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Top Ten Mistakes When Drafting and Negotiating Contracts

David Ira Rosenbaum

Commercial litigation often occurs as a result of common and recurring mistakes that are made during the drafting and negotiation of contracts. As litigators and transactional attorneys, we (and our clients) often wish we could turn back the clock so that a provision or two could be added to an agreement. Such daydreaming is particularly painful because contractual disputes frequently result in protracted and costly litigation.

Businesses that are conscious of the following top ten mistakes and that seek to avoid making them will be less likely to face litigation. If suits are filed against them, the avoidance of these mistakes will enhance the likelihood of a successful verdict or settlement.

1. Not Investigating and Understanding Future Business Partners

Perhaps the most fundamental mistake made by businesses is failing to adequately investigate the persons or entities with whom a business intends to enter a contractual relationship. While most companies analyze whether a proposed deal is financially advantageous, a surprising number fail to adequately study their proposed business partners. Such investigations are important because they can provide early warning signs about the desirability of a proposed business partner, the likelihood contractual obligations will be met and whether litigation is likely if disputes arise.

Pre-contract investigation should, at a minimum, include a credit search to determine the financial viability of a proposed partner and a litigation search, which may indicate how litigious the proposed business partner is, the nature and types of its past legal disputes, and the likelihood of litigation if problems arise.

A litigation search should do more than merely identify the number of suits that involve a potential business partner. It should focus on the nature and type of conduct that led to the litigation as well as the nature and reasonableness of the positions taken in the litigation. If your proposed partner has been difficult and unreasonable in the past, it may be a good

indication of future conduct. Most contentious commercial litigation involves one or more parties who are frequent litigants.

2. Hasty, Inadequate or Non-Existent Due Diligence

Assuming that a proposed business partner appears to be reliable and reputable, the next step should be to conduct a thorough due diligence investigation of the proposed contract. In some instances, businesses are so eager to "do the deal" that they perform hasty or inadequate due diligence.

While the pressure to complete a transaction may be so great that companies elect to take "calculated risks," clients should understand that there are real risks to circumventing due diligence. If a deal appears to be too good to be true, the need for due diligence is even greater.

We realize that in some situations a complete and thorough due diligence is not feasible. For example, in large asset based transactions, it may simply be impossible or economically impractical to perform a complete investigation. When this occurs, a risk benefit analysis should be performed to decide the scope of due diligence. If thorough due diligence will not be performed, the parties should consider including provisions providing compensation if representations, warranties or other contractual assumptions later prove to be inaccurate.

3. Entering a Contract that Was Neither Written Nor Approved

Given society's negative view of lawyers and the perceived expense of legal services, it is not surprising that companies, especially emerging entities, enter contracts that were neither signed nor approved by a lawyer.

The temptation to do so is greater when contracts "seem" simple and straightforward. However, the old adage that "things are rarely as simple as they seem" applies here. Prudent companies enter contracts that are either drafted or reviewed by lawyers. In most instances, paying a lawyer for an hour or two of time to review a contract is an investment that more than pays for itself and, if nothing else, allows a company to identify the risks of proceeding without greater attorney involvement. In situations where companies enter the same type of transaction over and over again, the use and development of form contracts is appropriate and justified as long as the agreement was drafted and approved by a lawyer, its use is not expanded to transactions other than those initially contemplated and the form is occasionally reviewed and evaluated in light of new laws and regulations and past performance and enforcement of the contract.

4. Not Defining Terms and Including Ambiguous Provisions

To ensure that contractual intent is achieved, contracts must contain well-defined terms and unambiguous provisions.

Whenever a party seeks to avoid their contractual obligations, their primary strategy is to do so by identifying ambiguities in their agreement. While it is impossible to entirely eliminate the risk that a party will assert that alleged ambiguities exist, careful drafting makes contracts harder to avoid and increases the likelihood that they will be fulfilled and construed as intended.

5. Failing to Include a Choice of Law Provision

While identifying the applicable law in a contract may seem to be formalistic and unnecessary to a layperson, the failure to do so is a major mistake that can make contractual disputes more difficult and expensive to resolve.

Where contracts either involve parties from different states or interstate performance, the law used to govern and construe a contract may be uncertain. If litigation occurs and there is no choice of law provision, motion practice will probably occur involving a complex and highly fact-specific interest analysis, which is often expensive and is particularly frustrating because the inclusion of such provisions is often uncontroversial.

In many instances, laws that can have a major impact on contractual interpretation vary from state to state and some

jurisdictions have laws that, for public policy reasons, do not enforce some types of contracts. For example, Florida and California each have laws that construe unilateral attorneys fee provisions as being bilateral so that a contracting parties may unwittingly assume duties and responsibilities that they never intended to accept. In other states, such as Pennsylvania, agreements to indemnify and defend against "any and all claims" are construed as not including a duty to indemnify and defend a party from their own negligence or culpable conduct. Parties that are unfamiliar with the laws of the states to be selected to govern their contracts may be surprised to find out that their stated and intended purposes cannot be achieved due to the applicable law.

Inclusion of a choice of law provision should not merely be a knee-jerk decision to merely identify the law of their home state. Instead, the choice of which jurisdiction's laws will be used to interpret and construe an agreement should be made after consulting with a lawyer knowledgeable of both the contractual intent and the proposed jurisdiction's laws.

6. Failing to Include Provisions Relating to Defaults, Opportunities to Cure and Termination

In some instances, companies are reluctant to raise issues like defaults, opportunities to cure and termination because they believe that doing so may cause their business partners to have second thoughts about entering the contract. However, these types of provisions are important ways to promote performance and avoid litigation. If notice of potential breaches and opportunities to cure are required, parties that might otherwise have litigated are forced to attempt to work out their differences.

Another important benefit of default notice provisions is that they can require alleged contractual breaches to be raised and addressed when they first arise and not after problems fester and damages escalate.

Contracts should also include provisions that define how long an agreement will remain in force and when it might be renewed or terminated. An early termination provision is often desirable so there is an escape route if undesired circumstances occur. Absent such provisions, a business unhappy with the performance of its business partner will have little or no other recourse and could conceivably be stuck in a contract that fails to achieve its goals.

7. Specifying the Damages that Should Be Available if Disputes Arise

Potential business partners should also reach an agreement about the types and scope of damages that can be awarded if material breaches occur.

Some business partners may be unwilling to assume the risk of certain damages or losses. When this occurs, parties can include limitation of damage provisions, which can either limit recovery to a certain dollar amount (which sometimes can be the contract price) or barring collection of certain damages, e.g., consequential.

These clauses help ensure that companies do not assume unnecessary risks or liabilities. Moreover, by limiting possible damage recoveries, these clauses may reduce the risk of litigation.

8. The Written Contract is the Final Expression of the Agreement

The parties should also limit evidence that can be used to construe a contract and the circumstances under which an agreement can be changed after execution. Typically, provisions are included stating that the written contract is a final expression of the parties' agreement and supersedes all other prior communications and understandings and that any modifications must be by a signed and written amendment.

These provisions make it more difficult to argue that there were side agreements or other understandings. Moreover, such provisions make it harder to argue that the agreement was later modified by subsequent performance or conduct.

9. Considering Where and How Contractual Disputes Should be Resolved

Parties entering contracts should also consider and address where and how potential disputes will be resolved. First, the parties should decide if they want their disputes litigated in court or adjudicated in some other alternative forum such as arbitration. The parties should also decide where a case or dispute will be tried or otherwise adjudicated, which can be important particularly when the contracting parties are far away from each other. A party with the "home court advantage" is not only more likely to prevail but also may have to spend less to prosecute or defend its case. Another consideration is that a potential litigant who will be forced to travel great distances may be less inclined to insist that disputes be adjudicated.

10. Establishing Internal Procedures and Protocols to Ensure Contractual Compliance and Avoid Disputes

The final and often most serious mistake that businesses make is that they merely put the contract away in a drawer or file it in a cabinet and then proceed to "do business." Having gone through the time and effort to draft and negotiate a detailed agreement establishing their rights and obligations, companies too often ignore the contract and only consult it when problems become apparent. By failing to establish procedures to monitor performance, companies may unwittingly breach their contracts or may waive the right to insist that their business partners fulfill their obligations.

Executed contracts should be forwarded to the managers and employees who will be responsible for performance and to ensure that their business partners fulfill their responsibilities. These people should be educated about the terms and requirements of the agreement and should be explicitly informed about what they should do if problems arise. If personnel changes occur, companies should have procedures to ensure that the new managers or employees are similarly educated about the contract. Finally, companies should verify that the designated managers and employees are fulfilling the requirements of the contract. It is often not enough to merely send a detailed letter or memorandum establishing procedures. Instead, companies should regularly check to ensure that protocols are being followed. Needless to say, companies that establish and later ignore their own internal audit procedures can expect to face some difficult questions when litigation ensues.

SUMMARY

When parties enter contracts, they expect that their goals will be achieved. That expectation alone is not likely to be achieved if companies rely solely upon the cooperative spirit that often exists at the onset of a relationship. Instead, agreements should fully reflect their expectations and the common mistakes set forth above should be avoided. If this occurs, it is less likely that parties will find themselves involved in commercial litigation.

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