 service firms for business entrepreneurs.
Corporate Information	http://www.corporateinformation.com/ Subscription-based website offering research reports on public, private, domestic, and foreign corporations.
The Corporate Library	http://www.thecorporatelibrary.com/ The Corporate Library is an independent research firm providing corporate governance data, analysis, and risk assessment tools.
Creative Commons	http://creativecommons.org A nonprofit organization founded by Prof. Lawrence Lessig of Stanford University that provides special copyright license forms and other free tools to enable authors, scientists, artists, and educators to share intellectual property.
Dun & Bradstreet	http://www.dnb.com/us/ Home page of Dun & Bradstreet. Subscribers can request reports and run online queries in proprietary databases.
Edgar Online, Inc.	http://www.edgar-online.com/

	Edgar Online, Inc. is a private company, not affiliated with the SEC, specializing in the extraction, packaging, and distribution of public company information contained in SEC filings.
Enterpreneur.com	http://www.entrepreneur.com/mag Free access to Entrepreneur magazine articles back to 1998.
Financial Accounting Standards Board (FASB)	http://www.fasb.org/ Access to FASB Statements of Financial Accounting Standards and other resources.
Findlaw Business Center	http://smallbusiness.findlaw.com/ Portal with links to articles and guides on starting a business, taxes and accounting, small business legal concerns, and more. Part of West Group.
Garage Technology Ventures	http://www.garage.com/ Venture capital fund for emerging technology companies.
GNU	http://www.gnu.org/ Organization promulgating the development and use of free software and the use of open-source software licenses.
Google Business News	http://news.google.com/nwshp?tab=wn&ned=us&topic=b Business news headlines with links to full stories from news organizations around the world.
Google Small Business Directory	http://directory.google.com/Top/Business/Small_Business/ A directory of small business resources.
Hieros Gamos Small Business Center	http://www.hg.org/sbcenter.html Portal with links to topics such as starting a business, choosing a legal structure, and financing.
Hoover's Online	http://www.hoovers.com/ Subscription-based site with industry snapshots, company profiles, earnings, and other information.
Intellectual Property Law Section of the State Bar of California	http://www.calbar.ca.gov/state/calbar/calbar_sections_generic.jsp?cid=10707 Home page with links to standing committees, programs, and publications.
International Franchise Association (IFA)	http://www.franchise.org/ Trade association promoting responsible franchise development worldwide.
Internet Corporation for Assigned Names and Numbers (ICANN)	http://www.icann.org/ Private agency responsible for global coordination of the Internet's system of unique identifiers, including domain names (such as .com, .org, and country codes such as .fr), as well as addresses used in a variety of Internet protocols.
IP Mall	http://ipmall.info/ Website sponsored by Franklin Pierce Law Center, with links to intellectual property resources around the world (including patents, copyrights, trademarks, trade secrets, licensing, and technology transfers).
JAMS	http://www.jamsadr.com Home page with information about JAMS mediation and arbitration services and a search engine to assist in locating qualified mediators and arbitrators. The website also offers a downloadable guide to dispute resolution clauses in commercial contracts.
Jeffren Publishing Co.	http://www.jefren.com

	Subscription service offering proxy statement forms and strategies.
MarketResearch.com	http://www.marketresearch.com/ Free database of market research reports representing all market and industry sectors.
NASDAQ	http://www.nasdaq.com/ Comprehensive current information on market performance and investments.
National Association of Attorneys General	http://www.naag.org/ Association of the attorneys general of all 50 states, with contact information and links to enforcement initiatives.
National Association of Seed and Venture Funds	http://www.nasvf.org/ Network of private, public, and nonprofit organizations investing and facilitating investment in entrepreneurs.
National Business Association	http://www.nationalbusiness.org/ Nonprofit association's site for the self-employed and small business community.
National Venture Capital Association (NVCA)	http://www.nvca.org/ Home page with links to members and other resources.
New York Stock Exchange (now, NYSE Euronext)	http://www.nyse.com/ Comprehensive, current information on market performance and investments.
Public Register's Annual Report Service	http://www.annualreportservice.com/ Free access to annual reports of over 2200 companies. Site also has links to the SEC's Edgar database for filings.
Reuters	http://www.reuters.com/finance Business and finance news database with reports on business transactions, markets, small business, industries, the economy, and other topics.
Safeselling.org	http://www.safeselling.org/ ABA-sponsored resource for business people launching e-commerce enterprises and for businesses venturing into online sales.
The Small Business Portal	http://www.thesmallbusinessportal.com/ Links to topics such as starting a business, franchise advice, financing, and home-based businesses.
Standard & Poor's	http://www.standardandpoors.com/ Home page with search engine for public company credit ratings and other features.
Tripod by Lycos	http://www.tripod.lycos.com/smallbiz/index.html Portal with tips on starting an online business, yellow pages, and some free and some fee-based services.
U.S. GAAP Information	http://cpaclass.com/gaap/ Comprehensive source of information on generally accepted accounting principles in the U.S.
Wall Street Journal Online Edition	http://online.wsj.com General business and financial news.
Washburn University School of Law Small Business Portal	http://www.washlaw.edu/subject/small.business.html Portal with links to a forms library and business and economic data.

Yahoo! Finance	http://biz.yahoo.com/i/ Free company profiles and stock charts for over 9000 public companies.
Yahoo! Small Business	http://smallbusiness.yahoo.com/ Portal with links to topics such as creating a website, promoting a business, and selling online.

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