

***The Big Deal about the Fine Print:  
Negotiating & Drafting  
Contractual Boilerplate***

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## **INTRODUCTION**

The term “boilerplate” connotes standardized one-size-fits-all provisions. Yet many of the provisions often referred to as boilerplate are anything but. For example, the representations, warranties, covenants, and conditions in one acquisition agreement may seem similar to those in another acquisition agreement. Nonetheless, an understanding of the legal and business effect of these provisions reveals that the differences are far more important than the similarities. These are the provisions that spell out the business deal.

The provisions that come closest to being standardized are the “miscellaneous” provisions that regularly appear at the end of a contract. These provisions of general applicability give the parties a road map, telling them how to govern and administer their relationship. They are generally peripheral to the substantive business deal. Common provisions are governing law, merger, severability, notices, amendments, and waivers. Once again, however, it would be a mistake to assume that provisions that work in one contract will work in another. Through careful craftsmanship, a lawyer can tailor these provisions to the client’s advantage.

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## REPRESENTATIONS & WARRANTIES

1. A **representation** is a party's statement of fact as of a moment in time intended to induce reliance by a second party.

Example of a representation of an owner of a car to a potential purchaser:

The car has been driven 50,000 miles.

This statement is made today (a moment in time) by the car's owner with the intention of inducing reliance (to induce the potential purchaser to rely).

In order to have a cause of action for misrepresentation, the recipient of the representation must have justifiably relied on the statement of fact. It must not have known that the statement was false.

2. There are three types of misrepresentations:

- **Honest and negligent misrepresentations**, for which the remedies are avoidance and restitutionary recovery. (Avoidance is often referred to as rescission.)
- **Fraudulent misrepresentations**, for which a party has a choice between avoidance and restitutionary recovery (just as with honest and negligent misrepresentations) or damages (and possibly punitive damages). Depending on the governing law, the measure of damages could be either benefit of the bargain damages or out-of-pocket damages (generally less than benefit of the bargain damages).

3. A **warranty** is a promise by the maker of a statement of fact that the statement of fact is true. The promise's practical ramification is that the maker of the statement must pay damages to the recipient if the statement of fact is false and the falsity causes damages. The measure of damages is benefit of the bargain.

4. Every statement that is a representation is simultaneously a warranty. The classic way of creating representations and warranties is to use language along the following lines:

The Borrower represents and warrants to the Bank as follows:

5. Representations and warranties are risk allocation mechanisms. There are flat representations and qualified representations.

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A flat representation is a statement that is posited as an absolute, without any kind of wiggle room. For example:

The Seller represents and warrants that the car has been driven 50,000 miles.

A flat representation is the most risky type of representation for the person making the statement. Any error results in the recipient of the representation having a claim for damages or other appropriate remedy.

A **qualified representation** is a statement that moderates the flat statement. For example:

The Seller represents and warrants that the car has been driven *approximately* 50,000 miles.

By adding the qualifier “approximately” to the representation, the Seller has given itself some leeway. Now, a small, immaterial error will not result in a misrepresentation. Thus the Seller’s risk has decreased and the Buyer’s risk has increased.

Here’s another example of a qualified representation:

The Seller represents and warrants that no *material* default exists under any contract to which the Seller is a party.

6. A party may make a representation with respect to the past or present. It may not, however, make a representation with respect to the future for two reasons.

**First**, in most instances, a court will not give effect to a representation as to the future. Courts’ opinions generally state that representations are statements of fact and that there are no facts with respect to the future, only opinions.

**Second**, a representation with respect to the future is, in reality, a disguised covenant and should be drafted as such. A covenant’s benefit is that it proffers the possibility of an additional remedy beyond damages: specific performance.

7. A party may make a warranty with respect to the past, present, or future. Warranties are promises that a statement is true. There is no limitation that the statement be a statement dealing with a past or present fact. The warranties with respect to the past and present are warranties of the statements of fact in representations. An example of a warranty with respect to the future is a promise that a product will perform for a 90 days.

Here are the reasons to receive both representations and warranties:

**First**, a party will have the option to void the contract and receive restitution only if that party receives representations.

**Second**, a party may sue for punitive damages only by claiming a fraudulent misrepresentation.

**Third**, if a party cannot prove justifiable reliance on a representation, that party can still sue for breach of warranty.

**Fourth**, if a state follows the out-of-pocket rule for damages for fraudulent misrepresentations, a party can still recover the greater benefit of the bargain damages by suing for breach of warranty.

**Fifth**, a breach of warranty claim may be easier to prove than a fraudulent misrepresentation claim. Specifically, to prove fraudulent misrepresentation, a plaintiff must demonstrate *scienter*, that the defendant knowingly made a false representation. As proving a party's state of mind can be difficult, a breach of warranty claim, which has no such requirement, may be the easier claim to win.

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## KNOWLEDGE QUALIFIERS

1. No litigation is pending or threatened against the Target.
2. Except as set forth in Schedule 3.3, no litigation is pending or threatened against the Target.
3. Except as set forth in Schedule 3.3, no litigation is pending or, to the knowledge of the Seller, threatened against the Target.
4. Except as set forth in Schedule 3.3, no litigation is pending or, to the knowledge of any of the Seller's officers, threatened against the Target.
5. Except as set forth in Schedule 3.3, no litigation is pending or, to the knowledge of any of the Seller's three executive officers, threatened against the Target.
6. Except as set forth in Schedule 3.3, no litigation is pending or, to the knowledge of any of the Seller's three executive officers, threatened against the Target. For the purposes of this provision, "knowledge" means
  - (a) each executive officer's actual knowledge; and
  - (b) the knowledge that each executive officer should have had after diligent investigation.
7. Except as set forth in Schedule 3.3, the Seller does not know, and has no reasonable grounds to know, of any basis for assertion against the Target of any claim or liability.
8. Whenever the Seller makes a representation and warranty "to its knowledge," the Seller has inquired of one or more of the following personnel of the Target regarding the matters that the representation and warranty covers: the President, the Vice President and General Manager, the Vice President of Purchasing, the Secretary, and the Treasurer.<sup>1</sup>

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<sup>1</sup> To enhance the readability of this provision, a drafter could tabulate the list of personnel.

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## COVENANTS

### *Covenants*

1. A **covenant** is a promise to do or not to do something.
2. Covenants are another kind of risk allocation mechanism. They establish a standard of liability. That standard can change by changing the degree of obligation.<sup>2</sup>

The Seller shall maintain the equipment *in good condition*.

The Seller shall maintain the equipment *in good condition, ordinary wear and tear excepted*.

The Seller shall maintain the equipment *in accordance with industry standards*.

3. Covenants should be drafted using *shall*. The plain English movement decries the use of *shall* and uses *will* instead. This is appropriate in the context of a consumer contract or an informal letter contract. But in a complex commercial agreement, which needs to distinguish the future from the imperative, using different words for the future and imperative makes sense.

4. Remedies for breach of a covenant:

Damages

Possibly specific performance

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<sup>2</sup> My colleague, Alan Shaw, coined the phrase degree of obligation

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## DEGREES OF OBLIGATION

### *Hypothetical One*<sup>3</sup>

1. Seller shall obtain the consent of Landlord Corp. to Seller's assignment to Buyer of the Lease.<sup>4</sup>
2. Seller shall use its best efforts to obtain the consent of Landlord Corp. to Seller's assignment to Buyer of the Lease.
3. Seller shall use its best efforts to obtain the consent of Landlord Corp. to Seller's assignment to Buyer of the Lease. In exercising its best efforts, Seller is not obligated to make any payment to Landlord Corp., except
  - (a) as otherwise required by the Lease; and
  - (b) for a payment, not to exceed \$10,000, to induce Landlord Corp. to consent to the assignment.
4. Seller shall use commercially reasonable efforts to obtain the consent of Landlord Corp. to Seller's assignment to Buyer of the Lease.
5. Seller shall request that Landlord Corp. consent to the assignment of the Lease from Seller to Buyer.
6. The Buyer's obligations under the Agreement are subject to the delivery to the Buyer on or before the Closing Date of the consent of Landlord Corp. to the assignment of the Lease from Seller to Buyer.

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<sup>3</sup> This hypothetical is based on one created by Alan Shaw, an adjunct professor at Fordham Law School.

<sup>4</sup> "Lease" means the Lease, dated February 1, 1999, between Landlord Corp. and Seller.

*Hypothetical Two*

1. Seller shall maintain its plants, structures, and equipment in good operating condition and repair.
2. Seller shall maintain its plants, structures, and equipment in good operating condition and repair, subject only to ordinary wear and tear.
3. Seller shall maintain its plants, structures, and equipment in customary operating condition and repair.
4. Seller shall maintain its plants, structures, and equipment in accordance with industry standards.
5. Seller shall steam clean, oil, and otherwise maintain each piece of equipment as prescribed in Exhibit B.
6. Seller shall not permit its plant, structures, and equipment to be in a state of operating condition and repair that would materially and adversely affect the operations of Seller.

## RIGHTS

A contract *right* flows from another party's duty to perform. The person to whom the performance is owed has a "right" to that performance. Therefore, when a duty exists, so too does a right. Although there are often business and legal reasons to express a provision as a duty, the provision can be expressed as a right. For example:

The Landlord shall provide air conditioning to the Tenant from May 1 to September 15 of each year.

The Tenant has a right to air conditioning from May 1 to September 15 of each year.

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## CONDITIONS

1. The classic definition of a condition is a state of facts that must exist before a party has an ***obligation to perform***; for example, a condition to the closing of an acquisition agreement.<sup>5</sup>
2. There are three other types of conditions:

- (a) A condition is a state of facts that must exist before a party has a right.

If the Seller paints the bedroom, the Seller is entitled to an increase in purchase price of \$1000.

- (b) A condition is a state of facts that must exist before a party may exercise discretion. A common example is that a borrower's default must exist under a credit agreement before a bank may exercise its remedies. Stated differently, once a default occurs, a bank has the discretionary authority to exercise its remedies. It may choose not to. It may instead decide to waive the default. But the bank may not exercise any of its discretionary authority unless there has first been a default.

- (c) A condition is a state of facts that must exist before a policy has substantive consequences. For example:

If a party assigns any rights under this Agreement in violation of this Section, that assignment is void.

3. Whenever there is a condition, it must be paired with an obligation (the covenant), a right, discretionary authority, or a declaration.

A condition to an obligation and the obligation.

A condition to a right and the right.

A condition to discretionary authority and the discretionary authority.

A condition to a declaration and the declaration.

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<sup>5</sup> The Restatement (Second) of Contracts §224 (1981) defines a condition as “an event, not certain to occur, which must occur, unless its non-occurrence is excused, before performance under a contract becomes due.”

4. The proper way to draft a condition to an obligation to perform is by using the verb “must.” This rule is rarely honored. Instead, most drafters use the false imperative.

All covenants must have been performed.

All covenants shall have been performed.

5. A condition to discretionary authority should be drafted in the present tense:

If the Borrower fails to pay interest when due, the Bank may foreclose upon its security.

6. A condition to a declaration should be drafted in the present tense:

If a party assigns any rights under this Agreement in violation of this Section, that assignment is void.

## BOILERPLATE QUIZ

1. The following choice-of-law provision does not cover “all matters” that might arise between the parties. What matters does it not cover and how should it be redrafted to cover them?

The law of New York, without giving effect to its choice of law principles, shall govern all matters relating to this Agreement

2. Does the following provision prohibit assignments, delegations, or assignments and delegations?

Neither party may assign this Agreement.

3. Which boilerplate provision should immediately precede the signature lines for the parties?

4. Name five matters that should be covered in an arbitration provision.

5. Is the following provision enforceable under the common law? Under the U.C.C.?

The parties may amend this Agreement only by an agreement in writing.

6. Assume that the following provision is in an agreement that you are reviewing. If the Buyer assigns its rights under the Agreement to a non-subsiary, is that assignment effective?

The Buyer shall not assign its rights under this Agreement to any Person, other than a subsidiary.

Bonus points: What is the derivation of the term “boilerplate?”

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## ASSIGNMENT, DELEGATION & CHANGE OF CONTROL

1. Common Law
  - (a) State law governs.
  - (b) Rights are generally assignable, except if assignment would increase the nonassigning party's burdens.
  - (c) Performance is generally delegable, except if the contract is one for personal service.
2. Anti-assignment Provisions
  - (a) Anti-assignment provisions are theoretically enforceable, but the courts have a bias against their enforceability because they dislike restraints on alienability.
  - (b) U.C.C. Article 2 and U.C.C. Article 9 provide that anti-assignment provisions are unenforceable.
  - (c) To prohibit the assignment of rights under an agreement, an anti-assignment provision must specifically prohibit the "assignment of rights" under the agreement.
  - (d) A prohibition against an "assignment of the Agreement" prohibits only the delegation of performance, not the assignment of rights.
  - (e) Most states interpret a prohibition against an assignment of rights as not only a prohibition against a delegation of performance, but also a prohibition against an assignment of rights.
  - (f) Despite a prohibition against an assignment of rights, an assignment is still enforceable unless the contract provides that any assignment in breach of the prohibition is "void." See F(2).
    - i) Rationale: common law dislikes restraints against alienability.
    - ii) Courts distinguish between the prohibition of the right to assign rights under a contract and the prohibition of the power to assign rights under a contract. If a contract provision merely prohibits assignment, the provision takes away only a party's right to assign. That party, however, retains the power to assign. Thus, if a party exercises its power to assign in the face of an anti-assignment provision, that party is in breach (because it violated the anti-assignment provision), but its assignment is enforceable (because the party

retained the power to assign). The following provision takes away only the right to assign.

“X shall not assign its rights under this Agreement.”

If the parties also want to take away the power to assign, the contract must declare void any assignment in violation of the anti-assignment provision. The following additional sentence takes away the power to assign:

“Any assignment of rights in violation of this Section is void.”

- iii) Due diligence implications of an anti-assignment provision:
  - a) What are the ramifications if a party assigns its rights despite a prohibition against assignment? It depends.
    - (1) Breaches of the anti-assignment covenant entitle the nonassigning party to sue for damages. However, there will often be no damages.
    - (2) BUT: Make sure to check whether the contract has specific remedies provisions. For example, a lease might state that if lessee breaches any provision of the contract, the landlord is entitled to evict the assignee. In this instance, although the landlord might not suffer monetary damages, it would have other rights against the assignee that could make the assignment problematic. Also, check whether a default in the contract would cause a cross-default in other agreements.
- (g) Consents to assignment in the anti-assignment provision.
  - i) When there is a consent provision, does the contract expressly provide that the nonassigning party may not unreasonably withhold consent?
  - ii) If the consent provision does not expressly provide that consent may not be unreasonably withheld, does the governing law impute a reasonableness requirement? That is, is the nonassigning party obligated not to unreasonably withhold its consent?
- (h) Does the contract prohibit assignments by merger or consolidation?
  - i) By its express terms?

- ii) In many states, the prohibition must be express (actual use of the word “merger”) in order for mergers to be prohibited.
  - (i) Does the contract prohibit assignments by operation of law?
    - i) How does the governing law interpret the phrase “by operation of law?”
    - ii) Does assignment by operation of law include mergers and consolidations?
  - (j) Does the contract prohibit involuntary assignments made by the court using its equitable powers?
3. Change of Control
- (a) Consider whether the contract should prohibit a change of control. This kind of prohibition is placed either in the anti-assignment provision or in the list of events of defaults. If the prohibition against change of control is in the anti-assignment provision, it is usually phrased so that “any change of control is deemed an assignment for purposes of this Section.”
  - (b) Is control defined? If so, how?
4. Anti-Delegation Provisions
- (a) Anti-delegation provisions are generally enforceable.
  - (b) Prohibit delegation of “performance” rather than duties. “Performance” is broader, taking into account not only delegation of a duty, but also delegation of a condition.
  - (c) Consider whether it is appropriate to permit delegation to a specific person or a class of persons.
    - i) Consider whether there should be conditions precedent to an effective delegation.
      - a) Test of creditworthiness.
      - b) Delivery of counsel’s opinion.
    - ii) When defining a class of potential delegates, determine what standards they need to meet. Wholly-owned subsidiary? More than majority-owned?
  - (d) If a delegation is permitted, consider whether the delegating party should be released, causing a novation.

**Sample Clause****X.X. Assignment and Delegation.**

- (a) **No Assignments.** No party may assign any of its rights under this Agreement, except with the prior written consent of the other party. That party shall not unreasonably withhold its consent. All assignments of rights are prohibited under this subsection, whether they are voluntary or involuntary, by merger, consolidation, dissolution, operation of law, or any other manner. For purposes of this Section,
- (i) a “change of control” is deemed an assignment of rights; and
  - (ii) “merger” refers to any merger in which a party participates, regardless of whether it is the surviving or disappearing corporation.
- (b) **No Delegations.** No party may delegate any performance under this Agreement.
- (c) **Consequences of Purported Assignment or Delegation.** Any purported assignment of rights or delegation of performance in violation of this Section is void.

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## ATTORNEYS' FEES & OTHER LITIGATION COSTS

Throughout the United States, parties are normally expected to pay their own costs in negotiating, executing, performing, and enforcing their own contracts.<sup>6</sup> Pursuant to this general rule, parties must pay their own expenses in bringing or defending contract actions – even when successful – unless either a specific statute provides to the contrary or the contract both places and, under the law, is permitted to place the burden on the other party.<sup>7</sup> This is certainly true in connection with litigation under the Uniform Commercial Code.<sup>8</sup>

Thus, parties wishing to reallocate these expenses must ensure that their contract contains a reallocation provision broad enough to cover all the different types of expenses that the party to be recompensed might incur.

### *Discussion Problem*

Lender is providing capital financing to Borrower, secured by a lien on virtually all of Borrower's assets. The Credit/Security Agreement includes the following provision intended to make the Borrower responsible for all of Lender's expenses and attorneys' fees:

Borrower hereby agrees to indemnify, save, defend, and hold Lender harmless from any loss, cost, expense, or liability, including reasonable attorneys' fees, incurred by Lender arising out of or in connection with this Agreement.
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What expenses, other than attorneys' fees, might Lender incur? Does this clause cover them? What attorney services might Lender need in the course of the parties' relationship? Will the fees incurred for those services be covered by this clause?

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<sup>6</sup> See, e.g., TINA L. STARK, ED., NEGOTIATING AND DRAFTING CONTRACT BOILERPLATE § 12.05 (2003).

<sup>7</sup> However, some pre-contract costs may be recoverable in a successful claim for rescission and reliance damages, because there the goal of recover is to place the aggrieved party in the position it would have occupied had the contract never been made. See *id.* at § 12.05[2].

<sup>8</sup> See § 1-305(a) (denying consequential damages except as expressly provided). Cf. §§ 2A-108(4), 4A-305(e) (both authorizing recovery of attorneys' fees in specific situations).

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### *A Synopsis of the Law*

Because attorneys' fees clauses override what is thought to be a general policy of the law, they are often construed rather strictly. Consequently, a clause requiring reimbursement of "costs" or "expenses" may not be adequate to cover attorneys' fees.<sup>9</sup>

Similarly, a contract clause providing for reimbursement of attorneys' fees for any claim "to enforce the agreement" may not reach a claim for rescission based on fraud or a related claim for damages in tort, such as for misrepresentation.<sup>10</sup> Parties who want an attorneys' fees provision with broad reach – as most lenders do – should instead use language such as "any action or proceeding arising out of or in any way relating to either this agreement or the relationship of the parties."<sup>11</sup>

### *Prevailing Party*

Contracts often provide that in the event of litigation, the "prevailing party" shall be entitled to reimbursement of attorneys' fees. One problem with such clauses is that, even when there is only a single claim, it is often difficult to ascertain who is the prevailing party. For example, if the plaintiff obtains a judgment for only a small amount on a very large claim, is it fair to treat the plaintiff as prevailing?<sup>12</sup> Trial courts generally have significant discretion in determining which party prevailed. They are to make their decisions in reference to the extent each party realized its litigation objectives, whether through trial, settlement or otherwise,<sup>13</sup> and in doing so should consider the parties' contentions in pleadings and settlement discussions.<sup>14</sup> In some cases, neither party

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<sup>9</sup> See *Coastal Power Int'l Ltd. v. Transcontinental Capital Corp.*, 182 F.3d 163 (2d Cir. 1999); *Allstate Ins. Co. v. Loo*, 54 Cal. Rptr. 2d 541 (Cal. Ct. App. 1996); *Jackson v. Hammer*, 653 N.E.2d 809 (Ill. Ct. App. 1995). But cf. *Boulevard Bank v. Philips Medical Systems Int'l B.V.*, 827 F. Supp. 510 (N.D. Ill. 1993) (clause in guaranty agreement allowing recovery of "collection costs" included attorneys' fees).

<sup>10</sup> Compare *Marcus v. Fox*, 723 P.2d 682 (Ariz. 1986) (rescission claim is not one "arising out of a contract"), with *Diamond D Enterprises USA, Inc. v. Steinsvaag*, 979 F.2d 14 (2d Cir. 1992) (franchisor's contractual right to attorneys' fees "incurred in enforcing" the agreement extended to those incurred in defending a fraud in inducement claim); *Lerner v. Ward*, Cal. Rptr. 2d 486 (Cal. Ct. App. 1993) ("any action or proceeding arising out of this agreement" covered a fraud in inducement claim).

<sup>11</sup> See, e.g., *Janotta v. Subway Sandwich Shops, Inc.*, 225 F.3d 815 (7th Cir. 2000) (action to recover punitive damages for fraud was "relative to the rights and obligations of the parties").

<sup>12</sup> See, e.g., *Marine Enterprises, Inc. v. Security Pacific Trading Corp.*, 750 P.2d 1290 (Wash. Ct. App. 1988) (party who won a judgment for \$5,701 in an action for \$600,000 was not substantially prevailing party).

<sup>13</sup> See, e.g., *Santisas v. Goodin*, 951 P.2d 399 (Cal. 1998).

<sup>14</sup> See, e.g., *Hsu v. Abbara*, 891 P.2d 804 (Cal. 1995).

substantially prevails and thus neither gets attorneys' fees.<sup>15</sup> Their determinations are often treated on review as factual findings, and thus are rarely reversed.

Lenders often want their loan agreements to provide for reimbursement of their legal fees regardless of whether the Lender is successful in bringing a claim against or defending a claim by the borrower. The enforceability of such clauses is questionable, however, and is highly unlikely in any state with a statute providing for reciprocity with respect to attorneys' fees.

### *Reciprocity*

At least six states have some sort of statute that convert a unilateral attorneys' fees provision into a bilateral one.<sup>16</sup> That is, by law, if one party to a contract is entitled to attorneys' fees in successfully litigating an issue arising under the contract, then whichever party is successful will be entitled to attorneys' fees from the other. Note, however, such statutes may not apply to tort claims, and thus a contract clause broad enough to cover attorneys' fees incurred in connection with a tort claim may not become reciprocal.<sup>17</sup>

Attorneys should be aware of these rules when selecting which jurisdiction's law will govern the parties' relationship. However, that selection may not be sufficient to ensure that some other law will not apply.<sup>18</sup> Accordingly, attention must also be given to drafting of a choice-of-forum clause,

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<sup>15</sup> See, e.g., *Walton General Contractors, Inc. v. Chicago Forming Co.*, 111 F.3d 1376 (8th Cir. 1997). Cf. *Wilkes v. Zurlinden*, 984 P.2d 261 (Or. 1999) (each party prevailed in defending against the other's claim). See also Cal. Civ. Code § 1717(b)(1) (providing that the court may determine that there is no prevailing party).

<sup>16</sup> See Cal. Civ. Code § 1717; Fla. Stat. Ann. § 57.105(7); Mont. Code § 28-3-704; Or. Rev. Stat. § 20.096; Utah Code § 78-27-56.5; Wash. Rev. Code § 4.84.330. See also Ariz Rev Stat. § 12-341.01 (authorizing the court to award attorneys' fees to any successful party in a contract action); Tex. Civ. Prac. & Rem Code § 38.001 (authorizing award of attorneys' fees to successful party in a variety of contract actions).

<sup>17</sup> See *Moallem v. Coldwell Banker Commercial Group, Inc.*, 31 Cal. Rptr. 2d 253 (Cal. Ct. App. 1994).

<sup>18</sup> Compare *ABF Capital Corp. v. Grove Properties Co.* 126 Cal. App. 4th 204 (2005) (because California Civil Code § 1717, which makes reciprocal a contractual clause awarding attorney's fees to only one of the contracting parties, is fundamental policy of the state, it applies to commercial litigation in California even though the parties' agreement had a valid clause choosing application of New York law), with *ABF Capital Corp. v. Berglass*, 130 Cal. App. 4th 825 (2005) (because, under choice-of-law principles, New York law would be applicable to this litigation in California court even if the parties had not contractually agreed to the application of New York law, New York rule enforcing unilateral attorneys' fees governs and whether that rule violates California fundamental policy is irrelevant).

as well as to the fact that no contract clause can alter the proper venue for a bankruptcy proceeding,<sup>19</sup> and such venue can affect which state law governs.<sup>20</sup>

### *Incurred in Bankruptcy*

Reimbursement of attorneys' fees incurred in connection with one party's bankruptcy proceeding presents difficult issues of both law and contract interpretation. With respect to the former, there is some question whether a party may recover attorneys' fees – even if expressly covered by a contractual provision – in litigating issues of bankruptcy law, rather than issues relating to the enforceability or breach of the contract.<sup>21</sup> Thus, for example, there may be a difference between fees incurred by a creditor in defending against an objection to its claim (an issue of nonbankruptcy law) and fees incurred in defending against a preference action (an issue of bankruptcy law). The issue is currently before the Supreme Court, which heard oral argument on January 16, 2007.<sup>22</sup>

With respect to the latter, careful drafting is essential. For example, a clause authorizing attorneys' fees in connection with any effort to collect a debt may not be broad enough to reach fees incurred in reviewing or objecting to a plan of confirmation or to defending a preference action. It may even not be broad enough to cover efforts to obtain relief from the automatic stay, to challenge the debtor's discharge, or to determine the nondischargeability of the creditor's claim.

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<sup>19</sup> See 28 U.S.C. § 1408.

<sup>20</sup> See *In re Miller*, 341 B.R. 764 (Bankr. E.D. Mo. 2006) (default rate of interest on business loan, though valid under Iowa law that the parties had chosen in their agreement, violated Missouri law, was against fundamental policy of Missouri, and was therefore unenforceable).

<sup>21</sup> Compare *In re Fobian*, 951 F.2d 1149 (9th Cir. 1991), *cert. denied*, 505 U.S. 1220 (1992) (bank not entitled to award of attorneys' fees in litigating the proper application of §§ 506 and 1225 of the Bankruptcy Code despite attorneys' fees clauses in promissory note and in deed of trust because issues were not contractual claims, rather matters of federal bankruptcy law) with *In re Dow Corning Corp.*, 456 F.3d 668 (6th Cir. 2006) (attorneys' fees incurred in litigating pure issues of bankruptcy law are recoverable if so provided by contract). See also *In re Shangra-La, Inc.*, 167 F.3d 843 (4th Cir. 1999) (landlord is entitled to recover attorneys' fees incurred postpetition in seeking relief from the stay and in opposing assumption of the lease if the agreement so provides).

<sup>22</sup> See *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co.*, 167 Fed. Appx. 593 (9th Cir.), *cert. granted*, 127 S. Ct. 377 (2006).

**Suggested Clause**

**X.X. Costs & Attorneys' Fees.**

Borrower shall indemnify, save, defend, and hold Lender harmless from any loss, cost, expense, or liability, including fees of accountants, attorneys, consultants, and expert witnesses reasonably incurred in defending or enforcing Lender's rights in connection with this Agreement or otherwise relating to the relationship of the parties, regardless of whether they are incurred before, during, or after any litigation or other dispute resolution procedure, regardless of success on the merits, and regardless of whether they relate to issues arising out of contract, tort, bankruptcy, or some other area of law.

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## AMENDMENTS

1. Enforceability of a No Oral Amendments Provision Under the Common Law.
  - (a) The provision is generally unenforceable.
  - (b) Written contracts are of no higher status than oral contracts.
  - (c) Parties may orally amend a no oral amendments provision, and then amend the contract.
  - (d) In some states, a party will be estopped (based upon its actions) from relying on the no oral amendments provision.
  
2. Effect of Statutory Provisions Regarding No Oral Amendments Provisions
  - (a) U.C.C. § 2-209(2) states that a no oral amendments provision is enforceable, but U.C.C. § 2-209(4) provides that even if a provision may not be amended, it may be waived by course of conduct.
  - (b) N.Y. Gen. Oblig. L. § 15-301. The statute provides that no oral amendment provisions are enforceable. However, partial performance can overcome the effect of the statute.
  
3. Drafting Matters
  - (a) If New York law governs, consider requiring that the amendment identify itself as an amendment to the agreement. *See DFI Communications, Inc. v. Greenberg*, 41 N.Y.2d 602, 606-608.
  - (b) Consider whether there should be any conditions precedent to effectiveness. For example, delivery of a certified copy of the resolutions authorizing the amendment.
  - (c) Determine whether any statutes are applicable. *See, e.g., Del. Gen. Corp. L. § 251(d)* which applies if there is a merger.
  - (d) Determine whether a supermajority is appropriate (e.g., in a shareholders' agreement or a multi-lender credit agreement).

**Suggested Clause**

**X.X. Amendments.**

The parties may amend this Agreement only by a written agreement of the parties that identifies itself as an amendment to this Agreement.

## WAIVERS

1. Definition
  - (a) Classic definition – A party’s intentional relinquishment of a known right.
  - (b) Commentators criticize the classic definition.
    - i) Waiver typically concerns waiver of a condition, not a right.
    - ii) “Known” is misleading. A party who waives need not understand the legal effect of waiving a condition; rather, it need only know that it is waiving the condition.
    - iii) A waiver need not be intentional.
2. Oral Waivers Are Enforceable Despite a Provision Prohibiting Oral Waivers
3. Drafting Matters
  - (a) Provide that failure to exercise a remedy is not a waiver.
  - (b) Provide that no course of dealing constitutes a waiver.
  - (c) Provide that a waiver on one occasion is effective only for that occasion.
  - (d) Provide that a waiver is not effective against any other person.

**Suggested Clause****X.X. Waivers.**

- (a) **No Oral Waivers.** The parties may waive this Agreement only by a writing executed by the party or parties against whom the waiver is sought to be enforced.
- (b) **Effect of Failure, Delay or Course of Dealing.** No failure or delay
  - (i) in exercising any right or remedy, or
  - (ii) in requiring the satisfaction of any condition,under this Agreement, and no act, omission or course of dealing between the parties, operates as a waiver or estoppel of any right, remedy or condition.
- (c) **Each Waiver for a Specific Purpose.** A waiver made in writing on one occasion is effective only in that instance and only for the purpose stated. A waiver once given is not to be construed as a waiver on any future occasion or against any other Person.

## WAIVER OF RIGHT TO A JURY TRIAL

1. Common Law
  - (a) The right to a jury trial is set forth in the Constitution of the United States and the constitutions of the individual states.
    - i) All criminal trials. (U.S. Constitution).
    - ii) Civil suits “at common law.” (U.S. Constitution). Not equitable matters.
  - (b) Some statutes provide a right to a jury trial.
2. Rationale for Waiving Right to a Jury Trial
  - (a) Large institutional clients often fear that jurors will be biased against them. Conversely, individuals often want to take advantage of juror bias in favor of “the little guy.”
  - (b) Bench trials are often quicker.
  - (c) Bench trials are often less expensive because the parties do not need to pick a jury, draft jury instructions, *etc.*
  - (d) Bench trials are often preferred when the issues are highly technical.
3. Enforceability of Jury Waiver Provisions
  - (a) Presumption is against the enforceability of jury waiver provisions.
  - (b) Despite presumption, jury waiver provisions are enforceable if properly drafted (except for Georgia).
4. Drafting Matters
  - (a) Waiver should be knowing, intentional and voluntary. Make the provision the last before the signature line.
  - (b) Language should be clear and prominent (*e.g.*, bold face font, large font size, and capitalization).

- (c) Parties should be of roughly equal bargaining power, or the party with the inferior bargaining power should be represented by effective counsel. Consider a provision requiring the party with inferior bargaining power to acknowledge that it has been effectively represented.
- (d) The scope of the waiver should be coordinated with the language in the choice of law and choice of forum provisions.

### **Suggested Clause**

**[Last section]. Waiver of Jury Trial.**

Each party knowingly, voluntarily, and intentionally waives its right to a trial by jury in any litigation arising out of or relating to this Agreement and the transactions it contemplates. This waiver applies to any litigation, whether sounding in contract, tort or otherwise. Each party acknowledges that it has received the advice of competent counsel.

*This Section should immediately precede the testimonium (the concluding paragraph) and the signature lines. It should be prominent. Options are a large font, bold font, caps or a combination of the listed options.*

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## CHOICE OF LAW & CHOICE OF FORUM

### *Choice of Law*

There are a variety of reasons parties may wish to choose which state's law governs their contractual relationship. Doing so may remove uncertainty and eliminate a subject on which briefing is necessary in the event of litigation. More significant, it allows parties, particularly those engaged in many multi-state or international transactions, to focus on compliance with one set of rules, rather than dozens. Most important, it can permit a party to seek refuge under the laws of the jurisdiction that are particularly favorable for its type of business. For example, a business with valuable trade secrets might want its agreements governed by the law of a jurisdiction which offers strong protection for them. A buyer of businesses might want its purchase agreements governed by the law of a jurisdiction that does not readily invalidate covenants not to compete. A merchant that deals with consumers may want its contracts governed by a jurisdiction that interprets the obligation of good faith in a narrow and predicable manner and which does not permit punitive damages for most contract-related torts.

In general, contracting parties are free to select which jurisdiction's law will govern their relationship. The major limitation on this freedom, as expressed in the Restatement (Second) of Conflict of Laws, is that the jurisdiction selected must bear a "substantial relationship" to either the transaction or to the parties, or there must be some other reasonable basis for the parties' choice.<sup>23</sup> A second limitation arises whenever application of the chosen jurisdiction's law would violate a fundamental policy of the jurisdiction whose law would govern but for the parties' selection. In such cases the parties' selection will not be respected.<sup>24</sup>

The rules for transactions governed by the Uniform Commercial Code are similar. Generally, parties are free to choose the law of any state or nation that bears a "reasonable relationship" to the transaction.<sup>25</sup> This phrasing differs to two respects from the Restatement formulation. First, it requires a "reasonable relationship," rather than a "substantial relationship." Second, the relationship must be to the transaction, rather than to either the transaction or the parties. However, neither of these differences appears material. The general UCC rule contains one additional – and seemingly significant – departure from the Restatement rule. It has no exception if the chosen jurisdiction's law would violate the public policy of the jurisdiction whose law would otherwise apply.<sup>26</sup> In all

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<sup>23</sup> See Restatement (Second) of Conflict of Laws § 187(a)(a).

<sup>24</sup> *Id.* at § 187(2)(b).

<sup>25</sup> U.C.C. § 1-105(1). Note, the citation is to the pre-revision version of Article 1. None of the states that have thus far enacted revised Article 1 have adopted its substantially different rules on choice of law. See U.C.C. revised § 1-301.

<sup>26</sup> *Cf.* U.C.C. revised § 1-301(f) & comment (adding such a rule and noting that it represents "an important safeguard not present under former § 1-105").

likelihood, however, the fundamental policy exception exists even though not expressed in the Code itself.<sup>27</sup>

There are, of course, other more specific limitations on choice of law in UCC transactions. In particular, parties are not free to select the law that governs perfection or the effect of perfection.<sup>28</sup> If they could, their choice might alter the proper place to file a financing statement, thereby leaving later searchers with no ability to restrict their search to one or two jurisdictions.

**State Statutory Variations on Choice of Law.** Some states allow contracting parties to choose their respective bodies of law regardless whether the state bears a substantial relationship to the parties or the transaction, provided the contract involves a set minimum amount of money. The most notable of these are New York and Delaware.<sup>29</sup> On the other hand, some have specific rules restricting contractual choice of law in certain types of contracts, such as franchise agreements or insurance policies.<sup>30</sup> Lawyers should check for such restrictions before drafting a choice-of-law provision.

**Drafting Considerations.** As in all contract drafting, the wording of a clause can affect its scope. Wording is particularly important in choosing a governing law because some jurisdictions continue to interpret choice-of-law clauses narrowly.<sup>31</sup> Parties wishing to designate a governing law generally want that law to govern all aspects of their relationship. Consider, though, the following.

#### *Discussion Problem*

Lender is providing capital financing to Borrower. The Loan Agreement includes the following provision:

This Agreement shall be governed by and construed in accordance with the laws of the State of New York.

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<sup>27</sup> See, e.g., *Aerospatiale Helicopter Corp. v. Universal Health Services, Inc.*, 778 S.W.2d 492 (Tex. Ct. App. 1989) (indicating in dicta that the parties' choice of law would be respected unless it violates fundamental policy of the forum state). See also § 1-103 (providing that principles of law survive enactment of the Code unless displaced by particular provisions).

<sup>28</sup> See U.C.C. §§ 1-105(2), 9-301, 9-302, 9-303, 9-304, 9-305, 9-306.

<sup>29</sup> See N.Y. Gen. Oblig. L. 5-1401(1) (\$250,000); Del. Stat. tit. 6, § 2708 (\$100,000).

<sup>30</sup> See TINA L. STARK, ED., *NEGOTIATING AND DRAFTING CONTRACT BOILERPLATE* § 6.02[c] (2003)

<sup>31</sup> E.g., *Thompson and Wallace of Memphis, Inc. v. Falconwood Corp.*, 100 F.3d 429, 433 (5th Cir. 1996).

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What issues or claims might not be covered by this clause? How should the clause be drafted to make sure such issues and claims will be governed by New York law?<sup>32</sup>

Another drafting issue is whether the choice-of-law clause must exclude the choice-of-law rules of the chosen jurisdiction. Consider the following two alternatives:

“. . . governed by the laws of the State of New York.”

“. . . governed by the laws of the State of New York (other than its choice-of-law rules).”

The latter formulation is thought to be safer because it avoids the argument and the possibility that a court would then look to New York choice-of-law principles and apply some other state’s law. However, this “safer” phrasing is not necessary. The Restatement makes clear that when parties by contract select a governing law, absent some expression to the contrary they are selecting its “local law,” not its conflict-of-law rules.<sup>33</sup> Courts almost universally agree.<sup>34</sup>

### *Choice of Forum*

A choice-of-forum provision in a contract does far more than provide where litigation must be pursued. It also helps give efficacy to the parties’ choice of law. Indeed, a choice-of-law provision unaccompanied by a choice-of-forum clause is almost useless. Consider the following:

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<sup>32</sup> See, e.g., *Thompson and Wallace of Memphis, Inc. v. Falconwood Corp.*, 100 F.3d 429 (5th Cir. 1996) (loan contract providing that the “agreement and its enforcement” were to be governed by New York law did not preclude application of Texas Deceptive Trade Practices Act and tort claims arising thereunder); *Northeast Data Systems, Inc. v. McDonnell Douglas Computer Systems Co.*, 986 F.2d 607 (1st Cir. 1993) (contract clause providing that “[t]his Agreement and the rights and obligations of the parties hereto shall be governed by and construed in accordance with the laws of California” covered all contract claims, whether motivated by bad intent or not, but did not cover fraud in inducement claim because it “concerns the validity of the formation of the contract, it cannot be categorized as one involving the rights or obligations arising under the contract”); *Valley Juice Ltd. v. Evian Waters of France, Inc.*, 87 F.3d 604 (2d Cir. 1996) (contract providing that “the Agreement is to be governed by the laws of the State of New York” did not apply to claim under Massachusetts Unfair Trade Practices Act); *Maltz v. Union Carbide Chemicals & Plastics Co.*, 992 F. Supp. 286 (S.D.N.Y. 1998) (fact that agreement was “to be construed in accordance with the law of New York” did not apply to tort claims); *Sunbelt Veterinary Supply, Inc. v. International Business Systems US, Inc.*, 985 F. Supp. 1352 (M.D. Ala. 1997) (“this agreement and the terms hereof shall be governed by and construed in accordance with the laws of the State of Florida” did not encompass tort claims); *Shelley v. Trafalgar House Public Ltd.*, 918 F. Supp. 515 (D.P.R. 1997) (“this letter shall be subject to and construed in accordance with the laws if the State of New York” did not apply to tort claims).

<sup>33</sup> See Restatement (Second) of Conflict of Laws § 187(3) & comment h.

<sup>34</sup> See, e.g., *Chan v. Society Expeditions, Inc.*, 123 F.3d 1287 (9th Cir. 1997); *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713 (7th Cir. 1994), *rev’d on other grounds*, 514 U.S. 52 (1995).

1. Lender, a resident of State X, loans \$100,000 to Borrower, a resident of State Y. The loan calls for interest at a rate that is permissible under the law of State X but which is usurious in State Y. The loan agreement specifies that the law of State X governs the parties' relationship. If litigation is commenced in State Y – a likely prospect no matter who brings the action – Lender bears the risk that courts in State Y will decide that State Y's usury laws represent fundamental policy. If State Y's law would have applied had there been no contractual choice-of-law provision, the court may well invalidate the loan agreement. In contrast, if the parties litigated their dispute in State X, there would be no risk that the loan would be deemed usurious.

2. Investment Bank is a New Jersey corporation with its principal place of business in New York. It enters into a large interest rate swap with Importer, whose business is located primarily in Florida. All the negotiations took place in Florida and over the phone. Relying on the New York statute that allows parties to opt into New York law, the swap agreement provides all matters arising under or relating to the swap are to be governed by the laws of the State of New York. A dispute arises and Importer brings an action against Investment Bank in Florida. A Florida court may refuse to enforce the contractual choice of law if it concludes New York does not have a substantial relationship to either the parties or the transaction.

Therefore, parties who select a governing law should always select the same jurisdiction as the *exclusive* forum for any litigation.<sup>35</sup>

Most states will enforce an exclusive choice-of-forum clause by dismissing an action brought in a forum other than the one selected.<sup>36</sup> In federal courts, the matter can be dealt with through a motion to transfer or a motion to dismiss. However, a forum selection clause can be invalidated on many grounds. First, such a clause can be substantively unconscionable if it makes one party – particularly the one with less bargaining power and fewer litigation resources – litigate in a distant place.<sup>37</sup> Second, it can also be unenforceable if, because of unforeseen circumstances, they are

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<sup>35</sup> In addition to having a statute that allows parties to opt into New York law, the State of New York also has a statute that allows parties to agree to litigate in New York courts regardless whether jurisdiction would otherwise be proper there. N.Y. Gen. Law § 5-1402. Note, however, that this rule has a \$1 million threshold rather than the \$250,000 threshold for selecting New York law to govern.

<sup>36</sup> *But see, e.g.,* Idaho Code § 29-110 (invalidation some contractual restrictions on forum); Mont. Code § 18-1-403. *But see Fisk v. Royal Caribbean Cruises, Inc.*, 108 P.3d 990 (Id. 2005) (invalidating the Idaho statute with respect to certain maritime claims)

<sup>37</sup> This is especially true with respect to arbitration fora. *See Nagrampa v. Mailcoups, Inc.*, 469 F.3d 1257 (9th Cir. 2006) (arbitration provision was substantively unconscionable because it selected a forum at the franchisor's headquarters, 3,000 miles away from the franchisee's location and where the franchise agreement was to be performed); *Brower v. Gateway 2000, Inc.*, 676 N.Y.S.2d 569 (N.Y. Sup. Ct. 1998) (arbitration clause that required N.Y. consumer to arbitrate in Chicago was financially prohibitive and

extremely inconvenient.<sup>38</sup> Third, a forum selection will not affect where venue lies for a bankruptcy proceeding,<sup>39</sup> Finally, absent express contractual language to the contrary, a forum selection clause will not be deemed to create personal jurisdiction where there is none or prevent application of the doctrine of *forum non conveniens*. Because of this last point, a forum selection clause should be drafted to include waiver of personal jurisdiction and of *forum non conveniens*.

### Suggested Clause

#### **X.X. Choice of Forum.**

- (a) Any party who wishes to bring against the other party a civil action or proceeding arising out of or relating to either this Agreement or the relationship of the parties may bring such action or proceeding only in a state or federal court in [insert location by state or county].
- (b) For this purpose, each party consents to personal jurisdiction in such state or federal court and waives any right to dismiss or transfer such action or proceeding because of the inconvenience of the forum.
- (c) Nothing in this section shall prevent enforcement in another forum of any judgment obtained in a court identified in subsection (a).

Note, a forum selection clause does not have to be exclusive. Occasionally, contracting parties wish merely to provide for the freedom to litigate in a particular forum, rather than to restrict all litigation to that forum. If a clause is intended to be exclusive, however, state that clearly. Otherwise, it may be deemed not to be mandatory.<sup>40</sup> Also, be sure to specify whether the parties may use state courts, federal courts, or either, and be unambiguous if removal is to be prohibited. If using a federal court, be careful not to specify a location that doesn't have one. That might render the clause completely unenforceable.

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effectively barred consumer from enforcing his rights, and was therefore unconscionable).

<sup>38</sup> See TINA L. STARK, ED., *NEGOTIATING AND DRAFTING CONTRACTUAL BOILERPLATE* § 6.03[2] (2003).

<sup>39</sup> See 28 U.S.C. § 1408. Because bankruptcy courts apply the law of the jurisdiction in which they sit with respect to nonbankruptcy law issues, such venue can affect which state law governs. See *supra* note 20.

<sup>40</sup> E.g., *Excell Inc. v. Sterling Boiler & Mechanical, Inc.* 916 F. Supp. 1063 (D. Colo. 1996).

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## ARBITRATION

Parties are free to arbitrate almost any type of dispute pertaining to contract. In addition, they may by agreement bind themselves to arbitrate disputes concerning private commercial rights created by many statutes, including those arising under the Securities Acts of 1933 and 1934,<sup>41</sup> the Age Discrimination and Employment Act,<sup>42</sup> ERISA,<sup>43</sup> the Fair Labor Standards Act,<sup>44</sup> and the Magnuson-Moss Warranty Act.<sup>45</sup> Indeed, arbitration agreements can be binding even in bankruptcy, where the strong federal policy in favor of arbitration can conflict the goal of having a centralized and expeditious resolution of issues pertaining to the debtor's financial affairs. Early circuit court decisions seemed to suggest that bankruptcy courts must defer to arbitration on non-core matters but have discretion to permit or refuse arbitration in core proceedings.<sup>46</sup> However, more recent cases indicate that arbitration agreements must be enforced even in core proceedings unless arbitration would interfere with the administration of the bankruptcy case.<sup>47</sup>

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<sup>41</sup> See *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989) (concerning the 1933 Act); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (concerning the 1934 Act).

<sup>42</sup> See *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991).

<sup>43</sup> See *Pritzker v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 7 F.3d 1110 (3d Cir. 1993).

<sup>44</sup> See, e.g., *Floss v. Ryan's Family Steak Houses*, 211 F.3d 306, 313 (6th Cir. 2000), *cert. denied*, 531 U.S. 1072 (2001); *Kuehner v. Dickinson & Co.*, 84 F.3d 316 (9th Cir. 1996). Cf. *Albertson's Inc. v. United Food & Commercial Worker's Union*, 157 F.3d 758 (9th Cir. 1998) (individual employee's FLSA claim not required to be arbitrated merely because it falls under the arbitration clause of the employer's collective bargaining agreement with the union.).

<sup>45</sup> See *Davis v. Southern Energy Homes, Inc.*, 305 F.3d 1268 (11th Cir. 2002), *cert. denied*, 538 U.S. 945 (2003); *Walton v. Rose Mobile Homes LLC*, 298 F.3d 470 (5th Cir. 2002).

<sup>46</sup> See *In re Gandy*, 299 F.3d 489 (5th Cir. 2002) (bankruptcy court may refuse to order arbitration of core bankruptcy actions, such as those to recover assets under § 544 or 548); *In re U.S. Lines, Inc.*, 197 F.3d 631 (2d Cir. 1999) (bankruptcy court does not abuse its discretion by refusing to order arbitration of core proceeding to determine debtor's rights under various insurance contracts); *Matter of National Gypsum Co.*, 118 F.3d 1056 (5th Cir. 1997) (bankruptcy court does not abuse its discretion by refusing to order arbitration of core proceeding by debtor against its liability insurer). Cf. *Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149 (3d Cir. 1989) (debtor's securities laws claim, that became part of the estate, must be arbitrated).

<sup>47</sup> See *MBNA America Bank, N.A. v. Hill*, 436 F.3d 104 (2d Cir. 2006) (debtor's core class actions against creditor for violations of the stay must be arbitrated); *In re Mintze*, 434 F.3d 222 (3d Cir. 2006) (debtor's action for rescission of home equity loan must be arbitrated even though qualifying as a core proceeding). Cf. *In re White Mountain Mining Co., LLC*, 403 F.3d 164 (4th Cir. 2005) (bankruptcy court did not abuse its discretion by refusing to order – or permit – international arbitration of core proceeding by insider to determine that prepetition advances to debtor were debt, not equity).

Perhaps because so many different types of claims are now arbitrable, arbitration clauses have become a fixture of both commercial and consumer contracts. Today it is difficult – if not impossible – to open a deposit account with a bank or a securities account with a broker without agreeing to arbitrate any disputes that may arise. Nevertheless, before including an arbitration clause in a standardized form or a negotiated agreement, the parties and their counsel should consider the attributes of arbitration. Because most – and possibly all – of these attributes can be altered by agreement, any arbitration clause should be crafted to the particular contractual relationship.

### *Principal Attributes of Arbitration*

The process involved in any particular arbitration proceeding can and will vary depending on the nature of the dispute, the arbitrator or arbitration association selected, and the language of the parties' arbitration clause. Obviously, it is essential that any arbitration clause specify – either explicitly or through incorporation of the rules of some arbitration association – how the arbitrators will be selected,<sup>48</sup> and how the arbitration itself will be conducted. Two of the most common arbitration associations for domestic commercial disputes are the American Arbitration Association (“AAA”) and the National Association of Securities Dealers (“NASD”).<sup>49</sup> Each organization has fairly detailed rules and procedures governing the arbitrations they conduct.

In fact, the AAA has different rules and procedures for dealing with different types of disputes, indeed, quite a large number of different sets of rules and procedures.<sup>50</sup> The most important is probably the Commercial Arbitration Rules and Mediation Procedures (Including Procedures for Large, Complex Commercial Disputes). These rules govern an AAA Arbitration if either the parties' agreement specifies or if the dispute is a domestic commercial dispute and the parties have merely agreed to arbitrate pursuant to the rules of the AAA.<sup>51</sup> For that reason, much of the discussion below is based on these rules.

**1. Discovery & Motion Practice.** Arbitration is often expeditious compared to litigation in court. This is because much of the legal and political maneuvering commonplace in litigation is not available in arbitration. For example, there is little or no motion practice. A dispute might be resolved without a formal hearing, but there is usually no equivalent of a motion to dismiss or motion for summary judgment followed by a lengthy wait for a decision. Similarly, discovery in

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<sup>48</sup> For example, perhaps each party will select one and the two chosen will select a third. If the arbitration agreement does not specify how the arbitrator(s) will be selected and the parties do not otherwise agree, the applicable rules of an arbitration association will likely provide a mechanism. *See, e.g.*, AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 1(a).

<sup>49</sup> From 2001 through 2006, an average of slightly more than 7,040 arbitration cases have been filed with the NASD. *See* [www.nasd.com/ArbitrationMediation/NASDDisputeResolution/Statistics/index.htm](http://www.nasd.com/ArbitrationMediation/NASDDisputeResolution/Statistics/index.htm).

<sup>50</sup> *See* [www.adr.org/RulesProcedures](http://www.adr.org/RulesProcedures).

<sup>51</sup> *See* AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 1(a).

arbitration is fairly limited and thus fights about discovery are infrequent. The parties may file pleadings and exchange documents,<sup>52</sup> but interrogatories and depositions are rare and subject to the arbitrator's discretion.<sup>53</sup>

These attributes may be desirable for a particular client or transaction, or they may not. Some clients benefit from a speedy resolution of a dispute, but others may want to use the prospect of lengthy and expensive litigation as part of their negotiation strategy. Similarly, some clients may be likely to have secrets that they would not want to disclose – such as the internal e-mail message revealing a hidden and improper motive – while others may need access to the other party's internal records to successfully present a claim. Counsel should consider what is most likely to be in their client's interests when deciding whether to include an arbitration clause and, if so, on whether to expand the types of discovery that will be available.

**2. No Juries, Rules of Evidence, or Class Actions.** Arbitration is less formal than litigation. It is conducted without a jury. In part because of that, the parties need not comply with the rules of evidence. Instead, they may submit and the arbitrator may consider any relevant and material evidence.<sup>54</sup> Contracting parties are no doubt free to require that arbitration proceedings be conducted in conformity with the rules of evidence, but that would be unusual.

A somewhat related point is that most arbitration associations do not have a procedure for class actions. This can be very significant. In consumer transactions where the amount in controversy in any dispute is low, the typical consumer has insufficient economic incentive to bring an individual action. Class actions are often the only way consumers can effectively assert and enforce their contractual and statutory rights. If their contracts require the consumers to arbitrate, the consumers are essentially left without recourse. While this may render an arbitration unconscionable and unenforceable, such arguments are notoriously difficult to win.

**3. Privacy.** Most arbitration proceedings are private. The proceedings themselves are not open to the public,<sup>55</sup> and the arbitrators are expected to maintain confidentiality.<sup>56</sup> A corollary to this is that the decisions of arbitrators are generally not known, discoverable, or precedent. This can be

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<sup>52</sup> See AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 21(b); NASD, Uniform Code of Arbitration, Rules 10314(a),(b), 10321(c).

<sup>53</sup> See AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 21(a), (c); NASD, Uniform Code of Arbitration, Rule 10321(a), (b). See also Philip D. O'Neill, *The Powers of Arbitrators to Award Monetary Sanctions for Discovery Abuse*, 60 DISP. RES. J. 60 (2006).

<sup>54</sup> See AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 31(a); NASD, Uniform Code of Arbitration, Rule 10323.

<sup>55</sup> See AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 23.

<sup>56</sup> AAA, Code of Ethics for Commercial Arbitrators, Canon VI. In contrast, NASD Arbitration awards are made public. NASD, Uniform Code of Arbitration, Rule 10330(f).

a powerful incentive to include in a contract an agreement to arbitrate. A party may not want the resolution of one dispute to have *stare decisis* effect or even to be persuasive authority for resolving similar disputes. Moreover, to the extent that an arbitrator may be persuaded by the decisions of prior arbitrators, the private nature of the proceedings may give one party a virtual monopoly on the relevant information. For example, a business that arbitrates disputes with its consumer customers will certainly have a record of all prior arbitrations, but individual consumers will not.

**4. Basis of Decision.** In general, an arbitrator's decision may be based on notions of justice and equity; it need not be consistent with the law. Accordingly, some arbitrations will result in decisions contrary to what the law requires. Regrettably, this is also true with respect to litigation, but for different reasons. With respect to litigation, however, appellate review provides an opportunity to correct legal errors by the trial judge. Arbitration decisions are not generally reversible for legal error. Contracting parties that expect their counterparts to strictly comply with their contractual and legal duties, may not want to grant such wide discretion to an arbitrator. They should therefore consider including in their arbitration clause a requirement that the arbitrator's decision be based upon and consistent with the parties' legal rights.

**Suggested Clause**

**X.X. Arbitration.**

\* \* \*

The arbitrator is to decide the case pursuant to and consistently with the governing law.

**5. Remedies Available.** In general and unless agreed otherwise, an arbitrator may make any award the arbitrator deems just and equitable and which is within the scope of the agreement of the parties.<sup>57</sup> This includes specific performance, interest starting at any date the arbitrator deems appropriate, assessment of costs and fees, and attorneys' fees if authorized by law or by the parties' agreement.<sup>58</sup>

Contrary to popular belief, arbitrators may award punitive damages. Even if the governing law selected by the parties would not allow for an award of punitive damages, as long as the arbitration procedures do not expressly prohibit them, punitive damages may be awarded.<sup>59</sup> Thus,

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<sup>57</sup> AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 43(a).

<sup>58</sup> AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 43(a), (c), (d).

<sup>59</sup> *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995); *Stark v. Sandberg, Phoenix & Von Gontard, P.C.*, 381 F.3d 793, 803 (8th Cir. 2004), *cert. denied sub nom. EMC Mortgage Corp. v. Stark*, 125 S. Ct. 1943 (2005).

parties wishing to foreclose the possibility of punitive damages should make that clear in their agreement.

**Suggested Clause**

**X.X. Arbitration.**

\* \* \*

Any award is to be limited to that necessary to put the aggrieved party in the position as if the other party had fully performed. The arbitrator may not award special, exemplary, or punitive damages, unless such damages are required by law.

**6. Appeal of Decision.** By submitting a dispute to arbitrations, the parties implicitly consent to entry of a judgment on that award by any court of competent jurisdiction.<sup>60</sup> They also implicitly agree that the award is not subject to appellate review for legal or factual error. Review on appeal is typically restricted to instances where the award was procured by fraud or corruption, the arbitrator was patently partial to one side, the arbitrator's misconduct prejudiced one party's rights, or the arbitrator exceeded his or her authority.<sup>61</sup> This is one of the things that makes arbitration inherently risky.

The parties may, however, provide by contract for more a expansive review, one that scrutinizes for error the arbitrator's findings of fact and conclusions of law . Such a review could be conducted by an appellate arbitrator or a panel of appellate arbitrators. Indeed, the rules of some arbitration organizations expressly envision an appeals process while those of others, such as the AAA, implicitly permit it.<sup>62</sup> If such review is desired, the arbitration clause should specify the grounds for reversal, the standard of review, and the procedures to be followed.

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<sup>60</sup> See AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 48(c).

<sup>61</sup> See 9 U.S.C. § 10(a).

<sup>62</sup> See Paul B. Marrow, *A Practical Approach to Affording Review of Commercial Arbitration Awards: Using an Appellate Arbitrator*, 60 DISP. RES. J. 10 (2005) (referring to rules of the International Institute for Conflict Prevention and Resolution, the Judicial Arbitration and Mediation Services, and the National Arbitration Forum).

**Suggested Clause<sup>63</sup>****X.X. Arbitration.**

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No later than 30 days after receipt of any award (which shall not be binding if an appeal is taken), any party may notify the AAA of an intention to appeal to a second arbitral tribunal, constituted in the same manner as the initial tribunal. The appeal tribunal may adopt the initial award as its own, modify the initial award, or substitute its own award for the initial award. The appeal tribunal may not modify or replace the initial award except [for manifest disregard of law or facts] [for clear errors of law or because of clear and convincing factual errors]. The award of the appeal tribunal will be final and binding, and any court having jurisdiction may enter judgment on it.

It may also be possible to provide for judicial review of an arbitrator's decision. However, courts are divided on whether parties may by contract provide for judicial jurisdiction over an arbitrator's decision. Some permit it,<sup>64</sup> others do not.<sup>65</sup> Given the uncertainty about whether such a clause would be enforceable, parties desiring appellate review for error should stick to review by appellate arbitrators.

*Scope of Arbitration Clause*

Even if the parties want to arbitrate their disputes, arbitration may not be an appropriate or desirable procedure for dealing with all types of disputes or protecting all types of contractual rights. For example, a secured party may wish to preserve its ability to get a writ of replevin – something that in most jurisdictions can be accomplished quickly and on an *ex parte* basis even before a judgment is entered – without first seeking arbitration. Similarly, a licensor of intellectual property may wish to preserve its ability to seek and obtain a temporary restraining order and preliminary injunction.

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<sup>63</sup> Adapted from AAA, *Drafting Dispute Resolution Clauses, A Practical Guide* 37 (2004).

<sup>64</sup> *Syncor International Corp. v. McLeland*, 1997 WL 452245 (4th Cir. 1997), *cert. denied*, 522 U.S. 1110 (1998); *Gateway Technology v. MCI Telecommunications Corp.*, 64 F.3d 993 (5th Cir. 1995). See also Richard C. Csolomon, *Appeals of Arbitration Awards By Agreement: Why They Should Be Allowed*, 58 DISP. RES. J. 58 (May/July 2003).

<sup>65</sup> *Kyocera Corp. v. Prudential-Bache Trade Services, Inc.*, 341 F.3d 987 (9th Cir. 2003); *Bowen v. Amoco Pipeline Co.*, 254 F.3d 925 (10th Cir. 2001); *UHC Management Co. v. Computer Sciences Corp.*, 148 F.3d 992, 998 (8th Cir. 1998); *Chicago Typographical Union v. Chicago Sun-Times*, 935 F.2d 1501 (7th Cir. 1991) (*dicta*); *Crowell v. Downey Community Hospital Foundation*, 115 Cal. Rptr. 2d 810 (Cal. Ct. App. 2002).

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Generally a contractual arbitration clause does not bar efforts to obtain a preliminary injunction; a court may grant preliminary injunctive relief pending arbitration, provided the requirements for such relief are met.<sup>66</sup> Indeed, the standard procedures of most arbitration organizations contemplate the availability of interim judicial relief.<sup>67</sup> One would think, therefore, that any effort to make this explicit in the arbitration clause would be proper, albeit perhaps unnecessary. Nevertheless, arbitration clauses that require one party to seek arbitration while permitting the other to seek recourse in the courts run the risk of being declared unconscionable.<sup>68</sup> Attorneys drafting arbitration clauses should therefore tread carefully in this area.

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<sup>66</sup> See *Teradyne, Inc. v. Mostek Corp.*, 797 F.2d 43 (1st Cir. 1986); *Roso-Lino Beverage Distributors, Inc. v. Coca-Cola Bottling Co. of New York*, 749 F.2d 124 (2d Cir. 1984); *Ortho Pharmaceutical Corp. v. Amgen, Inc.*, 882 F.2d 806 (3d Cir.1989); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bradley*, 756 F.2d 1048 (4th Cir. 1985); *Performance Unlimited, Inc. v. Questar Publishers, Inc.*, 52 F.3d 1373 (6th Cir. 1995); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Salvano*, 999 F.2d 211, 213-14 (7th Cir. 1993); *PMS Distrib. Co. v. Huger & Suhner, A.G.*, 863 F.2d 639 (9th Cir.1988); *Wine Not Int'l v. 2ATEC, LLC*, 2006 WL 1766508 (M.D. Fla. 2006). See also Cal. Civil Proc. Code § 1281.8(b). *Contra Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Hovey*, 726 F.2d 1286 (8th Cir.1984). *But see Ferry-Morse Seed Co. v. Food Corn, Inc.*, 729 F.2d 589 (8th Cir. 1984) (affirming, subsequent to *Hovey*, the grant of a preliminary injunction in an arbitrable dispute).

<sup>67</sup> See AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 34(c); NASD, Uniform Code of Arbitration, Rule 10335.

<sup>68</sup> See *Nagrampa v. Mailcoups, Inc.*, 469 F.3d 1257 (9th Cir. 2006) (arbitration clause in franchise agreement was substantively unconscionable in part because it gave the franchisor access to a judicial forum to obtain provisional remedies to protect its intellectual property, while providing the franchisee with only the arbitral forum to resolve her claims).

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## PRESENTERS' BIOGRAPHIES

### *Stephen L. Sepinuck*

Professor Sepinuck has an A.B. in history from Brown University, a J.D. cum laude from Boston University, and an LL.M in Taxation from New York University. In the 1980s, he specialized in creditor's bankruptcy rights and related commercial issues while practicing law in Florida and in the federal tax aspects of public and private financings while practicing in California.

In 1989, he began teaching at IIT Chicago-Kent College of Law. Two years later, he joined the faculty of Gonzaga University School of Law, where he has teaches courses on Secured Transactions, Bankruptcy, Sales, Contracts, and Appellate Advocacy.

Professor Sepinuck has authored articles on a variety of subjects, written two books, and won awards for both his teaching and his scholarship. He served as an advisor to the Drafting Committee that revised Article 9 of the Uniform Commercial Code, chaired its Task Force on Deposit Accounts, annually edits the survey of commercial law that appears in *The Business Lawyer*, and serves as Chair of the ABA's UCC Committee.

He is an elected member of both the American Law Institute and the American College of Commercial Finance Lawyers. He is a former Associate Dean for Academic Affairs, a current member of the Florida, Massachusetts, California, and the District of Columbia bars, and Scholar in Residence at the law firm of Paul, Hastings, Janofsky & Walker LLP.

### *Tina L. Stark*

Tina L. Stark has lectured on law and business issues at programs in the United States, Canada, China, England, and Italy. Currently, she is Adjunct Professor of Law at Fordham University School of Law where she teaches a course in drafting commercial agreements, a clinic that teaches transactional skills, and a seminar on business. Ms. Stark has been teaching at Fordham since 1993.

In addition to her teaching responsibilities at the law school, Ms. Stark is principal of Stark Legal Education, Inc., a New York City consulting firm that develops and conducts continuing legal education seminars. Ms. Stark's teaching emphasizes the relationship between law and business, and draws upon her experience both as a corporate law partner at Chadbourne & Parke LLP and as a banker at Irving Trust Company.

While at Chadbourne, Ms. Stark had a broad-based transactional practice, including acquisitions, dispositions, recapitalizations, and financings. In addition, she developed and implemented the firm's corporate training program.

Ms. Stark received her A.B., with honors, from Brown University and her J.D. from New York University School of Law, where she was a contributing editor to the *Journal of International Law & Politics*. After law school, Ms. Stark clerked for Judge Jacob D. Fuchsberg of the New York State Court of Appeals and was an associate with Barrett Smith Schapiro Simon & Armstrong.

Ms. Stark is the editor-in-chief and co-author of *Negotiating and Drafting Contract Boilerplate*, publisher, American Lawyer Media (2003). Her drafting textbook, *Drafting Contracts*, is to be published in 2007. Her new treatise, *A Handbook on Contract Drafting*, is also expected to be published in 2007.