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Discovering Consideration Through Part Performance of an Unenforceable Promise

2010 Emerging Issues 5203

Discovering Consideration Through Part Performance of an Unenforceable Promise: Dr. John E. Murray Jr. reviews Steiner v. Thexton, 48 Cal. 4th 411, 226 P. 3d 359 (2010)

By John E. Murray Jr.

July 21, 2010

SUMMARY: The Supreme Court of California concluded that when an offer for a unilateral contract is made and part of the consideration requested is rendered, the offeror is bound to a contract, but the duty of immediate performance is conditioned on the offeree's completion of performance. Dr. John E. Murray, Jr., reviews *Steiner v. Thexton, 48 Cal. 4th 411, 226 P. 3d 359 (2010).*

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ARTICLE: Real estate developer Steiner was interested in developing 10 acres of a 12.29 parcel of land owned by Thexton. Thexton had previously rejected a $750,000 offer to sell the 10 acres to another developer because it required Thexton to obtain the necessary county approval and permits. In exchange for Thexton's agreement to hold the offer open for three years, Steiner agreed to purchase the 10 acres for $500,000 by a certain date, but only if he secured the approval and permits and only if he decided to purchase the property after pursuing them. The "Real Estate Purchase Contract" that both parties signed stated that Steiner was not required to do anything and could cancel the transaction at any time in his sole and absolute discretion. Steiner spent thousands of dollars in pursuing the approval and permits and Thexton originally cooperated in this effort. Before the process was completed, however, Thexton announced that he no longer wanted to sell the property. Steiner sought specific performance, which Thexton opposed on the footing that the transaction evidenced an option unsupported by consideration. Thus, the "option" was a mere revocable offer and Thexton exercised his power of revocation.

The trial court agreed, stating that Thexton had received no benefit and Steiner suffered no detriment since he could withdraw at his sole discretion. The court held that there must be consideration at the time a contract is entered into and no consideration existed at that time. The court of appeals affirmed. The Supreme Court of California, however, reversed. It viewed the "Real Estate Purchase Contract" document as Thexton granting a three-year option to Steiner, which was not enforceable when it was granted since it was not supported by consideration. Steiner's claim that the parties had entered into a bilateral contract was rejected since Steiner could withdraw at any time for any reason or no reason. His promise was, therefore, illusory. The Thexton offer, however, could not be accepted by a promise in any event. It could only be accepted by Steiner's performance in securing the necessary permits and approvals and paying Thexton $500,000. The court assumed that Thexton desired this benefit since the approvals and permits were necessary to allow the land to be developed. The court intimated that Thexton was willing to accept $250,000 less than the earlier

offer if the buyer underwent the significant expense of procuring the approvals and permits. Steiner had already expended thousands of dollars in that pursuit.

The court chose a familiar theoretical base for its holding and rationale. It borrowed the theory that Justice Traynor took from the familiar § 45 of the First Restatement of Contracts in *Drennan v. Star Paving Co.* n1 Where an offer for a unilateral contract is made and part of the consideration requested is rendered, the court concluded that the offeror is bound to a contract, but the duty of immediate performance is conditioned on the offeree's completion of performance. Thus, the "Real Estate Purchase Contract" was an offer by Thexton to allow Steiner up to three years to gain the county approvals and permits and pay the $500,000. Steiner expressly declined to promise to Thexton that he would even pursue, much less achieve, success in that pursuit. Thus, Thexton's offer, unsupported by either consideration or reliance at the time the parties agreed, was clearly revocable. Once Steiner began to perform, however, the offer was converted into an option contract by Steiner's part performance. An offeree such as Steiner is not bound to complete performance since he made no promise to perform. His promise to perform could have no operative effect since the acceptance of the offer had to be a performance acceptance - effecting the necessary approvals and permits as well as paying $500,000.

Like any other offer exclusively requiring performance rather than a promise, once the offeree begins to perform, the offer becomes irrevocable. The court could have found an even more fitting application of a theory under the Restatement (Second) of Contracts version of § 45. It treats part performance in relation to an offer that can only be accepted by performance as an option contract making the main offer irrevocable, which is sole effect of any option contract.

One of the quiet but important changes in contract law effected by the Uniform Commercial Code and adopted by the Restatement (Second) of Contracts, however, was the recognition that the typical offeror is indifferent as to how the offer is accepted. n2 The First Restatement reflected the earlier case law that assumed courts could typically ascertain whether an offer required a promissory or performance acceptance. n3 In cases of doubt, it was presumed that a promissory acceptance would be desired to effect a bilateral contract. Absent a contrary expression or where it would make no sense to allow a promissory acceptance, as in a reward offer, the UCC and Restatement (Second) presume that the offeror is equally pleased with either a promise or performance acceptance. Thus, an offer to purchase goods can be accepted in any reasonable manner - by promise or shipment of the goods. n4 When such a typically indifferent offer is made, the beginning of performance forms a contract that is *not* conditional on full performance. Rather, the part performance is viewed as an implied promise to complete performance. This theory appeared at the start of the twentieth century in *Los Angeles Traction Co. v. Wilshire,* n5 but that court found part performance to be an acceptance of an offer that could only be accepted by performance. Though designed to attack the nefarious possibility of an offeror revoking an offer after performance began, the opinion was highly criticized since it failed to consider the burden on an offeree who has made no commitment to complete performance, but is saddled with an implied promise to perform simply by starting to perform. The UCC/Restatement (Second) implication of a promise occurs only when the offer is indifferent as to the manner of acceptance.

If an offer is not indifferent, but can only be accepted by performance, to avoid manifest injustice once the offeree has started to perform, there was never any question that permitting a revocation after part performance would have to be precluded. Either the First or Second Restatement § 45 theory meets that challenge, though it would have been more forthright to simply state that the offer becomes irrevocable to avoid manifest injustice. This is the true rationale. There is, therefore, nothing unusual in the Supreme Court's analysis, but the analysis has not been totally assimilated as evidenced by the decisions of the trial court and court of appeals in this case. The same analysis may be unearthed in a classic case.

Hay v. Fortier n6 involved a promise to pay an already due debt in exchange for the creditor's forbearance to sue immediately and await payment for an additional period. The debtor later asserted that her promise was not supported by consideration since the creditor's promise for which he was receiving nothing was unenforceable. Thus, there was an absence of so-called "mutuality of obligation," which is nothing more than an absence of consideration. The court recognized the unanimous view that a promise to forbear suit on a debt already due without any further consideration

cannot be enforced by the debtor. Nonetheless, it concluded that the promise was supported by consideration. While the court's rationale is opaque, it arrived at the correct conclusion in its apparent holding that the contract was not formed by the parties' exchange of promises, but only upon the completion of forbearance for the promised period. There has always been confusion concerning the rationale in this case. The curious analysis of Restatement (Second) of Contracts in an illustration based on this case exacerbates the confusion:

A promises to forbear suit against B in exchange for B's promise to pay a liquidated and undisputed debt to A. A's promise is not binding because B's promise is not consideration under § 73, [Performance of a legal duty], but A's promise is nevertheless consideration for B's. n7

A comment is as convoluted as the illustration: "The probability of performance may be greater for . . . a promise which is not binding . . . than for the judgment of decree of a court." n8 The analysis is hardly comprehensible, much less persuasive. n9 There is no escape from the absence of consideration at the time the promises of the debtor and creditor were exchanged. There was no consideration and no contract upon the exchange of the promises. The debtor's promise to pay the debt at a later date, however, was made to induce forbearance by the creditor.

The current analysis of the Supreme Court of California in 2010 supports the holding of the classic *Hay v. Fortier* case. The creditor could not be bound by a promise to accept nothing, but upon performing the act of forbearance for which the debtor was bargaining in making the promise, the consideration for the promise was supplied, creating a unilateral contract when the forbearance was completed. If the debtor had attempted to revoke the offer after the creditor began to forbear, the offer should have been deemed irrevocable, i.e., an "option" contract. The offeree-creditor could not make an enforceable promise to receive nothing, but he could suffer the detriment of performing the very act for which the debtor bargained to make the debtor's promise enforceable, and part performance of that unenforceable promise should make such an offer irrevocable as if it were an "option" to allow the offeree to complete the performance in keeping with § 45 of either Restatement of Contracts. The trial court and court of appeals failed to recognize this analysis. Even the plaintiff, Steiner, did not pursue this analysis. Fortunately, the Supreme Court of California unveiled an important analysis of fundamental contract law that can be applied in myriad situations.

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n1 *51 Cal.2d 409, 333 P. 2d 757 (1958).*

n2 The analysis of this and related changes is found in John E. Murray, Jr., *A New Design for the Agreement Process, 53 Cornell L. Rev. 785 (1968).*

n3 One of the better illustrations is found in *Davis v. Jacoby, 1 Cal. 2d 370, 34 P. 2d 1026 (1934).* In that case, a letter offer was made to a niece and her husband to leave property to them if they would relocate to take care of the offeror and his wife. The offerees promised to provide such care but the offeror committed suicide before they could perform. The issue was whether this offer could be accepted only by performance.

n4 UCC §§ 2-206(1)(a) and 2-206(1)(b) ("Unless otherwise unambiguously indicated ... an order or other offer to buy goods for prompt or current shipment shall be construed as inviting acceptance either by a prompt promise to ship or by the prompt or current shipment. . . ." Restatement (Second) of Contracts § 32 cmt. a cites § 2-206 in stating, "[T]he usual offer invites an acceptance which either amounts to performance or constitutes a promise." Section 62(2) states: "Such an acceptance operates as promise to render complete performance."

n5 *135 Cal. 654, 67 P. 1086 (1902).*

n6 *116 Me. 455, 102 A. 294 (1917).*

n7 Restatement (Second) of Contracts § 75 illus. 4.

n8 Restatement (Second) of Contracts § 78 cmt. a.

n9 Restatement (Second) of Contracts § 75 illus. 1. My criticism of this analysis which follows appeared in the Third Edition of *Murray on Contracts* and was noted in *Corbin on Contracts* § 6.1, note 32, long before I was involved as a co-editor of the *Corbin on Contracts* supplements, the author of *Corbin on Contracts* Revised Edition Volume 9, or the author of the *Corbin on Contracts Desk Edition*.

RELATED LINKS: For further discussion, see
- Corbin on Contracts § 6.1

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Dr. Murray is the author of the renowned *Murray on Contracts* and *Murray, Cases and Materials on Contracts.* In addition, Dr. Murray is the co-author of the *Corbin on Contracts* supplements, the author of *Corbin on Contracts* Revised Edition Volume 9, and *Corbin on Contracts Desk Edition*. He has also authored numerous op-eds and articles for national and local newspapers and magazines. Dr. Murray is particularly well-known for his scholarship dealing with the "battle of the forms."

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The U.S. Supreme Court decides Rent-A-Center, West, Inc. v. Jackson

2010 Emerging Issues 5194

The U.S. Supreme Court's decision in Rent-A-Center, West, Inc. v. Jackson, 2010 U.S. LEXIS 4981 (2010)

By Timothy Murray

July 16, 2010

SUMMARY: The U.S. Supreme Court held in *Rent-A-Center, West, Inc. v. Jackson, 2010 U.S. LEXIS 4981 (2010)* that a challenge to the validity of an arbitration agreement that contains a provision delegating to the arbitrator exclusive authority to resolve threshold issues relating to the validity of the arbitration agreement is to be decided by the arbitrator, not a court, unless the challenge is specifically made to the delegation provision itself.

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ARTICLE: In *Rent-A-Center, West, Inc. v. Jackson, 2010 U.S. LEXIS 4981* (decided June 21, 2010), the United States Supreme Court not only affirmed its long-standing commitment to arbitration as a preferred method of dispute resolution, it also constructed an additional barrier that needs to be overcome before a party may seek judicial intervention to determine the validity of an agreement to arbitrate. The Supreme Court held that a challenge to the validity of an arbitration agreement that contains a provision delegating to the arbitrator exclusive authority to resolve threshold issues relating to the validity of the arbitration agreement is to be decided *by the arbitrator*, not a court, unless the challenge is specifically made to the delegation provision itself.

Pre-*Rent-A-Center*

To understand the *Rent-A-Center* decision, it is necessary to consider its context. It has long been settled that a challenge to the validity of an agreement containing an arbitration clause is decided by the court, as opposed to the arbitrator, only if the challenge goes to the validity of the agreement to arbitrate. If, on the other hand, the challenge goes *to the validity of the entire agreement*, which agreement happens to *contain* an agreement to arbitrate, the controversy is decided by the arbitrator.

Justice Black famously labeled the decision that fashioned this rule, *Prima Paint Corp. v. Flood & Conklin Mfg., 388 U.S. 395 (1967)*, as "fantastic." After all, why should an arbitrator have the right to decide an issue if the agreement purporting to confer that right is invalid? Such a rule seems to contravene Federal Arbitration Act (FAA) §2: "A written provision in any . . . contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the

revocation of any contract." *9 U.S.C. §2*

Justice Stevens, writing for the dissent in *Rent-A-Center*, explained that while the rule fashioned by *Prima Paint* "may be difficult for any lawyer -- -- or any person -- -- to accept," it nevertheless "reflects a judgment that the "'national policy favoring arbitration'" . . . outweighs the interest in preserving a judicial forum for questions of arbitrability -- -- *but only when questions of arbitrabiliy are bound up in an underlying dispute. Rent-A-Center, West, Inc. v. Jackson, 2010 U.S. LEXIS 4981 (2010)* (dissent at *42) (emphasis in original). When questions of arbitrability are inextricably tied to the underlying dispute, Justice Stevens explained, "The question "Who decides" is the entire ball game. Id. at *42.

The *Rent-A-Center* Decision

The *Rent-A-Center* decision took *Prima Paint* one step further and held that a court may not decide a challenge to the validity of an agreement to arbitrate that contains a provision delegating to the arbitrator authority to resolve the validity of such agreement, unless the plaintiff specifically challenges the delegation provision.

The facts in *Rent-A-Center* are simple. Jackson, a former employee of Rent-A-Center, filed an employment discrimination suit against Rent-A-Center in a federal district court. Rent-A-Center filed a motion under the FAA to dismiss or stay the proceedings, *9 U.S.C. § 3*, and to compel arbitration, *9 U.S.C. § 4*, arguing that the Rent-A-Center Mutual Agreement to Arbitrate Claims (Agreement) that Jackson signed precluded Jackson from pursuing his claims in court. Jackson challenged the validity of the Agreement on grounds of unconscionability.

Unlike *Prima Paint*, the Agreement at issue in *Rent-A-Center* was nothing more than a free-standing agreement to arbitrate; aside from establishing the parties' rights and obligations with respect to arbitration, the Agreement did not spell out any other rights or duties of the parties. The Agreement provided for arbitration of all "past, present or future" disputes arising out of Jackson's employment with Rent-A-Center, including "claims for discrimination" and "claims for violation of any federal . . . law."

Critically, the Agreement also contained what the majority opinion, authored by Justice Scalia, called a "delegation provision." The delegation provision stated that "[t]he Arbitrator, and not any federal, state, or local court or agency, shall have exclusive authority to resolve any dispute relating to the interpretation, applicability, enforceability or formation of this Agreement including, but not limited to any claim that all or any part of this Agreement is void or voidable."

The majority sided with Rent-A-Center and held that an arbitrator, not a court, was to decide whether the Agreement was unconscionable. Justice Scalia noted that "[t]he FAA . . . places arbitration agreements on an equal footing with other contracts, . . . and requires courts to enforce them according to their terms . . . . *Rent-A-Center* at *8. Further: Under *§ 4* [of the FAA], a party "aggrieved" by the failure of another party "to arbitrate under a written agreement for arbitration" may petition a federal court "for an order directing that such arbitration proceed in the manner provided for in such agreement." The court "shall" order arbitration "upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue." *Rent-A-Center* at ** 8-9.

The majority explained that parties to an arbitration agreement are free to delegate to the arbitrator threshold or "gateway" issues of arbitrability, so long as there is a "clear and unmistakable" manifestation of intent to arbitrate. The "clear and unmistakable" requirement, the majority noted, has nothing to do with whether the agreement is invalid, due to unconscionability or otherwise. Indeed, Jackson did not dispute that the text of the Agreement was clear and unmistakable in delegating issues of arbitrability to the arbitrator.

There are two types of "validity challenges" under the FAA, the majority explained. First, a challenge to the validity of the agreement to arbitrate; second, a challenge to the contract as a whole. Only the first type of challenge is "relevant" to a court's determination as to whether the arbitration agreement is enforceable. That is so because § 2 of the FAA states that a "written provision" "to settle by arbitration a controversy" is "valid, irrevocable, and enforceable," the

majority explained, "*without mention* of the validity of the contract in which it is contained." *Rent-A-Center* at *14 (emphasis in original). Thus, the arbitration agreement is severable from the remainder of the agreement, and a court will only intervene when a party specifically challenges *the validity of the agreement to arbitrate*. A challenge to the contract as a whole will not trigger judicial involvement.

Here, the written provision that Rent-A-Center asked the Court to enforce was *the delegation provision*, while the underlying contract was a free-standing arbitration agreement. The former was severable from the latter. Accordingly, the majority concluded, since Jackson did not even mention, much less specifically challenge, *the validity of the delegation provision*, but challenged only the validity of the entire arbitration agreement, the delegation provision was valid under § 2 of the FAA, and the court enforced it under §§ 3 and 4, "leaving any challenge to the validity of the Agreement as a whole for the arbitrator." *Rent-A-Center* at *16. n1

The dissent, authored by Justice Stevens, noted that the majority's "breezy assertion that the subject matter of the contract at issue -- -- in this case, an arbitration agreement and nothing more -- -- "makes no difference," . . . is simply wrong." Id. at *24.

"Section 2 of the FAA dictates that covered 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."" Id. at *26. "In other words, when a party raises a good-faith validity challenge to the arbitration agreement itself, that issue must be resolved before a court can say that he clearly and unmistakably intended to *arbitrate* that very validity question." Id. at *33-34. The majority, however, "reads the delegation clause as a distinct mini-arbitration agreement divisible from the contract in which it resides -- -- which just so happens also to be an arbitration agreement." Id. at *39-40. Justice Stevens found the majority's reasoning "even more fantastic" than the reasoning in *Prima Paint*.

Practical Implications of the Decision

The *Rent-A-Center* decision makes arbitration provisions, which typically are drafted for the benefit of employers and businesses and are opposed by employees and consumers, less susceptible to challenge in a court of law. U.S. Senator Patrick Leahy, for one, condemned the decision as "a blow to our nation's civil rights laws and the protections that American workers have long enjoyed under those laws." He noted: "It is estimated that more than one hundred million Americans work under binding mandatory arbitration agreements. Most Americans are not even aware that they have waived their constitutional right to a jury trial when they accept a job to provide for their families." [http://leahy.senate.gov/press/press_releases/release/?id=f6b28e65-6a68-4db2-8799-624d07732b77]

The end result of Justice Scalia's majority decision is the creation of a formalistic hurdle that will enable parties desiring arbitration to limit judicial challenges to their contracts. Parties wishing to arbitrate disputes can be expected to start tacking onto their contracts clauses akin to the delegation provision in *Rent-A-Center* that explicitly delegate to an arbitrator the authority to resolve all threshold issues, including those related to the formation and validity of the arbitration agreement.

When a dispute arises over a contract containing a delegation provision, employees and consumers wishing to have a court, as opposed to an arbitrator, decide the validity of the arbitration agreement will need to specifically tailor their attacks on the delegation provision, which likely will prove very difficult. Justice Stevens explained in his dissent in *Rent-A-Center* that, from now on, an attack on the validity of the arbitration agreement as a whole will not trigger judicial involvement: "A claim that an entire arbitration agreement is invalid will not go to the court unless the party challenges the particular sentences that delegate such claims to the arbitrator, on some contract ground that is particular and unique to those sentences." Id. at *41-42.

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n1 Jackson argued that the delegation provision itself was substantively unconscionable for the first time in the Supreme Court. "He brought this challenge to the delegation provision too late," the majority concluded, "and we will not consider it." *Rent-A-Center* at *22.

RELATED LINKS: For more information, see
- Corbin on Contracts 29.4

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Beware of Losing Benefits of an Indemnity Provision Elsewhere in the Contract

2010 Emerging Issues 5087

Beware of Losing the Benefits of an Indemnity Provision Elsewhere in the Contract

By Timothy Murray

June 7, 2010

SUMMARY: Contract lawyers often exercise extreme care in allocating the costs and risks of loss with meticulously drafted indemnity provisions. But a party inadvertently may lose the benefit it sought to achieve in the indemnity clause in other provisions of the contract, most notably clauses limiting liability and clauses excluding consequential damages. Timothy Murray, partner, Murray, Hogue & Lannis, discusses possible drafting pitfalls.

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ARTICLE: Beware of Losing the Benefits of an Indemnity Provision Elsewhere in the Contract

This is a cautionary tale for attorneys who draft contracts -- a warning to avoid a common, often costly, mistake that is so fundamental that it is not only easy to make but easy to avoid, if only attorneys are on the lookout for it.

In negotiating contracts, lawyers often exercise extreme care in allocating the costs and risks of loss, as well as the cost of procuring insurance, with meticulously drafted indemnity provisions. Drafting complex indemnity provisions can be a daunting task for the novice, since such provisions pose innumerable traps for the unwary. There are all manner of special common law and statutory rules that govern the drafting of such clauses, often necessitating the incantation of particular buzzwords or catchphrases. Moreover, as a practical matter, consultation with the client's insurance provider is often necessary to be certain that the risks being assumed are, in fact, covered.

But regardless of how carefully the indemnity provision is drafted, it is possible for the parties inadvertently to lose whatever benefit they sought to achieve in the indemnity clause in *other* provisions of the contract, most notably clauses limiting liability and clauses excluding consequential damages.

The mischief to be avoided lies in drafting a contract without regard for how all the parts fit together. Commercial litigators are well-versed in the contract canons of construction that agreements are to be interpreted and construed as a whole, that all parts are to be given meaning if practicable, and that no part should be construed as surplusage. See, e.g., *Corbin on Contracts*, §24.21.

Such lofty tenets, however, are often not heeded in the drafting phase, where contracts are commonly stitched together by snatching shreds and patches of previous contracts involving the same or other parties, and grafting isolated

clauses from handy formbooks onto it regardless of whether the graft takes. The result is often a Frankenstein monster of a document, with disparate parts taken from multiple sources as opposed to a cohesive body fashioned in accordance with a grand scheme.

Atlantic City Associates v. Carter & Burgess Consultants, Inc.

A case illustrating how the benefits of an indemnity provision might be lost because of other clauses in the contract is *Atlantic City Associates v. Carter & Burgess Consultants, Inc., 2008 U.S. Dist. LEXIS 93684 (D. N.J. 2008)*, a dispute involving a construction project of an Atlantic City retail and commercial use property. Years before the dispute arose, the Architect submitted a proposal to Owner to provide architectural services.

Limitation of liability provision

Section F of the Architect's proposal capped damages recoverable from the Architect to the total compensation received by the Architect under the agreement:

To the fullest extent permitted by law, the total liability, in the aggregate, of [Architect] and [Architect's] officers, directors, employees, agents ... to [Owner] ... for any and all injuries, claims, losses, expenses or damages whatsoever arising out of or in any way related to [Architect's] services ... from any cause or causes whatsoever, including but not limited to, the negligence, errors, omissions, strict liability, breach of contract, misrepresentation or breach of warranty of [Architect] ... shall not exceed the total compensation received by [Architect] under this Agreement.

Subsequently, the parties entered into a signed contract. A paragraph in the contract provided that the proposal was incorporated into the contract "except where it might result in a conflict with this Agreement, and if such conflict exists, this Agreement shall prevail."

Waiver of consequential damages

The contract contained a ***waiver of consequential damages provision***:

The Architect and the Owner waive consequential damages for claims, disputes or other matters in question arising out of or relating to this Agreement. This mutual waiver is applicable, without limitation, to all consequential damages due to either party's termination in accordance with Paragraph 1.3.8.

Indemnity provision

The Contract also contained an ***indemnity provision***, which stated:

The Architect agrees to indemnify, hold harmless, protect the Owner and the Owner's agents, representatives, the Construction Manager, and any affiliated or related entities of the Owner against any and all claims, loss liability, damage, costs and expenses, including reasonable attorney's fees, to the extent caused by the negligent acts, errors or omissions of the Architect, its agents, consultants, employees or representatives.

The construction project experienced delays, and each of the parties blamed the other. They filed cross-motions for summary judgment to determine which provisions in the proposal and contract governed their dispute. The Owner sought to limit the effect of the provision excluding consequential damages by arguing that the Owner could recover consequential damages for damages falling within the indemnity provision. The court disagreed:

The Court finds that the indemnification provision . . . can be harmonized with the consequential damages provision ... . Under [the consequential damages provision], the parties mutually agreed to waive consequential damages. In that paragraph, the parties did not include a waiver of direct damages so that [Architect] was still liable to [Owner] for any direct damages. . . . . Under [the indemnity provision] . . . [Architect] agreed to indemnify [Owner] "... against any and all claims ... to the extent caused by the negligent acts, errors or omissions of the Architect ...." Since

the parties had already agreed to mutually waive consequential damages, this provision shows an intent by [Architect] to indemnify [Owner] for direct damages. Therefore, [the indemnity provision] requires [Architect] to indemnify [Owner] against all direct damages allegedly caused by [Architect's] negligence, errors or omissions. In this way, both provisions can be harmonized with each other so as to give effect to the parties' intent and relate them to the contractual scheme as a whole.

Id. at **12-13.

The Architect also alleged that the limitation of liability provision in its proposal limited the amount of damages the Owner could receive from the Architect to the amount of compensation paid to the Architect. The court rejected this contention:

The Court finds that [the limitation of liability provision] of the Proposal is in conflict with [the indemnity provision] of the Contract. [The limitation of liability provision] caps the damages recoverable by [Owner] against [Architect] at the amount that [Owner] paid [Architect] under the Contract. Conversely, under [the indemnity provision], [Architect] agreed to indemnify [Owner] against any and all claims, loss liability, damage, costs and expenses, except consequential damages, to the extent caused by the negligent acts, errors or omissions of [Architect], without limitation. Thus, these two provisions are in conflict. Under ... the Contract the parties agreed that the Proposal was incorporated into the Contract "except where it might result in a conflict with this Agreement, and if such conflict exists, this Agreement shall prevail." Given that the two provisions -- one from the Proposal and one from the Contract -- conflict with each other,... the indemnity provision from the Contract prevails and the amount of damages recoverable is not limited to the amount [Owner] paid to [Architect].

The matter proceeded to trial, and the jury returned a verdict against the Architect and awarded damages to the Owner in excess of $7.6 million for costs to fix errors, payments to contractors for delay, and lost rental income. *Atlantic City Associates v. Carter & Burgess Consultants, Inc., 2010 U.S. Dist. LEXIS 32133* at **19-20 (D. N.J. 2010). In its motion for new trial, the Architect claimed that the court erred in awarding the Owner damages stemming from the delay in completing the project as well as lost rental income. The Architect claimed these were consequential damages barred by the contract. The court rejected this argument:

Distilled to its essence, [Architect's] argument is that [the waiver of consequential damages provision] bars consequential damages and so lost rent and delay damages, which are generally consequential in nature, cannot be recovered as a matter of law regardless of what [the indemnity provision] provides. However, this ignores the reality of the contract negotiated by the parties.

[The indemnity provision] is a promise by Carter to perform its work with reasonable promptness, with the requisite level of professional skill and judgment, and to afford the project priority in its offices so as not to cause delay to the project. This provision by its very nature removes from the province of consequential damages certain categories of potential damages when they arise directly from its breach. When a promise not to delay is breached, it necessarily follows that delay damages may directly result. Likewise, when the contract containing the promise not to delay is for the design of commercial real estate property created solely for the purpose of generating rental income, it necessarily follows that lost rent damages may directly result from a breach. Accordingly, it was appropriate to allow evidence of such damages at trial.

The lessons of *Atlantic City*

The lessons of the *Atlantic City* case are unsettling. First, if the *Atlantic City* court had not been able to resolve the conflict between the indemnity and limitation of liability clauses by looking at the four corners of the documents, it is well to keep in mind that it would have resorted to parol evidence, thus raising the specter that, depending on the evidence, the Owner's damages might have been capped at the amount of compensation paid to the Architect. *See, e.g.,*

Corbin on Contracts, §24.10.

Second, significant client resources spent during litigation to determine the proper interpretation and construction of the three contractual provisions, and to decide whether the damages awarded were "consequential," could have been avoided by expressly stating in simple, clear terms how the clauses should be read together. In retrospect, it would have entailed a relatively simple drafting modification to avoid the litigation of these crucial issues.

In sum, an indemnity clause is not an island. It will be construed by a court, like all other contractual clauses, in conjunction with the contract as a whole. Contractual terms are not regarded as "surplusage," and if counsel does not want one section of the contract to be read in conjunction with another, ***he or she needs to say that***. An attorney can draft the most perfect indemnity clause imaginable, but if its benefits are given away elsewhere in the contract, it is of no value.

RELATED LINKS: For more information, see
- 5-24 Corbin on Contracts § 24.10 ;
- 5-24 Corbin on Contracts § 24.21

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Joint Patent Owners May Vary Their Rights by Contract

2010 Emerging Issues 4873

Joint Patent Owners, Although Free to Use Patented Technology Without Regard to the Other, May Vary Their Rights by Contract: The Interplay between contract and patent law as examined in Wisconsin Alumni Research Foundation v. Xenon Pharmaceuticals, Inc., 2010 U.S. App. LEXIS 173 (7th Cir. 2010).

By Timothy Murray

February 22, 2010

SUMMARY: Joint patent owners, although free to use patented technology without regard to the other, may vary their rights by contract. The interplay between contract and patent law is examined by Timothy Murray, Esq. in the context of *Wisconsin Alumni Research Foundation v. Xenon Pharmaceuticals, Inc., 591 F.3d 876 (7th Cir. 2010).*

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ARTICLE: The Seventh Circuit Court of Appeals' decision in *Wisconsin Alumni Research Foundation v. Xenon Pharmaceuticals, Inc., 591 F.3d 876 (7th Cir. 2010)* is significant in shedding light on the interplay between contract and patent law, but it is not the titanic clash between these two bodies of jurisprudence that, at first blush, it might have seemed. In fact, it more closely resembles a garden variety application of the rules of contract interpretation than a groundbreaking legal precedent.

Factual Summary

The Seventh Circuit's decision resolved a cornucopia of legal arguments by applying settled legal principles. The most significant issue was the interplay between patent and contract law. The pertinent facts with respect to that issue, described in the Court of Appeals' decision as well as in one of the District Court's decisions found at *2006 U.S. Dist. LEXIS 61077 (W.D. Wis. 2006),* are as follows. In 1999, researchers at the University of Wisconsin discovered that suppressing levels of an enzyme known as Stearoyl CoA Desaturase ("SCD") in the human body lowered cholesterol levels. The researchers assigned their rights in the discovery to the Wisconsin Alumni Research Foundation, the patent management entity for the University of Wisconsin. Thereafter, the Foundation filed a provisional patent application for the discovery and then entered into a series of agreements with Xenon Pharmaceuticals, Inc., a Canadian drug company, for various SCD research projects.

In February 2001 Xenon and the Foundation filed a joint patent application covering the SCD enzyme, as well as a method of using the enzyme. Xenon and the Foundation also entered into an Exclusive License Agreement giving Xenon an exclusive right to make, use, and sell patented products under the joint patent application within the field of human healthcare.

The Exclusive License Agreement did not allow assignments absent the Foundation's prior consent: "This Agreement is not assignable by either party except with the prior written consent of the other party, which consent shall not be unreasonably or arbitrarily withheld." It did, however, allow sublicenses. In exchange for the exclusive rights to make, use, and sell patented products, Xenon agreed that it would pay the Foundation a percentage of any product sales, royalties, or sublicense fees it received. Section 4B(ii), provided as follows:

For all Products sold by Xenon sublicensees, Xenon shall pay to [the Foundation] a percentage of any license fees, milestones, and royalty payments received by Xenon in consideration for the sublicense granted to such sublicensees . . . . The percentage shall remain fixed at a rate of ten percent (10%) for years one (1) and two (2) of this Agreement and seven and one-half percent (7.5%) thereafter until this Agreement is terminated.

In 2004, Xenon signed a license agreement with Novartis Pharma AG giving Novartis a license to the technology covered by the joint patent application. The Foundation demanded its share of the sublicense fees that Xenon received from Novartis under the terms of the Exclusive License Agreement. Xenon refused, stating that it had the right to license its undivided interest in the joint patent application without being subject to the terms of the Exclusive License Agreement. The Foundation filed suit. The District Court held, *inter alia*, that Xenon breached the Exclusive Licensing Agreement by granting the sublicense to Novartis.

Joint Patent Owners May Vary Rights by Contract

On appeal, the Seventh Circuit affirmed the portion of the District Court's decision holding that Xenon breached the Exclusive Licensing Agreement by granting the sublicense to Novartis. The court noted that under *35 U.S.C. § 262*, joint patent owners have control over the entire property, and either owner may freely use the patented technology without regard to the other. The court explained the potentially harsh application of this rule: ". . . [U]nder this principle of patent law, 'each co-owner is "at the mercy" of the other in that the right of each to license independently "may, for all practical purposes, destroy the monopoly and so amount to an appropriation of the whole value of the patent."'" *Wisconsin Alumni Research Foundation*, *supra* at *12.

However, the court explained that pursuant to the express terms of the statute, this rule is subject to variation by contract:

This statutory rule is subject to an important exception, however: Joint patent owners may vary their rights by contract. The statute provides that "*[i]n the absence of any agreement to the contrary*, each of the joint owners of a patent may make, use, offer to sell, or sell the patented invention . . . without the consent of and without accounting to the other owners." *35 U.S.C. § 262* (emphasis added). The statutory default rule therefore controls *unless* there is an agreement to the contrary.

Id. at *13 (emphasis in original).

Was the Exclusive License Agreement an "agreement" pursuant to *35 U.S.C. § 262* that prevented Xenon from using or selling the product to a third party without an accounting? The court answered in the affirmative. The Exclusive License Agreement modified the statutory default rule set forth in *35 U.S.C. § 262*, even though it neither specifically nor explicitly revoked Xenon's § 262's rights. The Exclusive License Agreement did not allow assignments absent the Foundation's prior consent. Sublicenses, on the other hand, were permitted, provided the Foundation received a specified percentage of royalty or sublicense fees. In return for the Foundation extending to Xenon the right to use or sell the pertinent products, Xenon would pay the Foundation a percentage of any payments, royalties, or sublicense fees it received. The court explained:

Xenon argues that nothing in the Exclusive License Agreement explicitly revokes its statutory right to license its interest freely. True, but the agreement's provision requiring that Xenon pay the Foundation a share of the fees derived from any sublicense plainly undermines Xenon's claim that it retained an unfettered right under *§ 262* to transfer its interest in the technology to third parties. So does the agreement's provision prohibiting assignment of the license

without the Foundation's consent. The bargained-for exchange between the parties provided that the Foundation would forego its right to separately license the patent in exchange for receiving a share of the profits from Xenon's commercialization of the technology--either directly or via a sublicense to a third party. Xenon received a significant benefit from the agreement--the exclusive right to exploit the technology protected by the joint patent application. Xenon cannot avoid paying royalties or sublicense fees to the Foundation simply by labeling the Novartis transaction a "license" rather than a "sublicense."

Id. at **14-15.

The Term "Agreement" Is Broader than the Term "Contract"

The court's decision is sound. Nothing in *35 U.S.C. § 262* requires the requisite "agreement" to expressly or explicitly reference the statute in order to vary it. Nor is there any requirement that it contain any special words.

The term "agreement" as used in *35 U.S.C. § 262* has been held to include *non*-contractual mutual assent. For example, in *Massachusetts Eye and Ear Infirmary v. QLT Phototherapeutics, 412 F.3d 215, 235 (1st Cir. 2005),* one of the litigants claimed that this exception only applies where there is a written, legally enforceable contract. But § 262 says no such thing. Congress knew how to insist upon a contract, and even how to specify that it must be reduced to writing. *Cf. 35 U.S.C. § 261* (holding that patent rights are "assignable in law by an instrument *in writing*") (emphasis added). However, § 262 simply speaks of "any agreement." MEEI has provided evidence of an agreement with QLT in which QLT promised to "negotiate in good faith with MEEI . . . to come to an agreement on reasonable terms and royalty rates which will be consistent with industry standards under similar circumstances." We have held, *supra* . . ., that this agreement was not enforceable as a contract, because the terms are too indefinite. However, if the fact-finder determines that there was such an agreement, it might still qualify as an "agreement" under § 262, and therefore form the basis for equitable relief on a theory of unjust enrichment without presenting any conflict with the allegedly preempting statute.

The holding in *Massachusetts Eye and Ear Infirmary* is consistent with the most commonly accepted meaning of the term "agreement," which is considered to be broader than the term "contract": "In the law of contracts . . . the term agreement is commonly used to mean the expressions of two or more persons respecting a subject-matter of a kind that in the past has stimulated official action on the part of organized society. In the law of contracts we mean by the term agreement an expression of mutual assent between two parties that frequently creates a contract." *Corbin on Contracts*, § 1.9.

In addition, to suggest, as Xenon did, that Xenon had the unfettered right under *35 U.S.C. § 262* to transfer its interest in the technology to third parties, however that transfer might be characterized, would have required the court to disregard, or treat as mere surplusage, the provision requiring Xenon to pay the Foundation a share of the fees derived from any sublicense. Such an interpretation would violate the admonition of Section 203(a) of the Restatement (Second) of Contracts that courts prefer "an interpretation which gives a reasonable, lawful, and effective meaning to all the terms." Comment b to Section 203 explains: "[I]t is assumed in the first instance that no part of [the contract] is superfluous ... . [P]articularly in the case of integrated agreements, terms are rarely agreed to without reason. Where an integrated agreement has been negotiated with care and in detail and has been expertly drafted for the particular transaction, an interpretation is very strongly negated if it would render some provisions superfluous. . . ."

The Seventh Circuit, quite properly, was unwilling to rewrite the contract by reading out of it the provision requiring that Xenon pay the Foundation a share of the fees derived from any sublicense.

RELATED LINKS: For further discussion, see
- Corbin on Contracts, 1.9

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Drafting Choice of Law Clauses That Cover Non-Contractual Disputes

2010 Emerging Issues 4798

Drafting Choice of Law Clauses That Cover Non-Contractual Disputes

By Timothy Murray

January 7, 2010

SUMMARY: The prevailing view in the United States is that whether a choice of law provision encompasses extra-contractual claims depends on its wording. Parties often draft choice of law provisions in a manner that excludes extra-contractual disputes from their ambit. In drafting choice of law provisions, prudent parties need to consider, and agree on, the extent to which they want their choice of law provision to apply to disputes that might arise.

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ARTICLE: Drafting Choice of Law Clauses That Cover Non-Contractual Disputes

Judicial Respect for the Parties' Contractual Choice of Law

Courts generally respect the choice of law agreed to by the parties in their contract. Restatement (Second) of the Conflicts of Laws § 187 is widely followed and provides that a court will follow the law of the state chosen by the parties "to govern their contractual rights and duties . . . unless either (a) the chosen state has no substantial relationship to the parties or to the transaction or there is no other reasonable basis for the parties' choice; or (b) application of the law of the chosen state would be contrary to fundamental policy of a state which has a materially greater interest than the chosen state in the determination of a particular issue and which . . . would be the state of applicable law in the absence of an effective choice of law by the parties."

While the Restatement speaks only to the parties' autonomy to choose the law of a state relating to their *contractual rights and duties*, and although there has long been tension as to whether parties ought to be permitted to choose the law governing extra-contractual matters, the prevailing view in the United States is that parties generally do possess the right to contractually agree on the law that will govern extra-contractual matters, as well as their contractual rights and duties. "[C]ourts tend to scrutinize clauses that purport to encompass tort-like issues much more closely than clauses confined to purely contractual issues." S. Symeonides, "Oregon's Choice of Law Codification for Contract Conflicts: An Exegesis," *44 Willamette L. Rev. 205 (Winter 2007).*

Scope of Choice of Law Clause Determines Its Applicability to a Particular Dispute

The prevailing view in the United States is that whether the choice of law provision encompasses extra-contractual

claims depends on its wording; specifically, whether it is a *narrow* or *broad* choice of law clause.

As with all other parts of a contract, courts will neither rewrite the choice of law clause nor construe it to be broader than its express wording allows. Care in drafting the choice of law clause is critical for at least two reasons: (1) because commercial litigation often entails both contractual *and* extra-contractual claims (examples of the latter include alleged tortious misconduct, including fraud and interference with contract), and (2) generally in the commercial setting, when parties choose the law of particular forum to govern disputes that might arise, they intend for that law to govern *all* disputes between the parties that in any way relate to the contractual relationship, including claims couched in extra-contractual claims.

Too often, however, parties inadvertently draft their choice of law provisions in a manner that excludes extra-contractual disputes from their ambit. In drafting choice of law provisions, prudent parties need to consider, and agree on, the extent to which they want their choice of law provision to apply to disputes that might arise.

In order to draft a choice of law provision properly, it is important to understand how courts construe them. The first point to understand is that when courts decide whether a particular dispute falls within the scope of a contractual choice of law clause, they generally look not to the law of the state chosen by the parties in the choice of law provision but to the law of the forum state. *See, e.g., Caton v. Leach Corporation, 896 F.2d 939 (5th Cir. 1990).* The court will apply the law of the forum state to discern whether the clause is a "narrow" or a "broad" clause. That will determine whether the dispute is within the scope of the choice of law provision.

Narrow Clauses

In *Caton v. Leach Corporation, 896 F.2d 939 (5th Cir. 1990),* the court held that a choice of law clause stating that "[this] Agreement shall be construed under the laws of the state of California" was a *narrow* clause that did not encompass the entirety of the parties' relationship. The court explained: "In contrast to broad clauses, which choose a particular state's law to 'govern, construe and enforce all of the rights and duties of the parties arising from or relating in any way to the subject matter of this contract,' the instant clause denotes only that California law will be applied to 'construe' the contract." *Id. at 942 n.3.* The court explained that claims arising in tort do not arise out of the contract. Thus, to decide which states' law applied to the tort claims asserted in the litigation between the parties, the court looked to the conflicts of laws rules of the forum state, Texas, which held that "the law of the state with the most significant relationship to the particular substantive issue will be applied to resolve that issue." *Id.*

In *Benchmark Elecs., Inc. v. J.M. Huber Corp., 343 F.3d 719 (5th Cir. 2003),* the court held that a clause providing that the "Agreement shall be governed by, and construed in accordance with, the internal laws of the State of New York . . . ." did not address the parties' entire relationship and therefore claims for fraud and negligent misrepresentation were not encompassed by it. "The provision at hand is narrow," the court concluded, "because it deals only with the construction and interpretation of the contract." *Id. at 726. See, e.g., Green Leaf Nursery v. E.I. Dupont de Nemours and Company, 341 F.3d 1292, 1300 (11th Cir. 2003)* (choice of law clause providing that "[t]his release shall be governed and construed in accordance with the laws of the State of Delaware" held to be narrow since "it does not refer to related tort claims or to any and all claims or disputes . . . arising out of the relationship of the parties."); *Krock v. Lipsay, 97 F.3d 640, 645 (2d Cir. 1996)* (choice of law provision stating that document "shall be governed by and construed in accordance with the laws of the Commonwealth of Massachusetts" did not apply to claim for fraudulent misrepresentation).

Even language that would otherwise be construed as "narrow" is sometimes held to encompass a tort claim if the tort claim is closely related to contractual performance. In *Fla. State Bd. of Admin. v. Law Eng'g & Envtl. Servs., 262 F. Supp. 2d 1004 (D.Minn. 2003),* the court held that the choice of law clause was narrow: "[T]his Agreement shall be governed by and construed in accordance with the laws of the State of Florida." Nevertheless, because the negligence claim at issue was based on the defendant's alleged deficient performance of the contract at issue, the court held that the tort claim was so intertwined with the performance of the contract that the tort claim was within the ambit of the choice

of law clause.

Broad Clauses

The court in *Caton v. Leach Corporation, 896 F.2d 939, 942 n.3 (5th Cir. 1990)* provided an example of broad language: "The law of [fill in the blank] state shall govern, construe and enforce all of the rights and duties of the parties arising from or relating in any way to the subject matter of this contract."

In *English Mt. Spring Water Co. v. AIDCO Int'l, Inc., 2008 U.S. Dist. LEXIS 43478 (E.D. Tenn. 2008),* the court held that a choice of law clause that stated "Resolution of disputes shall be conducted in accordance with the laws of the State of Michigan" was a broad provision that covered the entirety of the parties' dispute and not just the construction of the contract itself.

Use of the words "arising out of or relating to" are indicative of a broad choice of law clause. In *Gloucester Holding Corp. v. U.S. Tape & Sticky Prods., LLC, 832 A.2d 116, 124 (Del. Ch. 2003),* the court explained that the absence of words of this nature precluded a finding that the clause was a broad one: "The choice of law clause . . . does not claim to cover litigation that *arises out of or relates to* the Asset Purchase Agreement. Rather, the clause merely provides that Delaware law applies to the 'rights of the parties' derived from the contract. This clause is simply not sufficiently broad enough to cover tort claims such as fraud in the inducement."

While words such as "construed" and "interpreted" are widely held to be insufficient to encompass extra-contractual claims, some courts hold that tacking on the word "govern" to a choice of law clause serves to broaden the clause, but other courts disagree. In *Lincoln Gen. Ins. Co. v. Access Claims Adm'rs, Inc., 2007 U.S. Dist. LEXIS 67172 (E.D.Cal. 2007)* at **17-18, the court explained:

When contracting parties wish that all disputes arising from their relationship be subject to a particular state's law, they must use language indicating as much. In [*Nedlloyd Lines B.V. v. Superior Ct., 3 Cal. 4th 459, 466, 11 Cal. Rptr. 2d 330, 834 P.2d 1148 (1992)],* the California Supreme Court noted that "[t]he phrase 'governed by' is a broad one signifying a relationship of absolute direction, control, and restraint. Thus, the clause reflects the parties' clear contemplation that 'the agreement' is to be completely and absolutely controlled by [the foreign jurisdiction's] law." *Nedlloyd, 3 Cal. 4th at 469.* See also *Boat Town U.S.A., Inc. v. Mercury Marine Division of Brunswick, 364 So. 2d 15, 17 (Fla. App. 1978)* ("The difference between 'interpretation' and 'govern' is more than a technical distinction. It goes to the very heart of the purpose underlying a contract."). Here, however, those critical words were missing from the choice of law provision.

Nevertheless, not all courts have come to the same conclusion . . . . The Sixth Circuit in particular has rejected the view that there is a distinction between "interpreted and construed" on the one hand and "governed by" on the other. See *Boatland, Inc. v. Brunswick Corp., 558 F.2d 818, 821-22 (6th Cir. 1977)* (describing distinction between "interpreted and construed" and "governed by" as strained and narrow); *Kipin Industries, Inc. v. Van Deilen Int'l. Inc., 182 F.3d 490, 494 (6th Cir. 1999)* (citing Boatland with approval). See also *Hammel v. Ziegler Financing Corp., 113 Wis. 2d 73, 76, 334 N.W.2d 913 (1983)* (describing distinction as "a trick interpretation or twist on one word").

Likewise, in *Finance One Public Co. Ltd. v. Lehman Bros. Special Financing, Inc., 414 F.3d 325, 335 (2d Cir. 2005),* the Second Circuit construed a choice-of-law provision to be "narrow" despite the use of the word "governed." The provision read: "This Agreement will be governed by and construed in accordance with the laws of the State of New York."

Tort Claims That Attack Validity of Contract

When a claim is stated as a tort but is really a challenge to the validity of the contract, courts sometimes hold that the tort claim falls within the ambit of the choice of law provision even if the provision is a narrow one. In *Moses v. Business Card Express, Inc., 929 F.2d 1131 (6th Cir. 1991),* the plaintiffs sought to avoid enforcement of a contract on

a fraud theory and claimed that a choice of law clause stating "This Franchise and License Agreement and the construction thereof shall be governed by the laws of the state of Michigan" applied only to construction of the contract itself and not to the fraud claim. The court disagreed, and found the dispute to be within the scope of the clause: "The plaintiffs are not asserting a non-contractual claim or one that arose incidentally out of the contractual relationship. Rather, they are seeking to avoid enforcement of the contract itself. They put the validity of the contract in issue, and such a claim would appear to be encompassed by the language . . . ."

In addition: "Clearly, the clause refers to more than construction of the agreement; otherwise the first six words would be surplusage. If the clause provided merely that its construction would be governed by the law of Michigan, the plaintiffs would have support for their argument that it does not apply more generally." *See also, Nw. Airlines, Inc. v. Astraea Aviation Servs., Inc., 111 F.3d 1386, 1392-93 (8th Cir. 1997)* (even a narrow choice of law provision, providing that the contract "shall be deemed entered into within and shall be governed by and interpreted in accordance with the laws of" a particular state, "can govern tort claims arising out of the parties' performance under the contract or closely related to the interpretation of the contract, including claims of fraud in the inducement or misrepresentation").

Sample Choice of Law Clause

Given the vagaries of the judicial decisions on this subject, to assure the application of the law the parties desire to govern extra-contractual disputes, care must be taken in drafting the choice of law clause. A broad choice of law clause might read as follows:

Any and all matters in dispute between the parties to this agreement, whether arising from or relating to the agreement itself, or arising from alleged extra-contractual facts prior to, during, or subsequent to the agreement, including, without limitation, fraud, misrepresentation, negligence or any other alleged tort or violation of the contract, shall be governed by, construed, and enforced in accordance with the laws of [*fill in the blank for name of state*], regardless of the legal theory upon which such matter is asserted.

RELATED LINKS: For further discussion of choice of law provisions, see
- Corbin on Contracts § 79.7 ;
- Corbin on Contracts § 83.9

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Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.

6 of 10 DOCUMENTS

Opting Out of the Convention on Contracts for the International Sale of Goods

2009 Emerging Issues 4693

Should Your Client Opt Out of the United Nations Convention on Contracts for the International Sale of Goods?

By Timothy Murray

December 8, 2009

SUMMARY: The United Nations Convention on Contracts for the International Sale of Goods ("CISG") has been the United States law that preempts the Uniform Commercial Code when contracting parties are from different countries that have ratified CISG. Timothy Murray examines whether a client should opt out of CISG.

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ARTICLE: Should Your Client Opt Out of the United Nations Convention on Contracts for the International Sale of Goods?

Since 1988, the United Nations Convention on Contracts for the International Sale of Goods ("CISG") has been the United States law that preempts the Uniform Commercial Code ("UCC") when contracting parties are from different countries that have ratified CISG. CISG has been ratified by over 70 countries, including China, Japan, Canada, Mexico, Germany, France, Switzerland, and virtually every other major trading country. (It has not been ratified by the United Kingdom, Brazil, India, and South Africa.) Despite its importance and widespread application, CISG is not well understood by most of the U.S. practicing bar.

Recognizing CISG's Application

The first hurdle is that CISG's applicability to a contract is frequently overlooked by some or all of the parties, and in some cases, by the judge adjudicating a dispute between the parties. Any time a party is a non-U.S. entity involved in contracting, CISG's possible application ought to be considered. Moreover, even when a U.S. buyer of goods contracts with a U.S. distributor, if it appears that the goods are the product of a seller with a principal place of business in another CISG country, it is important to know that CISG applies.

Opting Out

Once the parties recognize that CISG applies to their transaction, they must decide in the drafting phase if they want the contract to be governed by CISG. In deciding whether to opt out, the prudent drafter will understand that although there are similarities between the law governing the sale of goods between U.S. buyers and sellers, the UCC, and CISG, there are also many important differences. Some of the most important differences are discussed below.

If the parties agree not to be governed by CISG, care needs to be taken in drafting to avoid being unwittingly bound by CISG. Article 6 of CISG allows the parties to agree that CISG will not apply, *i.e.*, they may "opt out" of CISG. Unless they agree to opt out, however, CISG automatically applies to any contract for the sale of goods between parties whose principal places of business are in different CISG countries.

Perhaps the most fundamental mistake parties make (aside from not considering whether CISG governs their contract in the first place) is in assuming that a standard choice of law clause that does not mention CISG is sufficient to opt out of CISG merely because it designates the law of a particular jurisdiction to govern the contract. *It is not. In Easom Automation Systems, Inc. v. Thyssenkrupp Fabco, Corp., 2007 U.S. Dist. LEXIS 72461 (E.D. Mich. 2007),* the court reiterated a rule that has become a trap for unwary drafters: where the contract is between parties within CISG contracting states, to opt out of CISG it is insufficient to merely include a choice of law provision stating that the law of that party's state or nation governs. The choice of law provision must expressly exclude application of the CISG because without an express exclusion, CISG will govern.

If a buyer's purchase order stated that the deal should be governed by the law of California, and the seller's acknowledgment stated that the deal should be governed by the law of British Columbia (Canada), CISG would apply because the law of California (or any other U.S. state) and the law of British Columbia (or any other Canadian province) *is CISG* where parties have principal places of business in different CISG countries. Both the U.S. and Canada have adopted CISG, and CISG supersedes the state law of California and the local law of British Columbia. If the parties do not want CISG to apply, they must expressly indicate that CISG does not apply to their contract before stating the law that will. To opt out of CISG effectively, the parties must include a clause such as the following: "The parties hereby agree that the United Nations Convention on Contracts for the International Sale of Goods will not apply to this contract." The parties could then substitute the law of the jurisdiction of their choice, assuming that law had a reasonable relation to the contract. If the parties failed to provide a substitute, the court would decide which law applied based on private international law concepts such as the dominant contacts theory.

Aside from opting out of CISG altogether, the parties may also decide that they wish to opt out of only one or more provisions of CISG. Whether they decide to opt out of CISG entirely or only certain parts, their contract should clearly indicate this intention.

Time For Accepting Offer

Mail is becoming less important in the contracting process, but where it is utilized, under the UCC, an offer to purchase goods is accepted by the mailing of the acceptance of the offer. In contrast, under CISG, an acceptance must be received to be effective, and it must be received within the time stated in the offer. Article 20(1) of CISG states:

A period of time for acceptance fixed by the offeror in a telegram or a letter begins to run from the moment the telegram is handed in for dispatch or from the date shown on the letter, or if no date is shown, from the date shown on the envelope. A period of time fixed by the offeror by telephone, telex of other means of instantaneous communication begins to run from the moment the offer reaches the offeree.

This rule can create problems where an offer states that a party has a certain time in which to accept, *e.g.*, ten days. Under the UCC, the ten days would not begin to run until the offer is received. Under CISG, however, the ten days begins to run as of the date on the offer. By the time the offer is received, a certain number of the ten days might have elapsed and the acceptance must be received by the offeror within the remainder of the ten days.

The parties could avoid these questions by clearly stating the moment in time the power of acceptance expires. For example, "This offer expires at 3 P.M., United States Eastern Standard Time, January 10, 2010."

Statute of Frauds

The UCC requires any contract for the sale of goods priced at $500 or more to be evidenced by a "writing" or

electronic record. There is no such requirement under CISG.

Firm Offer

Under the UCC, merely placing a time limit on the duration of an offer does not prevent the offeror from revoking it. If, for example, a seller or buyer makes an offer stating that it must be accepted within ten days, the offer may be revoked (withdrawn) at any time before the ten days elapse unless the offer provides written assurance that it will not be revoked. (Offers can be made irrevocable for up to three months.)

Under CISG, however, an offer that merely states that it will only last for ten days prevents the party making the offer from withdrawing it during the ten-day period. Article 16(2)(a) of CISG states that an offer "cannot be revoked if it indicates, whether by stating a fixed time for acceptance or otherwise that it is irrevocable." Thus, simply by inserting a time when the offer will expire, the offer becomes irrevocable under CISG. Moreover, there is no three-month limitation. *To avoid this result under CISG*, where an offer for the purchase and sale of goods governed by CISG is made with a definite duration, the power to revoke the offer must be expressly reserved *and* the parties' contract should expressly state that this provision of CISG does not apply. The parties are free to agree to opt out of CISG entirely. They may also "derogate" from one or more CISG Articles. Such derogation will not, however, be implied. It must be expressed.

Battle of the forms

Under the UCC, if a buyer sends a purchase order and the seller responds with an acknowledgment stating the same price and quantity terms, but adding other terms not found in the offer, the acknowledgment may still be an acceptance of the offer forming a contract. Typically, the buyer who makes an offer will prevail in this "battle of the forms."

Under CISG, virtually any additional term in the acknowledgment will convert the seller's acceptance into a counter-offer. The seller will then ship the goods and the buyer will accept the goods (ignoring boilerplate additional terms) and the seller's terms will prevail. Article 19(1) of CISG establishes the basic rule:

A reply to an offer which purports to be an acceptance but contains additions, limitations or other modifications is a rejection of the offer and constitutes a counter offer.

The language is more than reminiscent of the pre-UCC common law view of the "matching acceptance" rule. Where the buyer is the offeror, the mere inclusion in the seller's "purported acceptance" of any additional term, limitation (*e.g.*, a disclaimer of warranty or remedy limitation), or other modification (*e.g.*, an arbitration term) would constitute a counter-offer rejecting the original offer. Presumably, subsequent shipment of the goods and the buyer's acceptance would constitute acceptance of the seller's terms. Thus, the "last shot" principle "lives" under CISG.

Section 19(2), however, may be seen as an attempt to address the "battle of the forms" issue:

However, a reply to an offer which purports to be an acceptance but contains additional or different terms which do not materially alter the terms of the offer constitutes an acceptance, unless the offer, without undue delay, objects orally to such a discrepancy or dispatches a notice to that effect. If he does not so object, the terms of the contract are the terms of the offer with the modifications contained in the acceptance.

On its face, 19(2) may appear as a major exception to the "matching acceptance" rule and the corresponding "last shot" principle. The final subsection of Article 19, however, reduces the exception to what may be a de minimis level.

Additional or different terms relating, among other things, to the price, payment, quality and quantity of the goods, place and time of delivery, extent of one party's liability to the other or the settlement of disputes are considered to alter the terms of the offer materially.

CISG, Article 19(3).

It is not merely the extensive list of subjects to which any additional or different term would be deemed to be a material alteration that constitutes a severe limitation to the exception in 19(2). The list is also prefaced by "among other things" that provides a carte blanche invitation to any court to add to the expressly non-exhaustive list of subject matter terms that are not within the scope of 19(2).

The inescapable conclusion is that the typical buyer-offeror who receives a CISG seller's form with the kind of boilerplate commonly seen domestically in such forms will be subject to the "last shot" principle. Simply on this basis alone, buyers may not wish their contracts to be governed by CISG but sellers (as offerees) will have the same advantages that sellers had prior to the UCC.

Parol Evidence

One of the most important differences between the UCC and CISG involves the parol evidence rule. There is no parol evidence rule under CISG, and evidence may be admitted that contradicts the written contract. *Teevee Toons, Inc. v. Gerhard Schubert GMBH, 2006 U.S. Dist. LEXIS 59455 (S.D.N.Y. 2006).*

Under the UCC, where terms of the contract are reduced to a writing that manifests the parties' intention to be bound only by written terms, evidence of terms discussed in negotiation before the writing was executed will not be admitted into evidence. Under CISG, such evidence is admissible.

Interpretation of contract language under the UCC is based on the standard of what a reasonable person would have understood the words to mean under all of the surrounding circumstances. Under CISG, however, evidence of the subjective intention of the individual parties may even trump a document signed by both parties.

Article 8(2) of CISG establishes a standard of interpretation familiar to U.S attorneys: "[S]tatements made by and other conduct of a party are to be interpreted according to the understanding that a reasonable person of the same kind as the other party would have had in the same circumstances." However, this standard only applies "[i]f the preceding paragraph is not applicable." The preceding paragraph suggests a quite different standard:

[S]tatements made by and other conduct of a party are to be interpreted according to his intent when the other party knew or could not have been unaware what that intent was.

CISG Article 8(1).

In *Guang Dong Light Headgear Factory Co., Ltd. v. ACI International, Inc., 2007 U.S. Dist. LEXIS 76844 (D.C. Kan. 2007)* the court held that "[t]he plain language of the CISG requires the Court to evaluate a party's subjective intent, so long as the other party was aware of that intent. Otherwise, paragraph two of article 8 applies." (Article 8 paragraph two provides the reasonable person standard of interpretation).

Thus, the plain language of CISG requires an inquiry into a party's subjective intent as long as the other party to the contract was aware of that intent. This standard, while seemingly radical, is reminiscent of the familiar principle of domestic contract law involving latent ambiguities illustrated in the famous old case of two ships named "Peerless" where neither party was aware of the ambiguity and the court held that no contract existed since each innocent party subjectively intended a different Peerless. If, however, one party knows or reasonably should know of the ambiguity and is also aware that the other party knows of only one ship named Peerless, there is a contract according to the intention of the innocent party. *Raffles v. Wishelhaus, 2 H. & C 906 (1864).*

The third paragraph of CISG Article 8 is more important. In addressing how a court should determine the subjective intent of a party under 8(1) or the understanding of a reasonable person under 8(2):

due consideration is to be given to all relevant circumstances of the case including the negotiations, any practices which the parties have established between themselves, usages and any subsequent conduct of the parties.

CISG Article 8(3).

"Negotiations" would include any prior agreements or understandings that are admissible into evidence. Thus, there is no parol evidence rule under CISG. *See, e.g., TeeVee Toons, Inc. v. Gerhard Schubert GmbH, 2006 U.S. Dist. LEXIS 59455 (S.D.N.Y. 2006),* in which an American buyer claimed a subjective understanding that it was not bound by the German seller's printed terms. The court noted the absence of any CISG parol evidence rule in denying a motion for summary judgment and requiring a determination of the subjective understanding of the parties at the time the contract was formed.

RELATED LINKS: For further discussion of the CISG see
- Corbin on Contracts " 33.11

See also
- USCS Int'l Sale of Goods

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Murray on a Return to the Classic Analysis of Liquidated Damages Clauses

2009 Emerging Issues 4047

A Return to the Classic Analysis of Liquidated Damages Clauses: John E. Murray, Jr. on Carothers Constr. Co., LLC v. City of South Hutchinson, 207 P. 3d 231 (2009)

By Dr. John Murray Jr.

July 22, 2009

SUMMARY: The classical view enforces liquidated damages clauses constituting a reasonable estimate of damages in the event of breach. Under the modern view, they are enforceable if they are prospectively reasonable with respect to anticipated harm or retrospectively reasonable with respect to actual injury. Dr. John E. Murray, Jr. discusses both views in the context of *Carothers Constr. Co., LLC v. City of South Hutchinson, 207 P. 3d 231 (2009).*

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ARTICLE: One of the classic justifications for the enforcement of liquidated damages clauses is the prospective inability to prove actual damages with reasonable certainty. Thus, the classical view made a liquidated damages clause constituting an honest and reasonable estimate of damages in the event of a breach enforceable. Section 2-718(1) of the Uniform Commercial Code made an important change in this requirement in contracts for the sale of goods that was replicated in Restatement (Second) of Contracts §356(1) for other types of contracts. It announced a much more flexible approach by stating that the amount in the liquidated damages clause must be reasonable "in the light of the anticipated or actual harm caused by the breach." Under this "modern" view, liquidated damages clauses become enforceable if they are either prospectively reasonable with respect to anticipated harm (a "first look" or "single look" or "foresight" view) or retrospectively reasonable with respect to actual injury ("second look" or "hindsight" perspective).

The change was not without its critics. Early on, Professor (later Judge) Ellen Peters noted that the UCC "was unusually generous in the amount set by the contracting parties. Even if this amount was entirely unreasonable, as of the time of contract, it can apparently be recovered so long as it turns out, purely as a matter of accident, to approximate the harm actually caused by the breach." E. Peters, *Remedies for Breach of Contract Relating to the Sale of Goods Under the Uniform Commercial Code: A Roadmap for Article Two, 73 Yale L.J. 199, 278 (1963).*

A correlative critical analysis is patently clear. Under the flexible view, a contract containing a liquidated damages amount that is clearly unforeseeable and intended as a penalty at the time the contract is formed can become enforceable through the sheer accident of unusual actual damages accidentally bearing a reasonable relation to the amount in the clause. The change, therefore, could support clear violations of the sacred rubric of *Hadley v. Baxendale, 156 Eng. Rep. 145 (1854),* which continues to be regarded as the critical "foreseeability" limitation on recoverable contract damages. Foreseeability is measured at the time the contract is formed. If a clause contains an amount for damages that is clearly

unforeseeable but accidentally turns out to be a reasonable amount in relation to actual unforseeable damages, the clause is enforced. At the time the contract was formed, the clause was clearly intended as a penalty. Thus, its enforcement also undermines the fundamental policy of refusing to enforce penalty clauses since contract law is dedicated to reasonable compensation for losses suffered rather than punitive damages.

A countervailing policy justifying the more flexible approach may be discovered in cases of no actual injury under a clause containing an amount that is reasonable at the time the contract is formed. If contract law is designed to place an aggrieved party in the position that party would have been in had the contract been performed, allowing a recovery of liquidated damages when no actual harm has occurred allows a windfall that violates the purpose of contract law. On the other hand, the essential justification for enforcing the liquidated damages clause absent any actual injury is the avoidance of disputes over the fact and amount of actual injury, an argument that supports a return to the classic view of limiting enforceable clauses to those which are reasonable in terms of the educated guess made at the time the contract is formed.

Consider the case of *Carrothers Constr. Co., LLC v. City of South Hutchinson, 39 Kan. App. 2d 703, 184 P.3d 943 (2008),* aff'd, *207 P.3d 231 (Kan. 2009).* On March 12, 2002, *Carrothers Construction Company, LLC* (Carrothers), agreed to construct a wastewater treatment facility for the City of South Hutchinson (City) at a contract price of $5,618,000. The contract included a liquidated damages clause of $850 for each day of delay. The City withheld $145,830 from its payment to Carrothers for 171 days of delay. Carrothers claimed that the liquidated damages clause was a penalty when viewed retrospectively, i.e., it did not bear a reasonable relationship to the actual damages sustained by the City. The trial court granted summary judgment for the City. The court of appeals discovered language in its precedent that required a consideration of either prospective damages or actual injury, but concluded that the clause was reasonable as to either.

On this appeal to the Supreme Court of Kansas, Carrothers cited *Hutton Contracting Co. v. City of Coffeyville, 487 F.3d 772 (10th Cir. 2007),* a Tenth Circuit case applying Kansas law, in claiming that, though the clause may have been reasonable in terms of anticipated harm, the amount in the clause had to be reasonable both prospectively and retrospectively -- a "two hurdle" test. Carrothers argued that it was unreasonable in terms of actual harm to the City. Thus, it claimed that the second hurdle to an enforceable clause had not been cleared.

The Supreme Court stated that Carrothers was "wrong" in its analysis of *Hutton Contracting* because that opinion expressly indicated that Kansas had not definitely answered the question of whether Kansas law would adopt a "single look" or "second look" approach. The Court proceeded to provide a definite answer:

"To the extent any prior decisions of our Court of Appeals have contributed to that doubt by adding a retrospective test in their determination of this issue, they are overruled as to this limited point." *207 P.3d 243.*

The Court explained that the imposition of a "two hurdle" test would deny the parties' obvious intent as well as denying the City the benefit of its bargain. A "second look" at actual damages undermines the very purpose of an agreement designed to allow parties to include a reasonable estimate of probable damages in situations where actual damages are difficult to ascertain prospectively. Though its holding was in obvious disagreement with the flexible approach in Restatement (Second) of Contracts §356(1), the Court quoted Comment a of that section: a reasonable liquidated damages clause "saves the time of courts, juries, parties and witnesses and reduces the expense of litigation."

A similar analysis underlies the earlier return to the classical view in *Kelly v. Marx, 428 Mass. 877, 705 N.E.2d 1114 (1999).* In *Kelly,* the plaintiffs agreed to purchase the defendant's real property for $355,000 under a contract allowing the seller to retain a five percent down payment as liquidated damages. When the plaintiffs breached, they claimed they were entitled to the return of their down payment because there was no actual injury. The property was sold to another for $360,000 two weeks after the plaintiffs' repudiation of the contract. The trial court granted the defendant seller's motion for summary judgment, but the court of appeals reversed on the footing that the retention of the down payment was a penalty when compared to actual injury, of which there was none. Massachusetts precedent

included *Shapiro v Grindstoon, 27 Mass. App. Ct. 596, 541 N.E.2d 359 (1989),* which adopted a retrospective approach consistent with Restatement (Second) of Contracts §356. The Supreme Judicial Court of Massachusetts, however, reversed the court of appeals by rejecting a "second look" approach on the footing that an exclusive "first look" approach resolves disputes efficiently by making it unnecessary for a trial and other costly litigation to determine actual damages. An exclusive "first look" ("single look") approach fulfills the reasonable expectations of the parties.

The Court also discussed the reliance by the Shapiro court on Restatement (Second) of Contracts §356 and illustration 4 of that section, in which a delay in constructing a race track grandstand resulted in no actual loss. The illustration concludes that, since the actual loss was not difficult to prove, the liquidated damages clause constituted a penalty that was unenforceable. The Court concluded that the illustration contradicts the express language of § 356(1), which permits the enforcement of a clause that is reasonable in the light of anticipated or actual loss.

There has been a split of authority concerning the prospective ("first" or "single" look) approach versus the "first" and "second" ("hindsight") approach. The court of appeals in *Kelly v. Marx, 44 Mass. App. Ct. 825, 732-833, 694 N.E.2d 869, 873-874 (1998),* lists the cases and statutes suggesting different views. The flexible rule of the Restatement (Second) should not be viewed as a "two hurdle" approach that requires the clause to be reasonable in light of anticipated harm and actual loss. The rule in §356(1) is stated in the disjunctive: "reasonable in the light of the anticipated or actual breach caused by the loss." Thus, the *Kelly v. Marx* criticism of illustration 4 of that section is well taken.

It is important to recognize that, distinctions between "first look" and "second" or "single look" jurisdictions may not be clear. Cases that disallow liquidated damages where there is no actual loss may not necessarily suggest a "second look" approach. Rather, they may treat the total absence of actual loss as such an aberration that it constitutes a very limited exception to an otherwise "single look" approach. In such jurisdictions, if actual damages have been suffered, albeit much smaller in amount than the amount specified in an otherwise prospectively reasonable liquidated damages clause, the clause will be enforced because it meets the "single look" test of reasonableness when compared to anticipated harm.

The choice of a "single look" or prospective approach is not possible under the Uniform Commercial Code. Even where the classic single look approach has been clearly adopted, it will not apply to liquidated damages clauses in contracts for the sale of goods governed by Article 2 of the Code where §2-718(1) will allow a clause to be enforceable if it is reasonable in light of either actual or anticipated harm. See *TAL Fin. Corp. v. CSC Consulting, Inc., 446 Mass. 422, 431. 844 N.E.2d 1085, 1092 (2006).*

RELATED LINKS: For additional discussion and analysis on liquidated damages, see
- Corbin on Contracts § 58

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Dr. John E. Murray, Jr. is Chancellor and Professor of Law, Duquesne University. A respected author of 19 books and a legal scholar, Dr. Murray has written numerous treatises, classroom books, and teaching manuals. His articles have appeared in many prestigious law reviews and have been cited by courts in every jurisdiction in the United States.

Dr. Murray is the author of the renowned *Murray on Contracts* and *Murray, Cases and Materials on Contracts*. In addition, Dr. Murray is the author of supplements to the *Corbin on Contracts* multi-volume treatise. Most recently, Dr. Murray has authored *Corbin on Contracts Desk Edition*, a companion treatise to the full Corbin set. He has also authored numerous op-eds and articles for national and local newspapers and magazines. Dr. Murray is particularly

well-known for his scholarship dealing with the "battle of the forms."

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.

8 of 10 DOCUMENTS

Susan S. Azad on Central Valley Hospital v. Smith

2008 Emerging Issues 2357

Susan S. Azad on Central Valley General Hospital v. Smith (2008) 162 Cal. App. 4th 501: When Acquisitions Go Wrong An Inside Look At the Limits of Anticipatory Breach and Threatened Misappropriation of Trade Secrets

By Susan S. Azad

June 2, 2008

SUMMARY: In this Emerging Issues Analysis, Latham & Watkins partner Susan S. Azad, the successful lead counsel in Central Valley General Hospital v. Smith (2008), discusses how the case affects California law on anticipatory repudiation and threatened misappropriation of trade secrets, and gives an insiders perspective on the case and the lessons it imparts to practitioners facing similar issues in complex business litigation matters.

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ARTICLE: *Central Valley General Hospital v. Smith [162 Cal. App. 4th 501, 2008 Cal. App. LEXIS 624]* clarifies existing California law on two issues of import to practitioners in complex business litigation matters anticipatory breach and threatened misappropriation of trade secrets. On anticipatory breach, *Central Valley* holds that a repudiation of contract acts as a continuing breach until the repudiating party either retracts the repudiation or the time for performance arrives [*Central Valley General Hospital v. Smith (2008) 162 Cal. App. 4th at 510-514, 2008 Cal. App. LEXIS 624]. Central Valley* further holds that implied repudiation applies to executory covenants in a contract, excusing the non-breaching partys remaining obligations to perform [*Central Valley General Hospital v. Smith (2008) 162 Cal. App. 4th at 506, 514, 2008 Cal. App. LEXIS 624].* With respect to threatened misappropriation of trade secrets, *Central Valley* holds that Californias rejection of the inevitable disclosure doctrine (which presumes that trade secrets in a defendants possession will inevitably be disclosed) does not eliminate threatened misappropriation as an actionable cause of action. However, mere possession by the defendant of a plaintiffs trade secrets is not enough to support an injunction based on threatened misappropriation when the defendant acquired the trade secrets by proper means [*Central Valley General Hospital v. Smith (2008) 162 Cal. App. 4th at 518, 2008 Cal. App. LEXIS 624].*

Factual Summary

Central Valley involved a failed acquisition transaction. Plaintiff Hospital entered into a letter of intent to acquire certain rural health clinics owned by defendant Smith. Hospital paid $250,000 for the right to conduct due diligence, which amount was refundable if Smith materially breached the contract. Hospital promised to treat Smiths confidential trade secret information with the utmost confidentiality. During due diligence, Hospital discovered billing irregularities,

indicating Smith could not truthfully make the representations and warranties required by the contract at closing. Rather than immediately sue for breach, Hospital urged performance, including proposing alternative terms under which Hospital was willing to complete the transaction. However, Smith rejected all proposals. Hospital thereafter sent a termination notice and sued for anticipatory breach. The case was tried under a judicial reference. The referee held that Hospital waived its right to sue for anticipatory breach because it did not immediately sue upon learning of the repudiation. In addition, an injunction issued in favor of Smith prohibiting Hospital from using trade secrets obtained during due diligence against Smiths interests. The Court of Appeal reversed.

Anticipatory Breach--Will You Be There For Me Tomorrow?

Its Not a Race to the Courthouse. *Central Valley* clarifies that the election of remedies n1 discussed in *Taylor v. Johnson* [*Taylor v. Johnston (1975) 15 Cal. 3d 130, 137-138, 123 Cal. Rptr. 641, 539 P.2d 425]* does not require that the non-repudiating party immediately sue for breach when a contract is repudiated. Rather, *Taylor*s language is permissive, in that an aggrieved party *may* immediately sue upon repudiation, but is not *required* to do so. In addition, a plaintiff does not forfeit its right to sue by demanding performance in spite of the repudiation [*Guerrieri v. Severini (1958) 51 Cal. 2d 12, 19-20, 330 P.2d 635* (observing that an aggrieved partys manifestation of a purpose to allow or require performance in spite of a repudiation does not nullify the breach)]. *Central Valley* thus holds that an anticipatory repudiation of contract operates as a continuing breach until such time as the repudiation is nullified (retracted by the repudiating party) or performance under the contract is due.

The practical import of *Central Valleys* continuing breach holding is to make the actions taken between repudiation and time for performance of critical importance to both plaintiff and defendant. Upon anticipatory repudiation, the plaintiff has four potential options (each of which may be of varying attractiveness depending on the circumstances of the case). Plaintiff can:

1) Do nothing and wait to see if the defendant retracts its repudiation before the time for performance is due;

2) Demand performance in spite of the repudiation and hope that the defendant will retract its repudiation and/or perform;

3) Make the repudiation irrevocable by terminating or canceling the contract and sue for anticipatory breach; or

4) Tender its own performance when due and sue for total breach if the defendant does not perform.

The first two options (do nothing or demand performance) generally will be exercised prior resorting to options that will most certainly result in a lawsuit. In *Central Valley*, for example, the Hospital first demanded performance in spite of the repudiation. Because the defendant refused to remedy its repudiation, the Hospital took an alternative route--it gave the defendant *the option* of nullifying its repudiation by presenting an alternative proposal that rendered the repudiated representations and warranties immaterial. Defendant was then free to choose or reject the alternative proposal. It was only after defendant rejected the restructured deal that the Hospital terminated the contract and sued for anticipatory breach.

In many cases, urging performance may well be a plaintiffs first choice, because it offers the greatest possibility of obtaining the benefit of the contractual bargain with the least amount of risk (resort to litigation). *Central Valley* clarifies that a plaintiff who demands performance (or proposes alternative performance) does not forfeit its anticipatory breach claim. Only the defendant can nullify its repudiation.

Practice Tip. Because the ultimate outcome of the case may well depend on the actions taken during the interval between repudiation and the time for performance, best practice dictates clear communication during this critical interval. Hence, when demanding performance in spite of repudiation, it is advisable that the aggrieved partys counsel clearly state the grounds for anticipatory breach and specify what is expected in order for the repudiating party to nullify its repudiation. Likewise, clear communication by the alleged repudiator is also important. A repudiating party may rescind the repudiation at any time before the time for performance is due. Nullification should be done in clear and concise terms; otherwise, an alleged repudiator may end up with a cancelled contract and a lawsuit for anticipatory breach after it had changed its mind and intended to perform. Thus, clear communication by the plaintiff as to the basis of the alleged repudiation and clear communication from the defendant as to its intention and ability to perform are key to avoiding missteps and possibly averting costly litigation.

Practice Tip. Do not assume that a non-repudiating partys demands for performance or offers to re-negotiate the contract act as a counter-repudiation by the non-breaching party. In *Central Valley*, for example, the referee assumed that the Hospitals offer to restructure the deal amounted to Hospitals repudiation of the original contract. This was error. The anticipatory breach continued until it was withdrawn by the defendant or the time for performance arrived. This never happened. Plaintiffs offer in the interim to restructure the deal was just that--an offer--which was rejected by the defendant. The rejected offer had no effect on the defendants repudiation.

Practice Tip. Also of critical importance is the language employed in terminating or canceling a repudiated contract. In *Central Valley*, the notice stated that the contract was being terminated pursuant the contract because the defendant was in anticipatory breach. The referee seized on the reference to contract provisions to find that the Hospital terminated the contract pursuant to its own terms rather than because of Smiths anticipatory breach. While the referees analysis was based on legal error (and ultimately was reversed), it illustrates that small ambiguities can lead to unexpected results.

Implied Repudiation Excuse Me if I Dont Perform For You

Another important aspect of *Central Valley* is its holding that the doctrine of anticipatory breach applies even when executory covenants remain unperformed by the non-repudiating party. In *Central Valley*, the executory covenant that remained unperformed was that of proceeding to "interim closing," because it was only at interim closing that Smiths obligation to make representations and warranties would ripen. The referee held that because Hospital had not proceeded to interim closing at the time of repudiation, Smiths obligation to make the required representations and warranties never arose. In reversing, the Court of Appeal pointed out that the referees failure to apply anticipatory breach to excuse unperformed covenants was inconsistent with basic contract principles as well as with the non-repudiating partys obligation to mitigate its damages [*Central Valley General Hospital v. Smith (2008) 162 Cal. App. 4th at 514, 2008 Cal. App. LEXIS 624]*. Hence, when Smith repudiated the contract, the Hospital was not required to go forward with the deal in order to sue for anticipatory breach. Indeed, going forward with interim closing under the circumstances would have resulted in greater damage to the Hospital. Had it done so, Smith might have raised Hospitals failure to mitigate its damages as a defense.

Caution. The executory covenant holding of *Central Valley* could potentially be a trap for the unwary defendant, who may believe its implied repudiation of an executory covenant is not actionable because the non-repudiating party has yet to perform. *Central Valley* clarifies that this is not the case.

Threatened Misappropriation of Trade Secrets--A Shield and Not A Sword

Needs Proof, Not Presumptions. *Central Valley* further clarifies the law with respect to threatened misappropriation of trade secrets. In *Central Valley*, Smith argued that mere possession of proprietary information

gained through Hospitals due diligence was sufficient to enjoin Hospital from using that information against Smiths interests, including competing against Smith. Smith argued that because Hospital had access to Smiths trade secrets, Hospital would inevitably use those trade secrets to unfairly compete with Smith. During the trial, the referee found that Hospital had obtained access to Smiths trade secrets, but that access had been through proper means. The referee further found that Hospital had not improperly used or disclosed Smiths trade secrets. Nevertheless, the referee ordered an injunction prohibiting Hospital from using trade secrets obtained during due diligence against Smiths interests.

While not explicit, the referee implicitly relied on the inevitable disclosure doctrine in justifying injunctive relief against Hospital. The inevitable disclosure doctrine typically arises in the context of an employer suing a former employee who had access to the employers trade secrets on the job. Under the inevitable disclosure doctrine, the court presumes the employee will inevitably use these trade secrets during his or her new job with a competitor. Since the threat of disclosure is presumed, the employer need only show the employee has knowledge of the trade secrets and is employed by the competitor in a similar capacity [*see, e.g., PepsiCo, Inc. v. Redmond (7th Cir. 1995) 54 F.3d 1262, 1269; Interbake Foods, L.L.C. v. Tomasiello (N.D. Iowa 2006) 461 F. Supp. 2d 943)]*. California, however, has rejected the inevitable disclosure doctrine [*Whyte v. Schlage Lock Co. (2002) 101 Cal. App. 4th 1443, 1446, 125 Cal. Rptr. 2d 277]*.

In vacating the injunction against Hospital, the *Central Valley* court held that the California Uniform Trade Secrets Act, specifically *Civ. Code § 3426.2(a)*, authorizes injunctive relief based on threatened misappropriation of trade secrets. However, the issuance of an injunction based on a claim of threatened misappropriation requires a greater showing than mere possession by a defendant of trade secrets where the defendant acquired the trade secret by proper means [*Central Valley General Hospital v. Smith (2008) 162 Cal. App. 4th at 518, 2008 Cal. App. LEXIS 624; see also Del Monte Fresh Produce Co. v. Dole Food Co. (S.D. Fla. 2001) 148 F. Supp. 2d 1326* (applying California Uniform Trade Secret Act and finding that in order to establish threatened misappropriation, the aggrieved party must who more than mere possession of a trade secret); *cf. Degussa Admixtures, Inc. v. Burnett (W.D. Mich. 2007) 471 F. Supp. 2d 848* (same under Michigan Uniform Trade Secrets Act)]. Thus, the court will not presume trade secrets will be disclosed or improperly used when they were obtained in the first place by proper means.

Trade Secrets--Handle With Care

Central Valley will be of particular interest to practitioners who advise on acquisitions and the litigation that flows from them. When a party gains access to a competitors trade secrets during due diligence, the potential for a threatened misappropriation claim arises if the transaction is not consummated. An injunction might be sought for strategic reasons. In *Central Valley*, for example, Smith attempted to use the prohibitory injunction to force the Hospital back to the negotiating table (having failed to fix its repudiation of the acquisition deal when it had the opportunity to do so). Hence, Smith threatened to bring contempt proceedings (which the Hospital preempted) if Hospital continued to operate its own competing clinics the underlying message being purchase my clinics or lose your own. Thus, while Smith was not successful in its endeavors against Hospital, *Central Valley* leaves open the real possibility that an aggrieved seller could obtain a prohibitory injunction when there is evidence of trade secret misuse or intent to do so. Hence, in dealing with trade secrets obtained in due diligence, the astute practitioner should take to heart the old adage buyer beware with respect to the handling of a competitors trade secrets.

Lastly, it is standard practice in due diligence for the parties to enter into a confidentiality agreement, similar to the provisions in the *Central Valley* agreement. In particular, the agreement between Hospital and Smith provided that Hospital would return due diligence documents if asked to do so in the event negotiations were not pursued. While holding that insufficient grounds existed to obtain a prohibitory injunction based on threatened misappropriation of trade secrets, the Court noted that *Civ. Code § 3426.2(c)* could support a mandatory injunction requiring the return of documents in appropriate circumstances [*Central Valley General Hospital v. Smith (2008) 162 Cal. App. 4th at 519, 2008 Cal. App. LEXIS 624]*.

Point of Interest. In *Central Valley*, the Hospital was in somewhat of a quandry, since it required copies of due diligence documents showing billing irregularities in order to prove anticipatory breach. However, after the trial concluded, the Hospital returned and destroyed all non-work product documents and certified the same to the referee.

End Note--Lessons Learned--Following Best Practices Pays Off

The trial before the referee was conducted without pre-trial discovery (pursuant to the contract between the Hospital and Smith). This meant that the evidence was fluid, as facts were learned and legal theories proved out or didnt. When the original statement of decision and proposed injunction were issued, it was apparent that the referee had made a number of legal errors. We filed detailed objections to every finding we believed erroneous (our objections were over 100 pages long) and moved to conform our pleadings to proof on two issues identified by the referee. We proposed a narrow mandatory injunction requiring the return or destruction of documents. When the first revised statement of decision came out, we did the same. Our diligence paid off on appeal when the court declined to apply the doctrine of implied findings to remedy the deficiencies in the statement of decision and agreed with our suggestion that the only injunction that might possibly be appropriate would require the return of documents and no more.

For coverage of anticipatory breach and anticipatory repudiation, *see* California Forms of Pleading and Practice, Ch. 140, *Contracts*, §§ 140.54 (discussion) 140.105 (complaint for anticipatory repudiation); Ch. 500, Sales: Sales Under the Commercial Code, § 500.61 (anticipatory repudiation under the UCC); see also Matthew Bender Practice Guide: California Contract Litigation, *Ch. 22, Suing or Defending Action for Breach of Contract*, § 22.23 (discussion); Ch. 28, *Contract for Sale of Goods-Suing or Defending Action for Breach of Contract Under California Commercial Code*, § 28.45 (anticipatory repudiation under UCC)

Return to Text

n1 . When a promisor repudiates a contract, the injured party faces an election of remedies: he can treat the repudiation as an anticipatory breach and immediately seek damages for breach of contract, thereby terminating the contractual relation between the parties, or he can treat the repudiation as an empty threat, wait until the time for performance arrives and exercise his remedies for actual breach if a breach does in fact occur at such time.[] However, if the injured party disregards the repudiation and treats the contract as still in force, and the repudiation is retracted prior to the time of performance, then the repudiation is nullified and the injured party is left with his remedies, if any, invocable at the time of performance [*Taylor v. Johnston (1975) 15 Cal. 3d at 137-138,123 Cal. Rptr. 641, 539 P.2d 425* (citations omitted)].

ABOUT THE AUTHOR(S):

Susan S. Azad is a litigation partner at the Los Angeles office of Latham & Watkins, LLP, and was the lead counsel in the Central Valley case discussed in this comment, at both the trial and appellate levels. She specializes in complex business litigation and has extensive trial and appellate experience in both state and federal courts. She is a member of the firms Distressed Credit Markets Advisory Group as well as its Health Care and Intellectual Property Practice Groups. Ms. Azad has tried complex and high profile matters, including winning multi-million judgments against the United States under a regulatory takings theory after Congress enacted a prohibition on HUD mortgage prepayments in Independence Park v. United States, 62 Fed.Cl. 684 (Fed.Cl. 2004); Cienega Gardens v. United States, 38 Fed.Cl. 64 (Fed.Cl. 1997); Cienega Gardens v. United States, 331 F.3d 1319 (Fed.Cir. 2003); Cienega Gardens v. United States,

(Fed.Cl., 2005); and Claremont Village Commons v. United States (Fed. Cl. 2007). In the health care arena, Ms. Azad represents health care systems and providers in complex business disputes. In addition to the Central Valley case, she has successfully prosecuted and defended complex civil litigation matters for Adventist Health System, Catholic Healthcare West, Tenet Healthcare, Palomar Pomerado Health System, among others. These matters have included False Claims Act defense, contractual disputes, unfair competition, predatory pricing and trade secret misappropriation claims. Ms Azad is an eight-year member of Latham & Watkins Ethics Committee and regularly advises on ethics issues in addition to heading up the firms ethics training programs. She also has served on the firms Associates Committee and Finance Committee and is currently serving on the firms Pro Bono Committee, Recruiting Committee, and is a founding member of the Los Angeles offices Womens Committee. She is a former member of the Los Angeles County Bar Associations Judicial Election Evaluations Committee and the California State Bar Court Rules Committee.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.

van Horne on Weeks Marine, Inc. v. The United States

2008 Emerging Issues 1530

van Horne on Weeks Marine, Inc. v. The United States

By Jon W. van Horne

December 14, 2007

SUMMARY: Even though negotiated procurement has been the de facto standard in most federal procurements for many years, in *Weeks Marine, Inc. v. The United States, 2007 U.S. Claims LEXIS 353,* the U.S. Court of Federal Claims reminds government agencies that sealed bid contracting is still alive and well and that those internal justifications for procurement strategies may actually need to mean something.

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ARTICLE: In *Weeks Marine, Inc. v. The United States, 2007 U.S. Claims LEXIS 353*, a pre-award bid protest in the U.S. Court of Federal Claims, the government's attempt to move from the hoary and time-tested method of procurement, i.e., the firm fixed price contract awarded on the basis of sealed bids, to a more "modern" approach of negotiated indefinite delivery indefinite quantity (IDIQ) multiple-award task order contracts was soundly rejected, probably to the surprise of all involved.

The protester challenged the action of the US Army Corps of Engineers South Atlantic Division (SAD) in issuing an RFP for maintenance dredging and shore protection projects. Contracts for these projects had been awarded on the basis of publicly-open sealed bids awarded to responsible, responsive bidders on a firm fixed priced basis for many years. *See Federal Acquisition Regulation (FAR) § 14.101*. Breaking from that long standing process, SAD proposed to solicit proposals for maintenance dredging and shore protection projects using negotiated indefinite delivery indefinite quantity (IDIQ) multiple-award task order contracts. The proposed SAD approach represented a significant departure from the prior, successfully used approach and was widely criticized by the vendor community.

The Court hears these pre-award disputes under the authority of the Tucker Act (*28 USC § 1491(b)(1)*) and is authorized to provide declaratory and injunctive relief, but monetary relief only to the extent of bid preparation and proposal costs (*28 USC § 1491(b)(2)*). Judicial review is accomplished according to the standards of the Administrative Procedure Act, allowing agency action to be set aside if it is found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." *5 U.S.C. § 706(2)(A)*; *see 28 U.S.C. § 1491(b)(4)*. To prevail under this standard of review, the protester needs to show by a preponderance of the evidence a clear violation of applicable statutes or regulations or lack of "a coherent and reasonable explanation of its exercise of discretion." *Weeks Marine* at *10.

In this case, the Court found both a violation of law and a lack of rational basis for the agency's decision to abandon

sealed bid contracting.

The Court found that SAD had violated the requirement of *10 U.S.C. § 2304* and related regulations (e.g., *FAR § 6.401(a)*) to use sealed bid contracting as long as four conditions prevail. The record provided no support for any exception to the requirement to use sealed bids. The Court also found that SAD violated the Corps of Engineers' own FAR supplement's requirements for the use of IDIQ contracts.

In concluding that the proposed procurement lacked a rational basis, the Court reviewed an administrative record of almost 2000 pages. SAD relied primarily on its Acquisition Plan, a 30-page document; the Court found that the justifications stated in the acquisition plan were not supported by the record.

The Court also found that the Protester was prejudiced. The standard usually applied to post-award bid protests, i.e., substantial chance of award to the Protester but for the agency action, was held not to apply to solicitation based (i.e., before submission of proposals) bid protests. In the solicitation based bid protest, prejudice to the Protester was held to exist if the agency action causes a non-trivial competitive injury which can be redressed by judicial relief, citing *Winstar Comm. Inc. v. United States, 41 Fed. Cl. 748, 763 (1998)*. *Weeks Marine* at *20. The Court held that under the traditionally used sealed bidding procedures, Weeks had a substantial chance to win a significant portion of the anticipated projects; however, under the IDIQ task order solicitation, Weeks would only be guaranteed a minimum order of $2,500 and SAD could deny Weeks all task orders for the next five years without any explanation or discussions, or any ability for Weeks to seek bid protest review. The Court found this to be the required non-trivial competitive injury.

Conclusion. Sealed bidding was the norm for the award of government contracts before most contracting officers and government contracts lawyers practicing today were born. Since the advent of and emphasis on negotiated procurement, sealed bidding has taken a back seat, the abandoned, unloved child of federal acquisition. *Weeks Marine* is a reminder that it not only remains a viable method of procurement, but in fact is the statutorily preferred method.

Guidance for Practitioners. Statutory and regulatory requirements for procurement plans, determinations and findings, certifications and such, and all internal documents that for the most part precede the issuance of the solicitation generally dont see the light of day outside of the agency and, one suspects, it may not be much different inside the agency. *Weeks Marine* is remarkable for the weight attached to the Acquisition Plan and its pivotal role in the decision. The lesson for practitioners is that that the internal agency documentation, such as the SAD Acquisition Plan, is not above challenge and can be critical in demonstrating agency error. Acquisition begins at the point when agency needs are established and includes the description of requirements to satisfy agency needs, e.g., market research and acquisition planning. See *FAR 2.101*. The Court of Federal Claims has jurisdiction, not only over protests against the terms of solicitations and contract awards, but over protests based on an alleged violation of statute or regulation in connection with a procurement or a proposed procurement. *28 U.S.C. § 1491(b)(1)* (emphasis added). Agencies are not above making what are essentially procurement decisions without ever issuing a solicitation or embedding procurement decisions in solicitations that are only tangentially related, e.g., by designating GFI or by including undocumented brand name or equal requirements. It may be too late to protect the clients interests if a practitioner waits for issuance of a directly related solicitation.

From a government perspective, *Weeks Marine* is noteworthy as a reminder that the internal procurement paperwork is not merely meaningless bureaucratic make work, but needs to be taken seriously and prepared thoughtfully if the agencies procurements are to be successfully defended. As noted above, the acquisition begins as soon as the requirement is identified. Everything that follows must come up to statutory and regulatory procurement requirements.

Cross-references

For more complete discussion of negotiated procurement, *see* Government Contracts: Law, Administration and

Procedures, Ch. 9 (LexisNexis Matthew Bender).

For more complete discussion of procurement by sealed bidding, *see* Government Contracts: Law, Administration and Procedures, Ch. 10 (LexisNexis Matthew Bender) and Federal Contract Management, Ch. 3 (LexisNexis Matthew Bender).

For further discussion of IDIQ multiple award task order contracts and other types of government contracts, *see* Government Contracts: Law, Administration and Procedures, Ch. 19 (LexisNexis Matthew Bender) and Federal Contract Management, Ch. 3 (LexisNexis Matthew Bender).

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ABOUT THE AUTHOR(S):

Based on more than three decades of experience in government and corporate positions as well as private practice, **Jon W. van Horne** focuses on federal procurement issues, primarily pre-award disputes. In addition to a wide variety of federal contracting issues, he has been involved in international contracts, state and local public contracts, and U. S. Government regulation of international business, as well as a wide range of other federal administrative issues and transactional and litigation matters.

After working in the Office of the General Counsel of the Navy, Mr. van Horne served as in-house counsel in several departments of the General Electric Company. Since leaving GE, he has been in private practice in Washington DC. Mr. van Horne is a graduate of Harvard Law School and the Kennedy School of Government.

10 of 10 DOCUMENTS

Clifford on Wright v. Issak and Contractor Licensure Requirements

2009 Emerging Issues 4042

Robert C. Clifford on Wright v. Issak, 149 Cal. App. 4th 1116 (2007) and Contractor Licensure Requirements

By Robert Clifford

July 7, 2007

SUMMARY: Plaintiff contractor sued for breach of contract against defendant homeowners over a job dispute. The trial court found that the plaintiff was unlicensed and ruled in favor of the defendants. Robert C. Clifford discusses the California appellate court's decision, which held that a contractor's license is automatically suspended as of the date the contractor is required to obtain workers' compensation insurance but does not.

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ARTICLE: Introduction--Purpose of License Requirement

Wright v. Issak (2007) 149 Cal. App. 4th 1116, 58 Cal. Rptr. 3d 1 discussed the purpose of the contractor's licensing law as a means to protect the public. *Wright v. Issak* demonstrated the harsh result to a contractor for the failure to comply with the licensure requirement. Although denying compensation for a contractor who has provided extensive labor and material may be severe the *Wright v. Issak* court justified the result by citing *Hydrotech Systems, Ltd. v. Oasis Waterpark (1991) 52 Cal.3d 988, 995, 277 Cal. Rptr. 517, 803 P.2d 370,* which stated that the purpose of the licensing law is to protect the public from incompetence and dishonesty in those who provide building and construction services. The licensing requirements provide minimal assurance that all persons offering such services in California have the requisite skill and character, understand applicable local laws and codes, and know the rudiments of administering a contracting business. *Business and Professions Code section 7031* advances this purpose by withholding judicial aid from those who seek compensation for unlicensed contract work. The obvious statutory intent is to discourage persons who have failed to comply with the licensing law from offering or providing their unlicensed services for pay. Because of the strength and clarity of this policy, it is well settled that section 7031 applies despite injustice to the unlicensed contractor.

Section 7031 represents a legislative determination that the importance of deterring unlicensed persons from engaging in the contracting business outweighs any harshness between the parties, and that such deterrence can best be realized by denying violators the right to maintain any action for compensation in the courts of this state.

Automatic Suspension for Failure to Obtain Workers Compensation Insurance

A contractor's license may be suspended for the failure to obtain or maintain worker's compensation insurance.

Business & Professions Code section 7125.2 states the following: The failure of a licensee to obtain or maintain workers' compensation insurance coverage, if required under this chapter, shall result in the automatic suspension of the license by operation of law in accordance with the provisions of this section, but this suspension shall not affect, alter, or limit the status of the licensee as an employer for purposes of *Section 3716 of the Labor Code*. *Wright v. Issak (2007) 149 Cal. App. 4th 1116, 58 Cal. Rptr. 3d 1.*

In *Wright v. Issak* the contractor significantly underreported his payroll in his workers' compensation reports from the date of his initial application for workers' compensation insurance. The contractor under penalty of perjury stated that his payroll was $ 312 when in reality it was $ 135,000. The trial court found that the contractor was not a licensed contractor because his license had been automatically suspended by operation of *Bus. & Prof. Code, § 7125.2*, for failure to obtain and maintain workers' compensation insurance. The court stated that under section 7125.2, a contractor's license was automatically suspended as of the date the contractor was required to obtain workers' compensation insurance but did not. Thus, because the contractor underreported his payroll and consequently did not have workers' compensation insurance when he performed the work for the homeowners, his license was automatically suspended.

The homeowners paid the plaintiff-contractor approximately $ 27,000 for remodeling work on their residence. The contractor sued the homeowners for an additional $ 11,000. Because he was unlicensed at the time of the work the court held that he was not entitled to the $ 27,000 he had been paid and that he must refund that payment and in addition pay $ 10,000 in punitive damages, $ 90,000 in attorney's fees, and $ 7,000 in costs.

Pleading and Proof

The requirement that a contractor must plead and prove his or her compliance with the licensure requirement may be controverted by a general denial; it is not necessary to set forth the lack of licensure as an affirmative defense. A defendant's answer pursuant to *Code of Civil Procedure Section 431.30(b)(1)* containing a general denial of the material allegations of the contractor's claim is sufficient to controvert the contractor's allegation of licensure and thus invokes the requirement of *Business & Professional Code Section 7031(d)* that the contractor prove licensure by producing a verified certificate from the Contractor's State Licensing Board. In *Advantec Group, Inc. v. Edwin's Plumbing Co., Inc. (2007) 153 Cal. App. 4th 621, 63 Cal. Rptr. 3d 195* the answer did not include a specific challenge to the contractor's licensure status. The court rejected the contractor's contention that the issue of licensure constituted new matter and, as such, was required to be pleaded as an affirmative defense. The trial court stated that it planned to preclude the contractor from introducing evidence regarding his licensure other than that which is required by *Business & Professional Code section 7031*--a verified certificate of licensure from the Contractor's State Licensing Board.

Strategic Point--Contractor. In light of the holding of *Advantec Group, Inc. v. Edwin's Plumbing Co., Inc. (2007) 153 Cal. App. 4th 621, 63 Cal. Rptr. 3d 195* that there must be strict compliance with the licensure requirement, counsel for a contractor should make certain that if the issue of licensure is controverted (either by an affirmative defense or a general denial) that the requisite certificate is obtained from the State Contractors Licensing Board or that an appropriate Request for Admission is served. Courts have strictly construed the licensing requirements and if the issue has been raised counsel should early obtain the verified certificate. *Advantec Group, Inc. v. Edwin's Plumbing Co., Inc. (2007) 153 Cal. App. 4th 621, 63 Cal. Rptr. 3d 195.*

Strategic Point--Owner The owner should be alert to the requirement that proof of licensure shall be made by the production of a verified certificate of licensure from the Contractors' State License Board. [*Bus. & Prof. Code 7031 (a)*]. In *Advantec Group, Inc. v. Edwin's Plumbing Co* the contractor was in fact licensed, and was prepared to testify as to the licensure, but the court sustained an objection on the basis that licensure could only be proved by the verified certificate. The court denied a request for a continuance to permit it to obtain the required certificate. The Court of Appeals also upheld the trial court's denial of a continuance so that the contractor could obtain the required certificate. The court stated that the power to determine when a continuance should be granted is within the discretion of the trial court. The legal principles and policies involved militate in favor of the trial court's decision to deny the continuance.

The court stated that because of the strength and clarity of the policy to require licensure to be proven by a certificate from the State Contractor's License Board courts cannot resort to equitable considerations in defiance of Section 7031.

Doctrine of Substantial Compliance

> [A] court may determine that there has been substantial compliance with licensure requirements under this section if it is shown at an evidentiary hearing that the person who engaged in the business or acted in the capacity of a contractor (1) had been duly licensed as a contractor in this state prior to the performance of the act or contract, (2) acted reasonably and in good faith to maintain proper licensure, (3) did not know or reasonably should not have known that he or she was not duly licensed when performance of the act or contract commenced, and (4) acted promptly and in good faith to reinstate his or her license upon learning it was invalid.

Opp v. St . Paul Fire & Marine Ins. Co. (2007) 154 Cal. App. 4th 71, 77, 64 Cal. Rptr. 3d 260, 265-266. However, the doctrine of substantial compliance is strictly construed. The *Opp v. St. Paul* court noted that section 7031 had been amended several times since its enactment and the trend of such legislation has been to narrow the exceptions to section 7031's bar on actions by unlicensed contractors.

Adverse Effect of an Owner Using an Unlicensed Contractor

Among the legal consequences of hiring an unlicensed contractor who is injured or whose employee is injured performing the work is that different relationships may arise with respect to employer liability for worker's compensation benefits or tort damages. *Heiman v. Workers Compensation Appeals Board (2007) 149 Cal. App. 4th 724, 57 Cal. Rptr. 3d 56.* The court relied upon *State Compensation Ins. Fund v. Workers Comp. Appeals Bd. (1985) 40 Cal. 3d 5, 219* Cal. Rptr.13 where the Supreme Court concluded that a homeowner, who hired an unlicensed contractor who fell from a scaffold, was required to assume the status of "employer" for workers compensation liability. This is because *Business & Professions Code Section 2750.5* requires an independent contractor to be licensed as a matter of law. A general contractor who hired an unlicensed and uninsured subcontractor is the employer of the subcontractor and the subcontractor's injured employee. *Heiman v. Workers Compensation Appeals Board* citing *Blew v. Horner (1986) 187 Cal. App. 3d 1380.*

Cross Reference

For further information on the requirement for contractor's licensure requirements see California Mechanics Lien Law and Construction Industry Practice published by LexisNexis.

RELATED LINKS: See the Wright v. Issak opinion at
- 149 Cal. App. 4th 1116 (2007)

See also Advantec Group, Inc. v. Edwins Plumbing Co., Inc. at
- 153 Cal. App. 4th 621 (2007)

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Robert C. Clifford serves as a consultant to law firms and as a mediator in insurance and litigation matters. He has been the senior partner of a law firm based in Oakland, California, where he represented major insurance companies in litigation and coverage matters. His expertise in general litigation includes real property disputes, personal injury litigation, insurance matters, contract disputes, will contests and estate matters, and the defense of professional liability claims, including actions against attorneys, accountants, architects and, engineers.

He is a graduate of Stanford University and the Stanford Law School and a former member of the Board of Visitors of the Stanford Law School. He is a member of the American Bar Association and the California State Bar Association and serves on committees relating to insurance and litigation matters.

Mr. Clifford is the author or contributor to several Lexis Nexis Mathew Bender publications including California Uninsured Motorist Law, California Automobile Insurance Law, California Mechanics Lien Law and Construction Industry Practice, and California Insurance Law and Practice.

Information referenced herein is provided for educational purposes only. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.