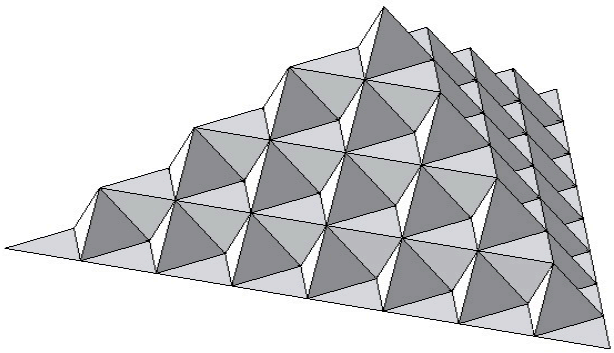
CONTEXT & ARCHITECTURE IN CONTRACT DRAFTING

The Opposite of Sweet is…Spicy or Dry or Sour?
The Opposite of Innocent is…Precocious or Guilty?



INTRODUCTION

Many lawyers prefer being engineers instead of architects regarding contract drafting. As long as the engineering is good, nothing else matters. But to the architect what matters is what matters to the user. What will make the building function for people? How will people use it and will they use it properly? Will the building encourage productivity? Will people be attracted to it? Will the users readily navigate it? Can the building be adapted to different needs over time?

To understand architecture – or contract drafting – you need more than a degree (or two). You firstly need to be alive to some aspects of human behavior, and

yes even the human aesthetic. You next need to understand superstructures, their components and their interaction. Finally you focus on any particular problematic areas. The latter focus for this paper is on representations and warranties and indemnities.

GUTENBERG V E-HARMONY

To state the banal, people come with different personalities. To state the subtle, those personalities help fix the superstructure of the contract. There are multiple **personality types** or dimensions.[1] One system colour codes and pigeon-holes people into the following types:

Catalyst	=	blue
Stabilizer	=	yellow / gold
Theorist	=	green
Improviser	=	orange

Amongst other traits blue sees possibilities, works well with others, values teamwork, creativity, and is democratic. Green works well with ideas, likes to start not finish, is insensitive, focuses on the big picture, and is rational. Gold prizes harmony, is realistic, dependable, takes charge, and is orderly. Orange is resourceful, independent, seeks action, is practical, likes to play, and is clever.

In addition, blues tend to be credulous / idealistic. Greens are skeptical / theoretical. Yellows are fatalistic / economical. Finally oranges are cynical / epicurean. To add complexity the theory argues that we are two colours; in the dominant colour we are either an extrovert or introvert; in the subordinate colour we are the opposite. Some internet dating systems use this regime to match the colour (dominate/subordinate) and type (extrovert/introvert). It seems at business negotiations that the colours are deliberately mismatched to fuel a fissiparous not harmonious process.

Another pertinent psychological context is how people approach risk. One school calls this "**risk cultures**"[2]. Each "culture" is biased towards highlighting certain risks and downplaying others. Pertinent to contracting, there are three types of cultures:

Hierarchal:	seeks legal equality – fears social deviance
Individual:	seeks equality of results – fears regulation

Egalitarian: equality of outcome – fears technology

This might seem arcane and densely academic, but pause for a minute and place yourself into contract negotiations having an environmental aspect. The hierarchist will say expert knowledge is required to prevent the system from being destabilized by human intervention. Regulation and data are necessary. The individual will hold that people underestimate the power of human ingenuity to overcome apparent limits. Resources can grow. Experimentation is encouraged. The egalitarian would seek strict regulation/prohibition to stop harm to Mother Nature. Individualists and hierarchists disturb the natural order, which is one of equality. Transmute the theory into realty, albeit crudely, as a boardroom negotiation amongst a government lawyer, an oil company lawyer, and an environmental lawyer.

The next consideration is **negotiating types**.[3]

Extroverts	v	Introverts
Intuitor	v	Sensor
Feeler	v	Perceiver
Judger	v	Thinker

Extraverts enjoy verbal interactions involved in negotiating, working with teammates; they are comfortable with stating their case in an adversarial strategy and stating clients' needs in a problem-solving strategy. They do have problems listening, think they know what you are saying before you say it or finish saying it, and will interrupt you with detailed comments. Introverts by contrast are non-talkative (better listeners usually); selectively disclose information; are reluctant to express themselves and are frustrated by detailed conversation. They tend not to be team players.

Sensors are linear, specific and literal. Sensors focus on facts to the exclusion of the big picture; can't see trends. They focus on specific details. Their opposite, the Intuit look at the big picture, the concepts; are random, theoretical.

Perceivers ignore deadlines, are tentative and go with the flow. They have a problem with making a decision, bringing things to closure, are forever seeking more data. Perceivers prefer to act spontaneously, have greater difficulty preparing and planning. Feelers emphasize the effect the decision will have on people and interpersonal relationships. They attend more to human than to technical aspects of problems and value these concerns more than any other type of evidence. Feelers are naturally attracted to problem-solving strategies; prefer harmony and agreement. Hence they do not favor a winner–take-all strategy

Judgers are structured in life, schedule to fixed deadlines, and seek control. They are uncomfortable with uncertainty, need control; are impatient with negotiating --- push to bring it to a conclusion, want to make decisions – get things done. They favor an adversarial strategy that defines and orders issues and like to control the flow of information. Thinkers do not focus on the needs of others. They are impersonal decision making and avoid emotional issues. They respond to attacking comments with strongly phrased counter attacks -- which intensifies conflict and may lead to impasse.

To add to this imbroglio, toss in **negotiating biases**. Optimum bias is the exaggerated view of success of the dispute at another forum. One is disinclined to make concessions e.g. requires production of all the data to disabuse the party suffering under the illusion. Then there is Reactive Devaluation. Party devalues the concessions or offers made, one becomes parsimonious rather than fixing the appropriate concession. Cognitive Bias speaks to the situation of wrong assumptions about why a party is acting a certain way thus misconstruing motives. Those misconstrued motives now form the foundation for a "mood" or "tone" in the negotiations.

Last but not least we have the concept of the co-operative vs. aggressive negotiator. The co-operative can turn ineffective by becoming gentle, obliging, patient, forgiving -- in short, appeasing. The cooperative continually gives concessions in the hope of securing the deal, while the aggressive keeps taking without giving any real concessions. In a worst case scenario the cooperative appeases an aggressive who bluffs, withholds information, demands, quarrels and is

disinterested in the needs of the other side. The oft quoted way to deal with an aggressive negotiator is called "tit for tat". No concession is given without a reciprocating equal value concession.[4]

WHAT IS A CONTRACT?

One often leaves a boardroom feeling physically exhausted, emotionally drained, intense, vaguely angry, muttering it need not have been that difficult. When one subsequently reviews the minutes of that meeting, there are occasions where one sputters a comment (inevitability with an expletive) that the other party obviously was not at the same meeting! How can one proceed now? To draft , you must reframe.

First clear the angst by recognizing the human element described above before you walk into the room. Next re-characterize the negotiations. Negotiations are not a compulsory unpleasantry on the way to a contract. Rather the negotiations are the process that provides a detailed list of the guidelines necessary to draft an effective contract.[5] Classically property law preserved status, contract law preserved promise, and tort preserved moral equilibrium.[6] The predominant purpose of law now is to allocate risk.[7] You cannot allocate risk and draft an effective contract without these idiosyncratic guidelines. Otherwise you have omissions, misdirected resources, and out of focus and out of balance provisions.

Risk allocation hides an uneasy fact. One will always have to deal with at least a scintilla of trust. Why?

- Contracts are designed to reinforce trust and reduce risk, but when they're too detailed or rigid, or when they send mixed signals, they can exacerbate the very problems they're supposed to prevent.

- Contracts that are too rigid can be problematic if they lock parties into arrangements that seem like a good idea at the time but don't allow for important adjustments as circumstances change.

- Many contracts include incentives such as performance pay, earn-outs and vesting schedules. However, in some contexts, such incentives can signal mistrust.[8]

Stephen Covey argues that when trust goes down, speed goes down and cost goes up. He argues it also creates work for lawyers — in itself something worth avoiding — promotes bureaucracy and undermines trust by discouraging spontaneous displays of goodwill.[9] The Warwick Business School demonstrated that deals conducted on the basis of trust, instead of precisely worded agreements, could lead to benefits for both parties to the tune of as much as an additional 40% of the total value of a contract.[10]

These notions of guidelines and trust are in harmony with the artisan / architect side of a transaction lawyer: apply the law to the deal, not the deal to the law. This is often phrased as the lawyer being a facilitator, not a spoiler. Evidently the premium is for creativity, insights and functionality. Otherwise drafting software readily replaces the lawyer.

WHO READS A CONTRACT?

The counsel of perfection holds that everyone should read the contract the same way; everyone should interpret it the same way. The effluxion of time compounds this problem in part because of the need for the contract to be both pliable and yet rigid, [11] and in part because legal and business contexts change. Still, who is this "everyone"? There are two schools of thought: "**speech communities**" and **five member audiences**.

The five audiences are: the immediate parties (or more accurately the negotiating team members in the hotel room at 2 am). Next come the administrators / successors. Anywhere along the time line are "arbitrators", be they judges, mediators, or arbitrators *per se*. Today there are also the regulators: be they government empowered or internal / external auditors. Finally each of these

parties have their advocates. And everyone is working at a different time and place in law, business, politics, and budgets. There are also different agendas, e.g. the administrators might be caught in a budget crunch and will narrowly interpret any cost bearing obligations. Still the notion is that all of these audiences will read that clause, paragraph or article as the negotiating parties intended at 2 am, whether or not the *quid pro quo* that begat that wording is immediately evident.

Speech communities is another concept that lawyers might, with a whiff of insouciance, harrumph as some obtuse academic concept. However, examine the definition:

> One of the primary variables among readers is the different speech communities to which they belong. A speech community consists of a group of person who share a lexicon, a syntax, and a body of knowledge and values. A lexicon includes all the information about words that is stored in human brains. It is much more detailed, more complex and more subtle than any dictionary could ever be. Syntax refers to the ways in which words are arranged in conventional structures that are meaningful to participants in the convention. Like a lexicon, the syntax of a language is complex and subtle and may differ in small but potentially significant ways from one speech community to the next. The final thing shared by a speech community – ***and this is crucial – is a set of beliefs, information, assumptions, preferences and values, in short, a body of "common" sense. This is what readers rely on to make judgments about what is plausible, probable, reasonable, relevant and important.*** Since we do not all belong to a single speech community, but to any such communities which only partially overlap, the meaning of a text may not be the same for all of us.[12] [Emphasis added]

For those involved in drafting contracts involving highly advanced technologies —from aviation to genetics to medicine to physics to zoology—recall how you have to both learn the subject matter and learn how to communicate with your client and appreciate their ethos or culture.

The point is that no matter how seemingly self-evident the text might appear to the lawyers or immediate parties, there are different audiences, different speech communities. Take a single word: the adjective "fresh". To a food shopper, "fresh" means recently harvested and unprocessed. To the food transporter it means unprocessed albeit preserved by gas or other means during transport,[13] e.g. South African white grapefruit. Indeed "fresh" to the food industry means less about time or distance than the technology that protects freshness.[14] To the US and Canadian regulator "fresh" includes produce that is waxed, acid or chlorine washed, or

subjected to ionizing radiation.[15] "Organic" too has multiple meanings often counter-intuitive to our food shopper but not to those not in the industry (or speech community) e.g. industrial organic[16] or the fact of additives and synthetics, from ascorbic acid to xanthan gum, beget the organic twinkie.[17] "Orange juice" is yet another entertaining example.[18] The shopper infers "not from concentrate" as something closer to freshly squeezed, thus fresher. The inference is wrong. Indeed this industry has fabricated fresh.[19] The audiences outside of the speech community are not privy to these sorts of lexicons. The key member of those outside audiences is the bench.

Consequently it comes with little surprise that this complexity of interpreting a contract has begat a tome of legal doctrines[20]:

- fundamental precepts (e.g. parol evidence);
- elements (e.g. custom and usage/ dictionaries);
- implied terms;
- outside doctrines (e.g. rectification);
- contract types (e.g. insurance)
- clause types (e.g. best efforts) etc.

Then there are the strategic approaches: textual v intentional v normative. [21] The Courts have voiced support for all manner of interpretation given what was before them.[22] The guise is the oft-quoted "business efficacy" or "fair result". The point is, how can one draft anything and expect a consistent interpretation? The drafter has to deal with a brew made up of personality / risk /negotiating types, speech communities/audiences, with a dollop of legal interpretation doctrines and more than a pinch of judicial arbitrariness. Using clarity of thought and presentation is a trite but nevertheless relevant response. There are two other strategic approaches that merit scrutiny: contract architecture and contract elements.

CONTRACT ARCHITECTURE

The foundation of any agreement is choosing the right device. Classically these structures were:

- Term Sheets / Minutes of Settlement
- Memorandum (MOU / LOU) Letter of Intent (LOI)
- Letter Agreement
- Comfort Letters
- Formal Agreement (as to structure not as to the use of a seal)
- Series of Agreements (matrix or parallel)
- Umbrella / master with subsidiary contracts
- RFP, Tenders, Expression of Interest, Request for Qualifications

Amongst the considerations in determining which device to use are: client's expectations, goals and needs; complexity of transaction; stage of transaction; sophistication of the parties; and costs. Each device generally has idiosyncratic concerns that require idiosyncratic clauses. The comfort letter should not be a *de facto* undertaking.[23] The MOU must explicitly identify if it is enforceable, not enforceable or a hybrid (e.g. confidentiality provisions).[24] Tendering has a whole plethora of decisions that make Canada unique in this field.[25] Letter agreements work best in industries with a shared ethos or operating principles, eg. oil & gas.

One key point gets forgotten in the fury of negotiations, personalities, industry norms. When is the deal the deal?

> If the documents or letters relied on as constituting a contract contemplate the execution of a further contract, it is a question of construction whether the execution of the further contract is a condition or term of the bargain or whether it is a mere expression of desire of the parties as to the manner in which the transaction already agreed to will in fact go through. In the former case there is no enforceable contract either because the condition is unfulfilled or because the law does not recognize a contract to enter into a contract. ***In the latter case there is a binding contract and the reference to the more formal document may be ignored***.[26] [Emphasis added]

Consequently a clause must explicitly state when the deal crystallizes, and contract *administration* must be alive for actions done on reliance of statements made in the negotiations or consistent with practices in that "speech community" but outside of a extant agreement.

That brings us to the formal contract and its particular architecture.

- Preamble
  - Title Date / Commencement / Parties
- Recitals
- Consideration
- Elements:
  - Definitions
  - Obligations [Covenants]
  - Statements,
  - Reps & Warrants,
  - Conditions
- Testimonium, Attestation and Seals
- Schedules / Appendices / Exhibits

For this drafting paper the emphasis will be on one forgotten device—recitals—and the incorrect used of the other—elements.

Recitals are often ignored by transaction lawyers, and utilized by intellectual property lawyers. Presumably this is because the IP bar deals with contracts that have decade or decades-long terms. Regardless, recitals provide the global context of the contract. Recitals articulate the lexicon and factual setting of the agreement.

- Explain the scientific, business, and legal backdrop in pedestrian terms;
- Highlight the history of the parties, what they bring, what they need;
- Identify the motives, expectations and approach of the parties; and
- Incorporate the extrinsic evidence.

Recitals are a roadmap and explanation left by the negotiators for the other audiences. One could argue recitals articulate what the "speech community" /

negotiators were thinking, doing and why they compromised. Recitals are scrupulously factual. Thus recitals are a briefing note for the judge. Indeed, the litmus test of efficacy is whether the recitals give the judge ignorant of all circumstances in the making, contents, subject matter and community of practice of the contract, a context and compass bearing for the intended interpretation of that contract.

Recitals are often dismissed as meaningless or without legal import. Incorrect. The rules are as simple as they are self-evident:

- If the recitals are clear and the operative part is ambiguous, the recitals govern the construction.

- If the recitals are ambiguous, and the operative part is clear, the operative part must prevail.

- If both the recitals and the operative part are clear, but they are inconsistent with each other, the operative part is to be preferred.[27]

The high water mark for recitals was the *Bitove*[28] decision that held that the courts will use recitals to achieve "an intelligent economic transaction and a reasonable arrangement between the parties".

There is one inescapable archaic point. To make well-drafted recitals effective, you must either reference the recitals in the contract proper—a statement to the effect the recitals are true and correct—or put the contract under seal.[29] The seal or statement acts as an estoppel against any party from later denying those facts in any action based on the contract.[30]

The contract proper can be broken into such divisions as consideration, payment terms, obligations, representations, conditions, boilerplate, definitions, etc. However the Alberta Bar in the early 1990s and the LSUC commenced teaching contract drafting through elements. Again these are:

- Definitions
- Covenants (obligations)
- Representations & Warranties
- Conditions
- Statements

The advantage of using the element structure to draft a contract is rooted in the fact the elements are mutually exclusive. A contract sentence can only be one of the five. This facilitates cleaner drafting and organization. An oft-quoted example is "Time shall be of the essence". It is written as a covenant but there is no action vested in a party. The example is really a statement, and as such should be properly written as "Time is of the essence".

Definitions come in various versions and most drafting textbooks identify them as follows:

- Restricting (means)
- Enlarging (includes)
- Confining (does not include)
- Compound (two or more defined terms)
- Extending (additional meanings)
- Clarifying
- Delegating
- Labelling (short name for a group / body / party)

The basic rule is to to avoid counter-intuitive definitions and not overburden them (easier said than done with some IP licences).

Covenants are identified by the verbs: shall, will, must, is entitled to. The key point to note is W5: who does what to whom, when and why. Furthermore, the covenant 's structure is "X shall [verb] Y, by not later than…". The subject, verb, object format is highly recommended for clarity. Beware: this is not an excuse to say "X agrees to assign to Y…." That is problematic for technical and substantive

reasons. The fact of agreement is expressed in the ceremonial consideration clause "NOW THEREFORE in consideration….the parties *agree* as follows" . To repeat "agree" is to be redundant.

A recent USSC decision also holds that to say "agrees to assign" speaks to the future not the present. So a subsequent agreement with the party that states the party "assigns" prevails over the antecedent agreement that covenants "agrees to assign".[31]

A **statement** is a bald fact: effective date, time of the essence, notice, etc.

A **condition** is a requirement antecedent or subsequent that then triggers or enables action. The classic structure is:

- Terms
- Time to satisfy
- Whose benefit
- Notice of satisfaction / outstanding
- If not satisfied, remedy
- If not satisfied, waiver by beneficiary

What gets missed is that if you have a possible or discretionary condition, then a further action is possible. Therefore the applicable verb is "will", not "shall", regarding the further action. If the condition is mandatory, the applicable auxiliary verb is "must". Law students *must* article prior to their call to the bar. If the purchaser pays 30 days in advance, then the seller *will* deliver to the seller the products…

Representations and warranties are a fact and a promise of veracity and you need both in order to have a cause of action.[32] Then again some say the distinction lies with breach. A breach of a representation is a tort, while a breach of a warrant is purely contractual, thus having different elements, remedies and limitations.[33] Most US lawyers hold that a representation states current facts while a warranty refers to the future.[34]

Whatever the case might eventually be, reps and warrants come in three families: the **contract itself** (e.g. the party has capacity and authority); **subject matter** of the contract (e.g. patents and no infringement); and the **parties themselves** (e.g. financial or scientific capacity).[35]

Representations and warranties are fixed in time, usually the closing or effective date. US commenters call this the "bring down". Representations are not made subsequent to the execution or effective date. In that instance the proper element is a condition. Sometimes a party will say the reps and warrant survive closing. This is not to say the reps and warrants are "evergreened". It merely is collateral effect from land transfers, where the reps and warrant merge with the transfer of title.

One must be intimately familiar with the applicable area of law in order to craft the subject specific reps and warrant. For example one does not rep that a patent is valid; rather the rep is that the patent issued or is registered. (A patent can be impeached unless there was litigation finding in favour of the patent, and the appeal periods, passed. Only in that instance can one say "valid".) One multi-national corporation was notorious for demanding a rep and warrant that the technology did not infringe any patents…or *trade secrets*.

Reps and warrants may be bald, but often come with some qualifications. The generic list typically involves:

- Time
- Territory
- Subject Matter
- Scope
- Knowledge
- Materiality
- Impact / Consequence.

The previous qualifications about materiality / impact ensure that neither a cosmetic breach of a rep and warrant nor a major breach with a trivial economic consequence, sounds in damages.

As to the future, the argument is that modern drafting techniques suggest all that is necessary is for a party "to represent". The objective is an assertion of fact to induce the contract. Misrepresentations come in three versions: innocent, negligent and fraudulent and those are a sufficient framework to deal with any breaches.[36] Warranty is a superfluous and confounding addition.

CONTRACT STYLE ELEMENTS

Style matters, and if you do not believe that ask yourself how you feel when you pick up a British Law Report that is one solid page of small font print with nary an indent, minimal line spacing and fully justified. When a page is so densely populated with text you need to usea ruler so as not to skip any lines. This style defeats the clarity or crispness of any drafting since readers eschew reading.

The first preliminary point is to pick the **typeface**, the font family. Some fonts work best in smaller sizes, others in larger sizes and still others for **conspicousness**. This is because of the height and especially the width, thickness and distance between letters. Times Roman is often used because it was the original default font. However, contracts are read on screens – computer, PDA, tablets – as well as on paper. Tahoma was originally designed for computer screens and paper.

The second point is **serif or sans-serif**. *Sans serif* letters do not have the little *serifs* – extensions – originally unavoidable in woodcut presses. Readers prefer serif fonts because the eye follows along via the serifs. It is easier to read long documents in serif. Two recent fonts – Calibri (sans-) and Cambri (serif) were designed for both text and screen.[37] The narrative in this paper is Cambri, the headings in Calibri. Some lawyers prefer Palatino Linotype and Book Antique for contracts and Garamond for correspondence.[38]

The next point is **line spacing**. Until Microsoft 2010 line spacing had three options—1 /1.5 and 2. Most contracts had single (one) line spacing. The suggestion then was to burrow into the software and change a setting to 1.1. Word software now provides 4 choices — 1 / 1.15 / 1.5 and 2. The new choice of 1.15 spacing is the line spacing in this paper.

Size matters. Type is measured in points, and anything 10 points or less is too small. It is too small to read, too small to effectively convert to pdf, and certainly too small for faxing.

Length matters. A line that is easy to read should be a maximum of 2 alphabets or 52 characters. After that readers start to lose their place. That is the reason for columns in newspapers, and smaller (less than 8.5 X 11) paper sizes in most books.[39] How do you avoid overly long lines?

Paragraph sculpturing is a key style device that enables any reader at any time to readily comprehend the objective of the paragraph Paragraph sculpturing entails indenting each section, sub-section, sub-sub-section.

1.0

1.1

(a)

(b)

(i).

Justification (left, centre or right) should be left, leaving the paragraph having a ratty edge. Left justification allows the typeface to have the same distance between each letter and word. By contrast, full justification while seeming neater with its box-like text requires differing spaces between letters and words, causing rapid eye fatigue. Newspaper columns use full justification and you sometimes see words s p r e a d o u t or the final word is far off.

Defined terms should be *conspicuous*. Lawyers often just capitalize their defined terms. Most contracts have a multitude of capitalized terms, not all of them defined. Hence the suggestion to used bold, italics or colour (not underlining—too

distracting) to strike the reader immediately that the word belongs to a lexicon / speech community.

Title paragraphs. Sound bite headings alert the reader as to what to expect. With Word, headings can be automatically generated into a table of contents, enabling quick document searching as opposed to "I read it in there somewhere". Some lawyers add a boilerplate statement that the headings are not part of the contract. The writer doesn't. I want the judge to consider them; I want to focus the judge using the headings.

The counsel of perfection states–never have **cross references**. The practical answer is they are unavoidable. But cross-references are deadly. As draft after draft is prepared, paragraph numbers change. The danger is not that the cross-reference makes no sense in the executed copy (that is a dud). Rather the problem is that it does operate with unintended obligations. The solution is to use both paragraph number and paragraph heading in every cross-reference. The heading clarifies any problem with the numbering.

Footers are wonderful devices to keep track of draft dates and versions. They also act as a thread weaving the contract to the execution page to the schedules. What belongs together is vividly marked. Thus you no longer need to have the last portion of the contract narrative leak onto the execution page.

Last but not least, beware of what I call the three stooges: shall, will, must. As noted there are rules for their use,

- To create a right, say "***is entitled to***"
- To create a discretionary authority, say "***may***"
- To create a duty, say "***shall***"
- To create a mere condition precedent, say "***must***"
- Post condition satisfaction obligations, say "***will***"
- To negate a right, say "***is not entitled to***"
- To negate a discretionary authority, say "***may not***"

- To create a duty or mere condition precedent, say "***is not required to***"
- To create a duty not to act ,say "***shall not***"

To **summarize** up to this point**:**

- Be alive to human personality, risk and negotiating types. The key point is to recognize which types conflict with your type so the friction can be managed and the objective met.
- Identify the core values / concerns (guidelines) of the parties and identify the degree of trust present. That can then be transmuted into a contract prose.
- Chose the architectural device befitting the situation and ensure structural and idiosyncratic clauses are prepared.
    - Ensure all the audiences understand the formal document the same way, irrespective of their knowledge or ignorance of the subject matter and surrounding circumstances. This entails fulsome recitals.
    - Use of paragraph headings means a table of contents precedes the recitals and reveals the entire narrative superstructure.
    - Employ style devices to easily guide the reader through the document and facilitate use of the document by anyone no matter how unfamiliar with the deal, subject or business culture.

INDEMNIFICATIONS

Indemnifications are *de rigeur* in contracts, but so are circumscriptions. The classic definition of an indemnity means either to prevent loss, so that it does not

occur, or to make reimbursement or compensation after the loss.[40] From a drafting perspective indemnifications are like ADR provisions – if not expected, a short pithy paragraph is inserted. If there is some likelihood of invocation, the paragraph now becomes an article or schedule in the contract.

Indemnifications arise in a number of legal contexts: statutory, contractual, restitutionary and negotiable instruments.[41] In the contractual context the indemnifying party either indemnifies the indemnified party for losses under the contract (direct)[42] or for third party losses claimed against the indemnified party (indirect) or both.

Indemnifications are distinct from damages in the sense that damages are subject to legal principles of reduction, remoteness, mitigation while an indemnity should be for "all losses".[43]

In intellectual property agreements, particularly licences, require an examination of:

- Risk - stage of development of the technology;
- Control – risk factor controlled by each or both of the parties
- Means– ability of each party to accept and manage the risk.[44]

For instance is the level of trust and experience such that an indemnity is not necessary? A party may be sufficiently robust and vigorous to aggressively defend both interests. In counter-distinction the vulnerable party seeks insurance and demands insurance coverage for the indemnifying party. Thorough due diligence fixes risk, control and means.

The superstructure of an indemnity has two prongs, what is covered and what is not. What is covered has the following components:

- Indemnity
- Subject matter
- Parties

- Scope of damages
- Limitations / Exclusions / Caps
- Term
- Procedures / notification

The **indemnity** often states "to indemnify, defend and save harmless". There is some dispute as to whether the three verbs are discrete. Also does the party want the other party to hire and direct counsel or does the indemnified want to hire his own paid by the indemnifier? Moreover the parties can wear both hats. The licensor may indemnify the licensee for infringement actions, while the licensee indemnifies the licensor for product liability. Regardless both parties should assist in the litigation, one may have the documents, the other the liability.

When it comes to settlement the parties are in a conflict of interest. Resolution for one might vests additional duties on the other or shave away some rights. The issue can be ignored. The issue can also be addressed by holding the party that accepts a greater economic burden will be indemnified by the party that benefits from it.[45] A licensee whose scope of IP rights is now reduced or otherwise disrupted are defrayed by a royalty abatement or otherwise mitigated by the licensor.

The **subject matter** while trite can be missed.[46] Is it obligations under the contract only? Is it any third party claims only? Is it both? Does it encompass any third party claims arising under the project, not just under that particular contract?

Scope can include whether the damages are foreseeable or not and whether or not the negligence of the indemnified party is included or excluded. The indemnity can be narrow and cover only patent infringement claims under the licensed patent.

Term can be complicated. Is it the term of the contract, the term of the contract plus any limitation period or for any claims arising during the term until the litigation is completed? Make it recondite with a multi-jurisidiction, multi-legal system indemnity.

Notification must be timely. In intellectual property cases the party needs to determine if it should commence impeachment proceedings in other jurisdictions. Conversely it enables a negotiated settlement before positions become ossified. Notification also triggers the right of the licensee to cease paying royalties pending resolution of the infringement action or the payment of royalties into trust.[47]

Exclusions from the indemnity beyond the four corners of the foregoing points generally include:

- Categories of damages
- Scope of damages
- Deductibles / Thresholds
- Caps
- Aggregates
- *Contra proferentum et al*

Thresholds avoid processing every picayune claim.

Deductibles instill some further probity or a disciplined approach by divvying some of the risk and costs.

Caps identify the maximum liability of a party per incident. For a licensor is it is some multiplier (including 1) of the royalties received. Otherwise the licensor could find itself in the painfully ironic position of being without an income stream under the contract yet paying to defend a licensee.

Aggregates are simply the maximum amount payment on all claims.

Scope of damages typically excludes consequential, incidental, punitive everything other than direct foreseeable damages.

Categories of damages often means which causes of action are in or out of the indemnity. A strictly written indemnity for patent infringement would necessarily exclude product liability. There are a number of torts that apply to IP / business so an exclusion of negligence *per se* might be insufficient. The exclusions would need to identify the relevant torts as well as negligence—and whose.

There is a plethora of decisions as to how the courts take a dim view of exclusion clauses.[48] *Hunter* is the seminal decision under which exclusion clauses are rendered nugatory as unconscionable, unfair, unreasonable or contrary to public policy.[49] Consequently, one does need to remove some arrows from the judge's quiver. The first is the ***contra proferentum*** rule. While not possible with contracts of adhesion, once a contract is a product of negotiation, there is no need for this doctrine. Both parties designed the contract. Both enjoy its benefits or suffer its deficits.

The second is collateral agreements, understandings and representations. This is typically dealt with in the "**entire agreement**" provision. Nonetheless, craft with an eye to inducements, compromises and "gentleman 's " understandings that are not evident in the document and not meant to be part of it that surrounded the negotiation of the indemnity.

The third is insert a clause in the reps and warrants provisions that unless otherwise explicitly prescribed in the contract, there are **no other implied or statutory representations.** You want to excise this from the compass of any indemnity.

Finally, depending on the jurisdiction, the indemnity provisions need to be conspicuous. CAPITAL LETTERS, red ink, **thick box like font**, a border or shading should be effective. Anything that makes the provisions obvious and readily readable is the objective.

THE CONTRACT IS TOO LONG

Every lawyer has had a client instruct him or her to put the deal on one page or at least keep it short. In one of life's many ironies, architecturally sensitive contracts take up to 4 times the length of the old turgid style. One could revert to small font, legal sized, wide margined, two-sided printing.

The other option is to keep the scope of work and party essentials on paper and put all of the boilerplate on the web. The federal Public Works Department has had its Standard Acquisition Clauses and Conditions on the web for over a decade.

The cell phone providers have the bulk of a subscriber's contract on the web, including the right to amend from time to time. The administrative imperative is keeping a record of those terms as they exist at any time, so the contract would cite: as per T & Cs, dated X.

Whatever the case, the key for a lawyer is to aim to be a great architect, continue to be a dependable engineer and always be a bit of a psychologist (for himself and of those across the table). Those dimensions enable effective contract drafting.

ENDNOTES

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[10] Sanbghera, Sathnam; *You Can't Write Trust into a Contract*; The Times, 22 February 2010.

[11] In general see: Hall, Geoff, Canadian Contractual Interpretation Law, LexisNexis, 2007. See also: *Consolidated Bathurst Export Ltd. V Mutual Boiler and Machinery Insurance,* [1980] 1 S.C.R. 888 at 901; *Eli Lilly v Novopharm Ltd.,* [1998] 2 S.C.R. 129, para 56.

[12] Sullivan, Ruth; *Contract Interpretation in Practice and Theory*; (2000), 13 S.C.L.R. (2d), pp. 369 – 394, p. 372.

[13] Wills, Ron; McGlasson Barry; Graham, Doug; Joyce, Daryle; Post Harvest: An Introduction to the Physiology and Handling of Fruit, Vegetables and Ornamentals (5th ed.); Cambridge: CABI (2007)

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[15] USA Title 21: Food and Drugs

PART 101—FOOD LABELING

Subpart F—Specific Requirements for Descriptive Claims That Are Neither Nutrient Content Claims nor Health Claims

§ 101.95 "Fresh," "freshly frozen," "fresh frozen," "frozen fresh."

The terms defined in this section may be used on the label or in labeling of a food in conformity with the provisions of this section. The requirements of the section pertain to any use of the subject terms as described in paragraphs (a) and (b) of this section that expressly or implicitly refers to the food on labels or labeling, including use in a brand name and use as a sensory modifier. However, the use of the term "fresh" on labels or labeling is not subject to the requirements of paragraph (a) of this section if the term does not suggest or imply that a food is unprocessed or unpreserved. For example, the term "fresh" used to describe pasteurized whole milk is not subject to paragraph (a) of this section because the term does not imply that the food is unprocessed (consumers commonly understand that milk is nearly always pasteurized). However, the term "fresh" to describe pasta sauce that has been pasteurized or that contains pasteurized ingredients would be subject to paragraph (a) of this section because the term implies that the food is not processed or preserved. Uses of fresh not subject to this regulation will be governed by the provisions of 403(a) of the Federal Food, Drug, and Cosmetic Act (the act).

(a) The term "fresh," when used on the label or in labeling of a food in a manner that suggests or implies that the food is unprocessed, means that the food is in its raw state and has not been frozen or subjected to any form of thermal processing or any other form of preservation, except as provided in paragraph (c) of this section.

(b) The terms "fresh frozen" and "frozen fresh," when used on the label or in labeling of a food, mean that the food was quickly frozen while still fresh (i.e., the food had been recently harvested when frozen). Blanching of the food before freezing will not preclude use of the term "fresh frozen" to describe the food. "Quickly frozen" means frozen by a freezing system such as blast-freezing (sub-zero Fahrenheit temperature with fast moving air directed at the food) that ensures the food is frozen, even to the center of the food, quickly and that virtually no deterioration has taken place.

(c) Provisions and restrictions. (1) The following do not preclude the food from use of the term "fresh:"

(i) The addition of approved waxes or coatings;

(ii) The post-harvest use of approved pesticides;

(iii) The application of a mild chlorine wash or mild acid wash on produce; or

(iv) The treatment of raw foods with ionizing radiation not to exceed the maximum dose of 1 kiloGray in accordance with §179.26 of this chapter.

(2) A food meeting the definition in paragraph (a) of this section that is refrigerated is not precluded from use of "fresh" as provided by this section.

[58 FR 2426, Jan. 6, 1993]

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[20] Hall, Geoff; Canadian Contractual Interpretation Law; (1st ed); LexisNexis: Toronto;(2007).

[21] Sullivan, *op. cit.*

[22] For the intentional school see: *Consolidated Bathurst Export Ltd. V Mutual Boiler and Machinery Insurance,* [1980] 1 S.C.R. 888; for the textual school see *Eli Lilly #& Co. v Novophar*m [1998] 2 S.C.R. 129 reversing (1996) 195 N.R. 378, reversing (1996) 91 F.T.R. 161.

[23] In general see: *Kleinwort Benson Ltd. v Malaysia Mining Corp. Bhd.,* [1988] 1 All E.R. 714 (Q.B. Commercial);*Toronto Dominion Bank v Leigh Instruments* (1992), 4 B.L.R. 220 (C.A.); *Langnese-Iglo GmbH v European Commission (supported by Mars GmbH)* (Case C-279/95 P) COURT OF JUSTICE OF THE EUROPEAN COMMUNITIES (FIFTH CHAMBER) [1999] All ER (EC) 616 .

[24] *Bawitko Investments v Kernels Popcorn*, (1991)79 DLR (4th) 97 OCA pp 103-4 ; see also US Jurisprudence *Adkistrote Systems Inc. v GAB Bus Sys Inc*, 145, F 3d 543 (2d Cir) 1998; *Skycom v Telstar* 813 F.3d 810 (7th Cir)– *Texaco v Pennzoil* 729 S.W.2d 768 (Tex App 1987).

[25] *Tercon Contractors Ltd. v. British Columbia (Transportation and Highways*), 2010 SCC 4, [2010]; 1 S.C.R. 69; *The Queen (Ont.) v. Ron Engineering*, [1981] 1 S.C.R. 111. For a detailed discussion see Paul Emanuelli / The Procurement Office.

[26] *Von Hatzfeld-Wildenberg v Alexander,* [1912] 1 Ch 282.

[27] *Ex parte Dawes, In re Moon* (1886), 17 Q.B.D. 275 (C.A.)

[28] *Canada AG v Bitove Corp* (1995), 47 R.P.R. (2d) 157.

[29] Elderkin, Cynthia; Shin-Doi, Julia; Behind and Beyond Boilerplates: Drafting Commercial Agreements (2ed): Thomsom-Carswell: Toronto; (2005) p. 65.

[30] *McMaster University v Wilchar Construction Ltd*., [1971] 3 O.R. 801, 812 (H.C.J.) As to the history and significance of a seal see: *Friedmann Equity Developments Inc. v Final Note Ltd*., [2000] 1 S.C.R. 842, 856. For ta text the use and need for seals under UK law see:

http://www.lawsocietyshop.org.uk/ecom_lawsoc/public/saleproduct.jsf?catalogueCode=9781853286995.

[31] *Board of Trustees of the Leland Stanford Junior University v Roche Molecular Systems Inc*. 563 US. (2011)

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[42] *Mobil Oil Canada v Beta Well* (1974), 453 D.L.R. (3d) 745, affd 50 DLR (3d) 158 found the indemnity only covered third party claims.

[43] Hebert, Brenda; Taylor, Melissa; *A Review of Specific Indemnity Problems* Indemnities in Commerce and the Courts; Canadian Bar Assoc., November 1994, p. 11.

[44] Lowman, Tim; *Indemnification and Insurance Provisions in Licence Agreements*; Presented to the Osgoode Hall (York University) Legal Drafting Course, Winter 2008, p. 3.

[45] *Ibid*., p. 6.

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[48] See in general: MacDougal, Bruce, Introduction to Contracts; Toronto:LexisNexis (2007); pp. 146-158; see also Hall, Geoff; Canadian Contractual Interpretation Law (1st); LexisNexis:Toronto 2007, pp. 238 – 252.

[49] *Hunter Engineering Co. v Syncrude Canada Ltd*. [1989] 1 S.C.R. 426.