Drafting Contracts in Light of Litigation Risks, Missouri Lawyers's Weekly

Contracts typically can accomplish two things: (1) tell the parties what each must do and (2) tell them what will happen if they don't do it. Because the vast majority of contracts are performed as agreed and few people enter an agreement planning to break it, nearly everyone pays far more attention to that first task of contract law. Thus, defining what the parties must do (the subject matter of the contract) is what we generally consider when drafting a contract.

Nevertheless, every type of contract contains numerous provisions ancillary to the main subject of the agreement. While the "boilerplate" clauses or "fine print" may shed little light on how the parties are to perform the contract, they assume paramount importance the minute one party stops performing it. If a breach of contract does occur, the essence of the agreement may be clear from the negotiated terms, but the rules for resolving the dispute are buried in the often-unexamined recesses of the contract. This article addresses those clauses that should be considered in the drafting stage because of their effect on potential contract disputes.

DEFINING THE PARTIES. Nothing would seem more obviously fundamental to a contract than stating who's in it. Nevertheless, there are issues related to identifying the parties that can easily be overlooked. If the party is a natural person, the analysis is rather simple: the signatory is the party and the only question is whether someone else should be bound by the contract as well (as spouse or a guarantor?).

Authorized Agent. When the party to the contract is a business or other entity, more issues arise. First, remember that it is not axiomatic that the named "party" is really bound by the contract at all. All that you know is that a person is signing the contract allegedly on behalf of, to take one example, a corporation. Therefore, you not only need to obtain a resolution verifying that the corporation has authorized the transaction, but, as in all contracts, you should include a statement that the signatory warrants that he or she has authority to sign for the business. While the "agent's" own statement may be little help in proving an agency if the principal denies it, you will at least have a cause of action against the signatory. That threat alone significantly curtails unauthorized agreements.

Guarantor. Next, if the president of a corporation does sign for the business, remember that he or she is an agent for a disclosed principal and, thus, not individually a party to the contract. You should consider whether your client also needs a personal guaranty. While personal guaranties are common enough, contracts (as opposed to promissory notes) often fail to have the guarantor waive certain rights that make it difficult to enforce the contract directly against that party (for example, the rule that one cannot amend the underlying obligation without the guarantor's consent). In the end, if you do not have the right party as a defendant, your breach of contract claim is worthless.

DEFINING THE BREACH. Closely related to the drafter's primary task of defining the subject matter of the contract is the obligation to place the different components of the contract's subject into their legal classifications. Everything that is to occur pursuant to a contract is (at least) one of three things: a duty, a material duty, or a condition. The consequence of the non-occurrence of each is different. The breach of a duty does not relieve the other party of his or her duty to perform, but gives only the right to sue for damages; the breach a material duty, however, also gives the other party the right to rescind the contract entirely; and the failure of a condition (precedent) prevents the other party's duty to perform even from arising. Careful drafting can characterize the subject matter of the contract into one (or more) of these categories to prevent what could be uncertain and extensive litigation on these questions.

Material Duty. When the other party breaches a contract, your client's right to sue for damages while still having to perform the contract may be cold comfort. When describing what the other party must do (his or her duty), you should state whether that duty is material. The courts define material provisions as ones going to the very substance or root of the agreement, rather than simply to a subordinate or incidental matter. Because the courts' analysis turns on the importance of the duty to the parties themselves, the parties have broad latitude in defining what duties are, in fact, material.

Be cautioned, however, that this latitude may not be without limits. Stating simply that "every duty of each party is material" may be like putting an exclamation point behind every sentence in your brief; the attempt to emphasize everything actually emphasizes nothing. Do, however, define what terms are essential to the agreement and have both parties agree that any breach of these terms would justify rescission of the contract. Having preserved the option of getting out of the deal, parties must remember that rescission is an elected remedy that precludes a suit for damages (though not restitution). In any event, the more duties of the other party you can define as material, the more assistance you will have provided your client if a breach occurs.

Condition. While the breach of a material duty may allow your client to rescind the agreement and avoid performance, the non-occurrence of a condition (at least of the most prevalent kind of condition, a condition precedent) will prevent your client's duty of performance from even arising. If you want to make it clear that your client has a duty to perform only when something has already occurred, specify that a condition precedent exists. By thinking through the expected chronology of performance, you often can classify certain obligations of the other party as a condition precedent to your client's duty to perform and further protect him or her from having to perform unwanted duties.

In drafting language about conditions, remember several points. Conditions precedent are disfavored, and courts will construe provisions as conditions precedent only when required by unambiguous language or by necessary implication. In addition to stating explicitly that something is a condition, a drafter must also state in whose favor the condition runs. Because a condition can be waived by the party for whose benefit it is included, clearly identify the beneficiary of any condition you draft. Also remember that if a condition is an action of another party, its non-occurrence will only relieve your client of the duty to perform; your client will not have a breach-of-contract claim unless you also define that condition as a duty.

Time is of the Essence. When you state that an action must occur, make sure you state when it must occur. Furthermore, if you want the courts to believe you meant what you said, include a Time is of the Essence Clause. Otherwise, courts may simply decide that the other party had the right to perform its obligations in a reasonable time (and once the word "reasonable" makes it into the analysis, all hope for certainty is gone).

Waiver. Waiver Clauses should be, and normally are, included in contracts as a matter of course. Just remember, however, that a contract cannot effectively mandate that the parties cannot, or will not, waive a breach - that's the funny thing about waiver. No matter what you say, your client can (and often will) find a way to waive a breach of contract through actions taken after the contract is signed. The only thing the Waiver Clause can accomplish is to specify that a breach of contract is not waived simply because previous breaches were. The Waiver Clause should stipulate that waiving one breach does not waive subsequent breaches and, if possible, specifically identify those actions (like accepting late rent) that could constitute a waiver in making your point more explicit.

DEFINING THE REMEDIES. A breach of contract gives rise to three remedies: a suit for specific performance, damages, or rescission and restitution. While addressing what is a duty, a material duty, or a condition goes a long way toward determining what remedy is available, you should also address the issue of remedies directly where possible.

Specific Performance. While parties facing a breach of contract will often want to break the agreement or sue for monetary damages, many will want to force the other party to stick to the deal. Specific performance is an equitable and discretionary remedy. For specific performance to apply, the contract, at a minimum, must include the essential terms of (1) the parties, (2) the subject matter, (3) the duties, (4) the price, if applicable, and (5) the consideration. In addition, courts will order specific performance only if "equitable," which depends largely on the adequacy of the legal remedies (money damages) and the actions of the parties. While a drafter should, of course, ensure that all the essential elements are in the contract, a drafter can do little to affect whether the court will later find it equitable to order the contract performed.

Many contracts include language in which the parties stipulate that legal remedies will be insufficient to remedy a breach and that the courts can specifically enforce the contract. While

including such language cannot hurt, it should just be noted that no court has found "the parties said we could" as a legitimate basis to order specific performance; furthermore, it is highly doubtful that a court would conclude legal remedies are insufficient and it is equitable to order specific performance just because the parties had stated that when the contract was signed. It is essential to remember that if you do include such a provision, you must specify that your client also has the right to seek damages and other remedies, so that your client is not found to have elected this as his or her sole remedy.

Liquidated Damages. If monetary damages are sought, then the question is whether the parties can agree on the amount of damages at the outset (a Liquidated Damages Clause). For a Liquidated Damages Clause to be enforceable, (1) the stated amount must be a reasonable estimate of those damages likely to arise from a breach and (2) the harm must be of a kind that is difficult to estimate accurately. Most contracts that provide for liquidated damages state that both of these standards have been met. Again, it is not clear that merely stating that the standard for enforcing the clause has been met will require the court to conclude the same thing, but if the parties can specify why the damages are hard to estimate at the outset and show some basis for the liquidated amount, then there will be a greater chance the clause will be enforced.

When using a Liquidated Damages Clause, there are several traps for the unwary. If there are several different types of breaches that can occur, make sure you specify the particular breaches to which the Liquidated Damages Clause applies. (One liquidated amount cannot be a reasonable estimate of widely varying damages for vastly different types of breaches.) In addition, be sure that the provision is only an option for your client, not the sole remedy so as not to preclude, for example, the option to elect rescission and restitution.

Attorneys' Fees. Drafters typically include provisions authorizing attorneys' fees in case of breach. Consider a couple of issues when doing so. First, the provision for attorneys' fees does not always need to be symmetrical; courts have enforced agreements authorizing fees to just one party. Second, do not limit the applicability of the fee provision too narrowly by saying, for example, your client is entitled to fees in any action "to collect rent or to evict the tenant" rather than on any claim "to enforce any provision of this lease." Finally, be aware that no matter what the contract states, if your client does not prevail on its contractual claims (or defenses), it cannot recover its fees under the contract.

DEFINING WHAT IS IN THE AGREEMENT. Defining the scope of the agreement or, more accurately, limiting what can be considered by the courts as part of the agreement is, largely, in the parties' control.

Integration or Merger. If an agreement is not integrated, then the parol evidence rule does not apply; alternatively stated, if a writing (or writings) are not the entire agreement of the parties, then, obviously, evidence of other portions of the agreement are admissible. So, if you have a complete and final written version of a contract, say so. Courts can find an integrated, complete agreement in the absence of an Integration or Merger Clause, but there is no reason to leave the issue open to dispute. Identify the documents that constitute the agreement and state that these are the complete and accurate integration of all contractual terms. While the parol evidence rule is riddled with limits and exceptions, it should be employed if you go to the trouble of drafting a contract.

Modification. While a Merger Clause eliminates evidence of prior oral agreements, a Modification Clause typically specifies that only written modifications of the contract are valid. This attempt to limit prospectively the admissibility of oral agreements is, however, even less effective than the Merger Clause. No matter what the parties say they have to do in order to reach a new agreement (or modify the existing one), they can always, in essence, waive that requirement by entering into a new, oral agreement. Often, the requirement of written modifications is only as effective as your client is diligent in adhering to it.

DEFINING THE RULES. Once the dispute begins, we need to know where it is going to be held and by what rules it will be determined. On some of these issues, the attorney has largely unhindered freedom to draft an enforceable clause; on others, the courts will subject any contractual provision to a rigorous test before giving it any effect.

Arbitration. While drafting an enforceable clause mandating where a lawsuit will be held or what rules apply to it can be difficult, it is surprisingly easy to mandate that there can be no suit at all. To commit the parties to arbitration under Missouri law, the contract must state adjacent to or above the signature line in ten point capital letters: "THIS CONTRACT CONTAINS A BINDING ARBITRATION PROVISION WHICH MAY BE ENFORCED BY THE PARTIES." Otherwise, the contract must involve commerce falling within the purview of the Federal Arbitration Act (which is not difficult), in which case the arbitration is subject to the substantive, federal law.

Forum Selection. Choosing what state should host the lawsuit is the province of the Forum Selection Clause. Ordinarily, the parties can sue in any state with minimum contacts over the other party (if that state has a Long Arm Statute). They can also agree on what state can be the forum, and the only forum, for the lawsuit through a Forum Selection Clause. Forum Selection Clauses are constitutional and enforceable, however, only if the agreement is not unreasonable or unfair. The opponent to the Forum Selection Clause must prove it is unreasonable or unfair, and the courts make that determination based on whether the contract was one of adhesion or a freely negotiated agreement between parties with equal bargaining power and whether the selected forum is an unreasonable location considering the location of the parties, witnesses, and evidence.

While the parties cannot simply stipulate that this test has been satisfied, many things can be done that greatly increase the chance the clause is enforceable. If it is a form contract, leave the state blank and have the parties fill it in and sign it; have the parties state they specifically discussed the provision and agreed that the choice of a particular state was reasonable. With evidence the clause was specifically discussed and agreed upon, with some reasonable basis for the forum's selection, the provision should be enforceable. It is the aspect of an adhesion contract and unwitting signatories to such a clause that seems to give the courts the most pause.

Venue Selection. Venue Selection Clauses are treated the same as Forum Selection Clauses and are often part of the same provision, "The Forum for all disputes is the Circuit Court of St. Louis County, State of Missouri." If there is a difference, it is when parties are simply selecting between different venues within a state that already has jurisdiction. Here, the same test applies, but it would be very difficult not to meet the test for enforcement.

Waiver of Jury Trial. The parties may waive their rights to a jury trial, but, as one might expect, this is subject to a rigorous standard for enforcement. A Waiver of Jury Trial Clause is enforceable only if the waiver was knowingly and voluntarily made, which, according to Missouri courts, requires an explicit waiver in "clear, unambiguous, unmistakable, and conspicuous language." Even with such a provision, the courts may examine the negotiability of the contract, the bargaining power of the parties, and the sophistication of the person against whom the waiver is asserted. As with Forum Selection Clauses, steps taken that can show the agreement was not an adhesion contract are vitally important.

Choice of Law. The parties have some authority to specify which state's substantive law applies (procedural law will always be the state's in which the case is pending). Unfortunately, determining whether the contractual Choice of Law Clause is effective involves negotiating the labyrinth of choice of law rules the parties often were trying to avoid in the first place. Whether the parties' Choice of Law Clause is valid is determined on an issue-by-issue basis. The question is: if the courts apply the law chosen by the parties would the result be one that the court would accept had the parties specifically and expressly agreed to that result?

To answer that question, the court first must identify the issue and then identify the outcome if the chosen law would apply. Then, the court must, on its own, select the law to be applied to determine if that outcome is acceptable by using the "most significant relationship" test. In other words, assuming the parties specifically agreed on the outcome called for by the chosen law, would the law of the state with the most significant relationship uphold that choice?

For example, assume there is a dispute about a landlord removing the doors from residential real estate in Missouri because the tenant was late on rent. If the parties elected that the laws of the State of Iowa would apply to the lease, and that law affords the landlord the remedy of door

removal, the issue is whether an express agreement between the parties allowing door removal would be enforceable. The Missouri court in which the issue is pending would look at which state had the most significant relationship, which would be Missouri; in Missouri, an express agreement allowing door removal would be invalid. Therefore, the choice of law as to that issue would be invalid.

In general, Choice of Law Clauses can be very effective, but only if that result called for by the chosen law is not fundamentally contrary to the law of the state with the most significant relationship to the action. Thus, one cannot be certain that a Choice of Law Clause will work in every instance unless one knows the law of the state that would otherwise apply. These provisions have significant benefits, but certainty or ease of application is not necessarily one of them.

Because, generally, parties negotiate agreements in the hopes they will be performed (rather than in the fear they will be broken) and attorneys concentrate on drafting those provisions that have their clients' attention, the boilerplate or fine print in contracts is often overlooked. While drafting a contract with its breach in mind may be pessimistic, it also offers an opportunity for an attorney to provide significant assistance to a client if a breach does occur. To do so, one must not only identify the issues that are important in a contractual dispute, but also recognize the extent to which these issues can be affected by contractual language.