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Avoiding Contracts That Make You Sick

By Ken Alexander

Even sophisticated companies expose themselves needlessly to contract disputes. I know from representing them in litigation that might have been avoided or shortened if only they had inserted one of my top ten prophylactics for avoiding contractually transmitted disease.

1. Default Interest Rate. You know that if you don't pay your credit card bill on time, you are charged significant interest and late fees. But it is amazing how often sophisticated businesses make no provision in their contracts for interest due on pastdue sums. As a practical business matter, it is difficult for a party negotiating a contract to object to an interest rate provision that at least covers the real cost to the other party of delayed payment. If the contract is silent, most states provide for an interest rate on past due sums substantially below what most business people regard as sufficient to cover the real cost (and risk) of delayed payment. Depending on the state and whether the debtor is a corporation or individual, you may be able to charge 18% or more on past due sums, if the contract so provides. (A choice of law clause is important, too, for this and other reasons.) If your company borrows money at the prime rate, the contract ought to at least provide for an interest rate that reasonably approximates the prime rate just to keep you whole.

2. Attorneys' Fees & Litigation Expenses. State laws differ on whether the plaintiff who sues successfully for breach of the contract automatically recovers its reasonable attorneys' fees, absent a contract clause that so provides. In most states, including New York and California, the answer is "no." In Texas, it's "yes." However, almost no state's law awards attorneys' fees to the successful defendant in such a case, unless the contract says so. In other words, if the other contract party brings a meritless breach of contract case against your company, you don't recover your attorneys' fees. As an economic matter, awarding fees to the successful plaintiff but not the successful defendant makes no sense, but it's the law in some places. A more level playing field is created in many contractual situations if the contract provides that the prevailing party in any lawsuit will recover attorneys' fees. There are also many other expenses of litigation that are not recoverable unless the contract says they are. Expert witness fees are but one example. It may be appropriate to for your contract to state that a prevailing party recovers all its reasonable expenses of litigation. Business executives often feel compelled to settle for or surrender half a loaf because their company's contract didn't provide for an appropriate default interest rate and recovery of attorneys' fees and litigation expenses. If you want a full loaf, your contract had better so provide.

3. Oral Contracts. With few exceptions, oral contracts are as binding as a written contract. But I tell my clients that oral contracts are not worth the paper they are (not) written on. Juries are justifiably skeptical of oral contracts, and some writing, any writing, is better than nothing. Equally important, the best evidence that somebody doing business with your company did not have the oral contract he now claims is a written contract covering the same subject matter. You've probably seen contracts providing that the contract may not be orally modified. In many situations, this clause is effectively unenforceable. This has important implications for contract administration. Keep a consistent record of your dealings with other contract parties so that you can show that the oral modification the other side now "remembers" it made is not supported by the surrounding circumstances.

4. Notice of Claim Provisions. Particularly if you have a contract under which performance will continue for an extended period of time, it is highly desirable to require parties who claim that the other side has not complied with

its obligations to give specific notice of the basis and amount of the claim in a specified way and by a specified time. Statutes of limitations on contract claims are often four years or more. There is nothing that would keep a party from completing performance under a contract and then waiting nearly four years to bring a lawsuit on a claim it had never before asserted. That might not be wise, but it certainly would be worthwhile to have provisions in the contract requiring timely assertion of claims. Timely assertion also gives you a chance to keep a molehill problem from growing into a mountain.

5. Dispute Resolution. I encourage my clients to think through carefully whether they want their contracts to be subject to arbitration, jury trial, bench trial, mandatory mediation, and the like. Arbitration is good for some contracts; it is lousy for others. Picking among the many different types of arbitration and litigation is a subject for another day. However, if you do pick arbitration, have some well-considered specifics about the kind of arbitration you want. I once had a case where we spent nearly a year arguing over the shape of the table at great expense, because the arbitration clause was so vague.

6. Insurance and Indemnity. Lots of the contracts that I see in litigation, especially "standard form" contracts, have poorly drafted insurance and indemnity provisions. I have seen contracts that required one party to carry insurance, but the scope of that insurance is unstated or there is no requirement to name the other contracting party as an additional insured under the policy. Indemnity provisions are often under-inconclusive, over-inconclusive, unenforceable, or downright incomprehensible. They often confuse indemnity from third party claims with indemnity from contract party claims. If your adolescent child couldn't figure out what it means, don't expect an interpretation that you will like. Indemnity and insurance provisions are not "one size fits all." Here is where an ounce of prevention spent with a qualified attorney will avoid a metric ton of cure.

7. Warranties. If you haven't thought through, and stated, the warranties you want your opposing contracting party to make with respect to its performance under the contract, don't expect the law to imply what you want. The only alternative is to plan to spend a lot of money on lawyers pursuing or defending your position.

8. Damages. If you read the fine print on all those software warranties you click by, for sure you will see that the publisher disclaims most damages that could be caused because your hard drive fried or the software caused some system failure. It's easy to see why: it's likely uninsurable, and the claims could be vastly greater than the price of the software license. Your contracts need to contemplate what damages each party is really on the hook for. Lost profits? Costs of delay? Only out-ofpocket costs?

9. Risk Assessment. Have you estimated the risks of proposed contract terms to both parties? Often, I see contracts in which there is an uninsured risk that is assigned to a party that does not understand it, is not in the best position to hedge or control it, or that imposes a cost it is simply unable to withstand. Even if the contract clearly assigns that risk to the other contract party, the result may not be a happy one for your company. If the risk becomes reality, the result will be nonperformance and likely an expensive lawsuit in which that party claims, even without merit, that your company was at fault. One of the unhappiest situations in which I have repeatedly seen clients is defending a lawsuit brought by a contract party who must win in order to "get well" or avoid bankruptcy. Guarantees from a solvent guarantor may deter such a desperation lawsuit, but no contract clause will completely protect you.

10. Qualify the Parties. If you have been in business long, you've figured out that there are some people out there that it is never worth doing business with. Yet over and over again, sophisticated business people say to me, "Our contract is supposed to protect against that." No contract term will truly protect you from the dishonest, incompetent, or insolvent contract party. Careful screening of prospective contract parties before you do business of any complexity is essential.

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