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2009

### Transactional Skills Training: Contract Drafting – The Basics

George Kuney

*University of Tennessee College of Law*

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## TRANSACTIONAL SKILLS TRAINING: CONTRACT DRAFTING—THE BASICS

TINA L. STARK\*

In today's session, we will do two things. We are going to teach the basics of contract drafting, but, as we teach it, we are going to tell you some of the issues that you might face with students as you teach a particular concept. George will start us off.

GEORGE W. KUNEY\*\*

It is always difficult to do two things rather than just one, so, if I am failing in some regard, please stop me and ask me a question as we go. We are also going to try and reserve some time for questions at the end. The slide presentation is organized by topics, usually in the headings, followed by examples of some of the techniques and micro issues within the slides. What we are trying to do is show you the pedagogical goals that are involved in each step. We also will discuss some of the ways we try and address those goals or bring them up.

At the outset, the one thing that I very much increasingly believe in doing is making sure that students understand the overall perspective into which they are drafting. It's very hard to get second and third-year law students or even junior associates at law firms to understand the big picture of what's going on. I think that is what makes all the little stuff—the micro stuff that we nag them about—important and that is why it is fundamental that they read closely and use provisions in the right way, use the right provision to do the right thing, etc.

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\* Tina L. Stark is a Professor in the Practice of Law and the Executive Director of Emory's Center for Transactional Law and Practice. Professor Stark is an internationally recognized authority on contract drafting and the teaching of transactional skills and has written extensively on these topics. She is the author of the textbook *Drafting Contracts: How and Why Lawyers Do What They Do* and the editor-in-chief and co-author of *Negotiating and Drafting Contract Boilerplate*. A noted educator of both lawyers and law students, Professor Stark has been teaching transactional law and skills since 1989.

\*\* George W. KuneY is the W.P. Toms Distinguished Professor of Law and the Director of the Clayton Center for Entrepreneurial Law at the University of Tennessee College of Law. Professor KuneY's expertise and scholarly interests relate to business transactions and litigation with an emphasis on mergers and acquisitions, recapitalizations, and reorganizations. He is the author of, among other books, *Mastering Legal Drafting* (with Donna C. Looper), *Contracts: Transactions and Litigation* (with Robert L. Lloyd), *Legal Drafting: Process, Techniques, and Exercises* (with Thomas R. Haggard), *Legal Drafting in a Nutshell* (with Thomas R. Haggard), and *The Elements of Contract Drafting with Questions and Clauses for Consideration*.

So one of the things that I try and do is talk to students about things in their everyday life that they encounter. Maybe not always everyday life, but a number of things that they have experienced that are governed by contracts and the nature of the relationships between the parties. That discussion ends up, often, concerning Knoxville, Tennessee's West Town Mall or the Aladdin Casino and Resort complex in Las Vegas, Nevada, both of which are owned and operated by multiple parties and for both of which I have copies of relevant documents—the transactional drafting issues involved in these projects involve the shared rights and obligations and remedies to address problems, such as when somebody doesn't clean the parking garage. What can you do? How do you assess fees? What do we do about the food court at the mall and how do we assess the charges for cleaning up all those little trays at the airport when people come through and change planes and buy bagel from Einstein's and a burger from Burger King—and who is getting short shift under the arrangement based upon the nature of their products and customers.

One of the things that I like to do first is show students actual agreements to give them a brief overview of what we are talking about. Hundreds of millions and sometimes billions of dollars being invested in a joint enterprise where the consideration and the performances have to cross at precisely the right periods of time and, if they don't, there has to be a remedy or some mechanism for dealing with that. This sets the tone for why we are getting into the more focused, micro issues. I try to give them what I call a “market perspective of contract drafting.”

### **MARKET PERSPECTIVE ON CONTRACT DRAFTING**

*All types of lawyers can benefit from instruction about contract drafting: What lawyer hasn't had to interpret or draft a contract and struggled to understand or express the parties' purported intent?*

Everybody needs it, prosecutors need it for plea deals—I have brought out plea agreements and we have discussed whether or not they are sufficiently broad in scope and can be interpreted properly, how they kick in when new matters, new crimes, new indictments, for example, arise and that sort of thing. We do concentrate mainly on transactions, commercial transactions of some size, but everybody has to interpret a contract, be they a criminal court litigator or a transactional drafter. I think the best contract litigators are the ones that actually understand what the pieces of a contract were supposed to do even if they don't actually do that, so that we can get to the intent of the parties and have a discussion on that important topic.

### CURRICULUM FUNDAMENTALS

- “How-to” learning should include writing and feedback.
- Small class sizes accommodate intensive instruction and individual feedback.
- Teach concepts first (how to determine parties’ rights, duties, and allocation of risk)—then drafting.
- Use a variety of contract problems.

“How to” learning that includes writing and feedback. There is no way to teach this material without actually having students work on contracts—get in with their hands and really work on them. You can talk to them all day long, you can show them provisions, you can show them exemplars—that alone does not work.

Whether or not the feedback on their work has to be individualized is a real barrier for teaching this. Certainly, the best model in the world is for me or you to teach a student one-on-one for 14 weeks and draft a couple of big contracts and concentrate on various things as we go along and build something. Of course, to do that we need about 300 contract drafting professors, and where I come from we don’t have the budget for that. Some folks have used a group analysis to throw up exemplars on the board to talk about problems and then have students then reflect as to whether or not their drafts reflect those same problems or not. That’s very efficient, but it’s not that effective with the students because, like most of us, we see flaws that are shown on the board and we say, “well, I’ll never do that,” and we move on.

So getting some utility out of leveraging yourself, but not totally leveraging yourself seems to be the best way to go. I use small class sizes as much as possible. I try and run between five and eight contract drafting sections at UT each semester, each of which has between 8 and 14 students in it. Any more students than that and I can’t get the adjuncts to sign back up to do it again the next semester—it is just too time intensive. Imagine the time it takes to grade one short in class assignment and one larger, say five- to fifteen- page assignment, for 12 students each week—depending on the assignments, that is between six and twelve hours a week, not counting class time and preparation time. That is an awful lot of time and effort to expect of an adjunct professor in the first place. Many burn out after a few semesters. And that is the challenge: turnover. Once we have got the adjuncts up the skill curve and effectively teaching transactional drafting it’s horrible to lose that investment by burning out an adjunct. Professional feedback for students from a knowledgeable attorney is critical to the success of our program.

You can teach the students to review other students' work to preprocess it for you—looking primarily for objective errors and areas that need improvement—much in the way that an associate might help another associate produce a document before it goes to senior associate or partner review. I tend to grade not only the initial document and its follow-on final draft, but also the reviewer's comments in-between. That's fairly easy to do and you can get them to do lot of the legwork because they have been learning about the subject through the lectures and the reading materials and then you leverage that into the feedback/markup process, and they are putting the feedback down and giving you a rough draft of the comments themselves.

Teach concepts first and then the drafting. Emphasize thinking about what you are doing; not just diving in, but getting students to slowdown is critical to having them think through the entire deal. The tendency of law students is to grab a form and the start changing the party's names and just keep working through it. That, of course, does not work all that well and you end up with an abomination of some documents that are out there.

I recommend using a variety of contract problems because not every contract is of interest to everybody. I once made the mistake of teaching an entire real estate-based class and there were people in there that were not interested in real estate at all. They didn't think shopping malls were interesting. (I don't know why they didn't think shopping malls were interesting; they go there all the time). But moving the subject matter, the deal context, around so they see that there are a variety of problems and a variety of contexts is critical. The reason it is critical is because *the same concepts are being used in different deal contexts*. Contract drafting principles are universal and getting them to see how they are universal is very empowering to them, it stops them from thinking "oh, this is a new kind of deal and I don't know anything about it, I can't do this." What we are trying to give them are empowering tools to analyze different contexts of contract and other deals.

### CONTRACT DRAFTING TEACHING SEGMENTS

- Basic techniques for drafting terms
- Layout of a contract
- How to avoid ambiguity and unintentional vagueness
- Boilerplate

I break things down at the beginning of the course and this is where we cover a lot of ground, at the start. Basic techniques for drafting terms, including the



way that the term is negotiated in terms of being first proposed by one side and framed as an absolute provision or requirement which is then modified by a materiality threshold or carve out—these are forms of “provided, however” clauses for those of you who don’t know what I am talking about with this shorthand—and see how those things are built and how they affect one another.

The layout of a contract, and we will get to this in a second, is critical: *they are all in some sense the same*. You know, they really are. Just like is true of a memorandum of law, a research memo, and its striking resemblance to a memo of points and authorities or a brief, in terms of first setting out a preliminary statement, in terms of second going into the facts, and, third, moving into the legal argument or legal structure, which have been broken down issue by issue, coming to a conclusion and having signatures at the end.

### THE FORM OF TRANSACTIONAL DOCS

- Title
- Introductory Paragraph
- Recitals or Background Facts
- Definitions
- Core provisions—Consideration
- Risk Allocations—Representations, Warranties, Covenants, Conditions, Indemnities, Guaranties
- Closing Provisions
- Events of Default & Remedies
- Boilerplate
- Signature Blocks
- Exhibits & Attachments

The same can be said for a contract that opens up with recitals. Well, actually it opens up with a title and then we get recitals that set the context for the deal; then we get to some factual statements that are woven into the consideration, the heart of the deal, and then we get to the more boilerplate or legalese sections, which we as attorneys are almost solely responsible for and which the business people may not have finalized in their discussions. Having students see that these contracts—be they a lease, a master loan agreement, a reciprocal easement agreement, an acquisition agreement—all have the same basic structure is critical to letting students understand that they can handle various types of deals.

I am not going to touch much on ambiguity today—there are other speakers who are going to address that—but that’s, of course, the big bugaboo of contract drafting along with the unintentional use of vagueness. Vagueness has a lot going for it. As we all know, vagueness gets you over precision which is sometimes too hard and costly to achieve on. Understanding what you are doing as you are using vagueness *intentionally* seems to be a skill that you can impart, but you have to address it specifically.

(As to boilerplate, I would just refer you to Tina’s book on the subject).

So, I concentrate quite a bit about teaching the form of transactional documents. Here it is and those of you who deal with contracts understand this is the basic structure that’s out there. There may be some variations to it, but we have got title, introductory paragraphs, recitals or background facts, followed usually by definitions here or maybe the definitions are at the end because they are so copious that we need to separate them out. Next come core provisions consideration, the stuff that the parties are actually focused on, and then risk allocations which they may or may not have focused upon using representations, warranties, covenants, conditions, indemnities and the like. Then on to the mechanics of closing—if we have a delayed closing as opposed to a sign-and-close deal—and, then, events of default and remedies, which *I love*.

#### TINA L. STARK

It takes all kinds.

#### GEORGE W. KUNEY

It does, but when I started out in the bankruptcy and debtor/creditor group at Morrison & Foerster back in the late 1980s, I was just enchanted by the notion of events of default and remedies. I realized that there was no need to remember all that stuff from contracts class about the default rules of breach of contract like material and immaterial breach and substantial performance because *you could draft around the whole thing!* Right.

That’s great, that’s empowering, and that theme actually really does resonate with students an awful lot. You don’t have to use the default and remedies of the common law or your state statutes—barring contract provisions that are going to be struck as being unconscionable and the rest—we can actually design the whole dispute resolution mechanism including tribunals, ADR, and the rest in order to allow you to sue mainly for *enforcement* of you contract rather than breach of it. That

key perspective can cause the students to understand what they are doing when drafting a contract: they are engineering a relationship from start to finish, good times and bad times, in sickness and in health.

Another thing I remember from my first position as an associate was the astounding beauty of a master loan agreement. (As Tina points out, it takes all kinds.) Master loan agreements with all their little provisions for bring down certificates and the subsequent notes and additional security interest documents that are attached. These are fascinating documents. Look at how the master document is referring each one of these instruments—and somebody shall execute this and after they do and deliver it to somebody else then this will happen—it's wonderful.

I know this sounds a little silly—getting this worked up about events of default or a master loan agreement or attachments to contracts—but when the students actually see how this thing called a contract works, it can be quite motivating to them. Otherwise they would have just thought, “oh, that's stuff at the back of the contract and it doesn't matter that much.”

### **MACRO-ORGANIZATIONAL TIPS**

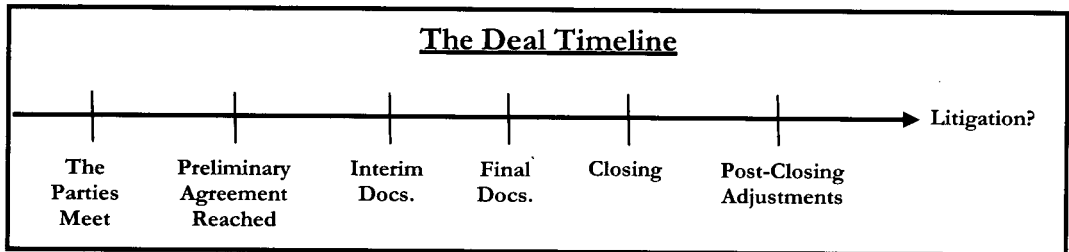
- General provisions before specific ones (“what” before “how”)
- Key provisions before lesser ones (e.g., order by frequency of occurrence)
- Rules before exceptions
- Separate sections/subsections for each concept
- Meaningful Headings for each section

I also like to focus on the macro organizational tips that the students don't necessarily think about explicitly. General provisions, before the specific; give me key provisions before the less important ones; give me the rule before the exceptions. It's amazing how many of students, trained to see all the problems that will come up, start their clauses with “except this” and “except that.” You have to turn that on its head. It's just like unpacking dependent subordinate clauses in the middle of a sentence in a brief.

Using separate sections and sub-sections for each concept, avoiding those provisions that grow like onions and continue to grow and grow and grow, layer upon layer; at some point everybody needs to say “we need a separate section for this. I think we will create section 2.03 and not keep building on 2.02.”

Of course we want to use meaningful headings for each section. I am always embarrassed—and I actually refuse to put it in my own contracts—the boilerplate provision that says “the headings shall not be construed or used to interpret this agreement.” That just seems disingenuous to me. I mean, make it a good heading, if you need to make it more general, make it more general. I tend to strike the nullifying boilerplate provision and it makes some lawyers very angry when you mess with that provision, but for the students, at least, this may be aspirational: Let’s have good headings. (I mean, what if we started to use a broader boilerplate provision that said “the words of the contract shall not be used to interpret this agreement?”—Ridiculous—What is the point of writing all this down? Making a record, a good record, that can be used to determine the rights and obligations of the parties in the future. Let’s just concentrate on doing it right, not disclaiming our workproduct.)

### THE CONTEXT OF THE CONTRACT



The context of the contract, this is the deal context that I teach from—the deal timeline.<sup>1</sup> Knowing where the document is on this timeline is critical to me. It starts with the parties meeting. I tell students I have had the privilege in the past of working with clients on a repeat basis and it’s always nice if your client meets with you before they talk to the other side in any depth, so that you can say, “here are some key issues that you might want to explore” because, of course, often the other side often hasn’t consulted with its attorneys first. So they are not thinking about those issues, they are thinking about “how much for how long” and “what do I get out of it.” By setting things up so that your client is educated at the beginning they can come up with or induce the opposing parties to give up many things their lawyers would advise against when the clients work out some kind of a chicken scratch term sheet to start working from.

Then we have the preliminary agreement stage. This is where we talk about term sheet issues, binding or non binding memoranda of understanding and the like,

<sup>1</sup> See GEORGE W. KUNEY & ROBERT M. LLOYD, *CONTRACTS: TRANSACTIONS & LITIGATION* (2d ed. 2009) (discussing this diagram in the introduction); see also GEORGE W. KUNEY, *THE ELEMENTS OF CONTRACT DRAFTING WITH QUESTIONS AND CLAUSES FOR CONSIDERATION* (2d ed. 2007).

which leads to our interim documents which may include a lease or a management agreement to take over the assets while we are working on whether or not due diligence will be complete and will turn out positive results. We discuss preliminary due diligence and whether the client wants to go forward with final documents. The final documents need to address who needs to do what for whom, when in the period before closing. Who needs to deliver what, when does something need to be approved by? If it is not approved within a period of time, who has walk away rights and what do they get back after exercising those walk away rights?

At each step along the deal time line, which of the provisions of these documents are binding? Confidentiality, non-disclosure—things like that that you want to have binding at all times. Things like that you want to have survive termination. Have them think through the divorce that may occur anytime along the relationship's time line—thinking about that before everybody gets to the altar is critical.

Finally, it is time for closing, but the process is not over yet because, although we close the deal, we still don't know what the last quarter's financial adjustments are going to show. So we have got escrowed funds and other deposits that will adjust the consideration afterwards—think through that ahead of time. As with marriage in America, there is always the possibility of divorce at the opposite end and how is your client going to land if that happens? You need to be thinking about that possibility even as you are putting together the documents.

Students, by the way, understand the concept of getting to know someone, getting to know them better (preliminary due diligence), deciding you really want to do a deal with them (heightened due diligence), deciding that the deal is over and feeling the need to terminate this relationship or deciding to make it more permanent and keep going with it. In fact, most of the law students that I have are at a stage in their life where that's *all* they are thinking about. Okay, so putting transactional drafting in that perspective is the relationship model. It really makes a lot of sense to students.

### **THE GOAL: PRACTICAL AND PRECISE DOCUMENTS**

Contractual Precision Consists of:

- Accuracy
- Completeness
- Exactitude—Lacking Unintentional Vagueness and All Ambiguity
- Able to Withstand Hostile, Critical Review.

After the contract is executed, the next thorough review is likely to be by someone trying to break the contract or sue over the transaction. Review it in that light and from that perspective.

Practical and precise documents—this pedagogical goal really consists of these four items: accuracy, completeness, exactitude, and being able to withstand hostile and critical review. Now, my perspective of this comes from a practice background as a bankruptcy and restructuring lawyer, working in and around Chapter 7 and 11 cases, primarily. Things have gone bad, we are going to change things, etc. This is when the client comes to you and says, “here are my documents. I haven’t looked at them since the closing, what can I do to get what I deserve out of this deal?” So, I tell the students that, after the closing, your client is going to take that nice closing binder you gave them, and they are going to file it. They are not necessarily going to look at it. They are very likely going to continue to work with the other party to the extent they have to by calling them up on the phone and doing essentially whatever they want to do, based upon what they think the terms of the deal are. They are not necessarily going to follow the terms of the documents.

So what we have got is a contract that, after it’s been executed and after people have performed in their relationship for a period of time, has parties that are going to become dissatisfied and they are going to say, “I want to break this deal and I want to get what’s mine.” You have to be able to look at the document as you are drafting it, reviewing it in terms of the perspective that is going to dominate things later. I think you will see that attitude coming up in a couple of these slides.

### **AIDING THE READER**

- Tabbed format
- Tables, especially in schedules
- Left justified, properly spaced, line length, headings and subheadings

It is important to remember to be explicit about simple things like aiding the reader. I am always amazed at how much students can fit on a page by widening the margins, going to single space with no break between paragraphs, and shrinking the font down to 10-point. I am thinking about going to a “local rule” (like that of the Sixth Circuit) of requiring type no less than 14-point because I just can’t read the tiny letters anymore. So it is worth while reminding them about having white space on the page, adding a blank line between provisions, breaking things out into easy to read lists, so that we can mentally tick them off as we go, and using no less than 12-point Times-Roman font. These are things that they don’t necessarily think about without being prompted.

For whatever reason in the traditional, common-law, first-year classes they have not been encouraged to think in terms of tables and tabulations. There is a reason that business people use charts. Try and explain what interest rate variables are based upon a textual sentence, it often just doesn't work, it's not readable. Making them understand that it is okay to use a chart or a formula even if you separate that out and put it in an attachment where there may be a worksheet that people can use.

I am still a “two spaces after a period to make things readable” kind of guy. They don't seem to follow that rule anymore. One student recently told me it was a “typewriter rule” that has no application in modern word processing. I disagree. I find it makes skimming the document that much faster because you know where one sentence ends and can move to the next. Please join the cause and teach them two spaces at the end of a sentence.

Again, I like good headings. In our program, we keep hitting them over the head with some practical, precise documents: plain English in a simple style. If we could get through the first year without having them read nineteenth century opinions that are dressed up in horrible language—that would be lovely. We were not able to get them all out of our contracts casebook—it is hard to think about cutting *Sherwood v. Walker*,<sup>2</sup> the “replevin for a cow” case—but we have tried. But it is sad to see them emulate the style of these older, more opaque cases in their writing, and it will not serve them well in practice.

When talking about how to format a document, have them go back and look at one of those older cases—see how it is written as one four page paragraph. It's incomprehensible without a lot of work on the part of the reader. There is the reason that students had trouble with that case in class. It wasn't the concepts involved. It was mostly the layout of the document.

The active voice and the uniform use of shall for duties and may for rights and privileges clauses. I aim to make use of “shall” and “may,” knee jerk, absolutely knee jerk. So they are not thinking about it at all. It is a critical point that they should take out of that course.

Unpack provisions, simplifying the reading again. Define terms, information, schedules, and supplemental documents. They are not just convenient places to stash things—they are useful appendages to the contract that make the whole thing work.

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<sup>2</sup> *Sherwood v. Walker*, 33 N.W. 919 (Mich. 1887).

**DRAFTING TRANSACTIONAL DOCUMENTS—DRAFTING FUNDAMENTALS**

- Practical, precise documents.
- Plain English, simple style.
- Active voice, uniform use of shall (duty) and may (right/privilege clauses)
- Unpacked provisions: defined terms, information schedules, etc.

The bugaboo of small minds like those of lawyers is consistency, consistency, consistency. If you are going to say it one way, say it the same way every time you say it. Getting that through students' heads is very tough especially when they have been taught to think about big picture items and big context of everything in their doctrinal courses. Getting them to focus on consistency until it becomes a complete habit is important. I tell them—and it's true—I can't even read the Wall Street Journal without a pen in my hand wanting to change words to make them consistent with what came before in the article. The English Department and its practice of "elegant variation" it has no place in transactional drafting. It helps to be explicit about this.

**SHALL, WILL, MUST & MAY**

- Shall or Will—Specifies duties (mandatory, imperative). Pick one and be consistent.
- Shall not—Specifies prohibitions ("may not"—stronger?).
- May—Specifies rights, options (permissive).
- Will—Can be reserved for the predictive (future) if you use "shall" for your duties; avoids the ambiguity of using will for both.
- Is—for statements involving no actor (e.g., choice of law).

We turn now to the basics of shall, will, must, and may. "Shall" or "will" for duties that are mandatory or imperative. Pick one and be consistent. I go with "shall"—there are others who want to use will. I think the New Zealanders have now finished rewriting their statutes so that the word "shall" has been banned from them and they always use "will" for consistency of duties. I don't think you have to go that far, but pick one and go with it. Cover "shall not" and then the question of whether "may not" is a stronger provision. Tina has a wonderful exercise regarding anti-assignment which deals with this distinction and getting people thinking about whether or not there are teeth in the agreement. Just because the contract says you may not do something doesn't mean you can't do it. We might want to render the



prohibited action void, for example. “May” is used for rights and options as it is permissive. “Will” I reserve for the predictive future.

### **MORE DRAFTING CONVENTIONS**

- Question the need for doublets, triplets, etc. (Historical roots no longer apply).
- Omit needless words and lawyerisms.
- Avoid “Notwithstanding anything to the contrary in this agreement, . . . .” and other sloppy drafting fixes and tricks.

These are bad habits that students get from the first semester courses especially, but they then carry them over into lots of documents. Consider the archaic use of multiple synonyms (doublets, triplets, etc.): Instead of reciting synonyms, we should use the word that generally encompasses everything we mean to say. For example, the phrase “sell, transfer, assign, convey, etc.” should be simplified to “transfer.” The historical background on this fashion of writing appears to have come out of 1066 and the Norman invasion of Britain. During that time, the statutes and laws were re-written to cover the meanings of law French, Latin, and Anglo-Saxon words, if I remember correctly. So, drafters used synonyms to cover all possibilities, in whatever translation. It also happens that scribes of that day were paid by the word. It’s not 1066 anymore.

The sloppy drafting technique often used at the last minute: “notwithstanding anything else in this agreement . . . .” Great. I didn’t have to review the document. It cost the client only one minute of my time to add that in and make everybody happy. But what have we nullified in the rest of the agreement? Presumably, somebody thought about all those other provisions—or not. I find this technique to be a lazy habit and I try and teach the students not to get into the habit or at least recognize that it’s a lazy habit and they are engaging in a risky behavior when they do it.

### **AN EXAMPLE OF PLAIN ENGLISH IN ACTION**

Consider the following passage:

A series of losses arising from the same event shall be treated as a single loss in the application of the deductibles. However, notwithstanding the foregoing, in the event of losses to property arising out of which separate deductibles are applicable, then such

deductibles will be applicable by class of property as if the losses had occurred separately.

*What does it really mean?*

One event with many losses = single loss for deductible (apply it once). But, if those many losses are spread across different classes of property set out elsewhere in the insurance policy, e.g., vehicles, inventory, equipment, which each have separate deductibles, then apply each deductible to each class.

This little exercise seems to work pretty well. I want you to take a minute and read that, taken from an actual insurance policy. We decode it in class with the students, asking what does it really mean? One of event with many losses equals a single loss for deductible purposes. We apply the deductible only once. Well that's pretty easy, we understand that. But if we have got losses spread across various classes of property covered—houses, boats, trucks, trailers—then we are going apply separate deductibles if they are separate ones for each class. That's pretty straightforward conceptually speaking. So how do we fix it? One approach is the line edit:

A series of losses arising from the same event shall be treated as a single loss in the application of the deductibles. However, ~~notwithstanding the foregoing~~, in the event of losses to multiple classes of property ~~arising out of which~~ each having separate deductibles ~~are applicable~~, then ~~such~~ the deductibles will be applied class by class. ~~Applicable by class of property as if the losses had occurred separately.~~

It's a little messy, but we can see how we can just sort of cobble the language around. We get rid of words as “such” and the like, but then we get to a conceptual redraft and here is what we did: We took the meaning of the first provision and we thought through what it means. Then we drafted a new clause in plain English.

### THE CONCEPTUAL REDRAFT

*Think:* When there are lots of losses from the same event, apply the deductibles once, class by class. This is not about a series of losses (as the original wording of the provision might suggest). *It is a declaration about application of deductibles!* Its real purpose, then, is better expressed as:

*Each deductible is to be applied only once [to each class of property] to a loss or losses caused by the same covered event.*

At this point in the exercise, students are bored with deductibles. But that is okay; it is a good exercise to run them through. This makes for good in-class work. Something you can do it in about 20 minutes if folks are working along with you at each step and I think it's pretty illustrative of the approach.

Directed edits allow me to leverage myself, and I encourage our adjuncts to leverage themselves as much as possible. One way to do that is to use the students themselves and to teach them how to review documents. Now, they are horrible at document reviews at first and there is a peer pressure problem. They learned it in their first year; the code is: don't volunteer. If I volunteer I make other people look bad, they will feel that they have to volunteer, all we are going to do is raise all the boats at once, we don't want to do that, there is no percentage in that for us because we are graded relatively, on a curve. So, to get around that, I first of all tell them that I will grade their review of the material, which gets turned in after the document has been returned to the principal drafter who has then redrafted it and come up with the final draft that's turned in for a grade to me. Now they have some skin in the game and a reason to subject their colleague's draft to scrutiny.

Second of all, I give them a structure to use in commenting and I even have a bunch of little stamps. If anybody wants to see a scan of one such, you can have the stamps made, they are a little self-inking stamps and they have symbols for each one of these categories: (1) M for macro issues (2) P for paragraph and section level issues, (3) S/WC for sentence level and word choice issues, (4) CF/P for cite form, proofing, and cross reference issues, and (5) S for substance issues. Assign 20 points to each one for a total of 100. You give them a structure that they can work with, they have to mark things up and then assign a grade within each of those concepts. What this approach does is give you and the students the ability to isolate things that the student may have done very well that you can't really mark up effectively in the document. So if their overall macro structure is really good and clear you can give them 20 points—a perfect score! And that perfect score feeling remains even when they get only 5 points in CF/P because of bad proofing. You can then proceed to dissect everything else and tear it apart, but they have got to quantifiable thing that is the personal reaction equivalent of a “good” or “good try” at the top of the page, which many of them by now have learned is just window dressing to save them from a feeling of ultimate failure. It makes them feel that they have got something that they have succeeded at and they can focus on the other areas in which they have not done so well.

**A PERSON OF REASONABLE INTELLIGENCE WHO KNOWS NOTHING  
ABOUT THE DEAL CAN UNDERSTAND THE TRANSACTION AFTER  
ONE READING OF THE CONTRACT**

*That is likely to be all the time the judge has or cares to devote to it.*

The preceding is the standard that I like to strive for and that I try to have my students strive for. In some ways, when you get to litigate a contract in Federal Court amongst parties who are represented by large firms and it's a large deal, nobody in court cares about the contract, nobody other than you and your client really cares about the dispute in the way that the clients do. The judge doesn't—the judge is probably making less than a first-year associate in a top-flight firm. This is not a criticism of judges, just a realistic statement—and nobody's life or civil rights are on the line here, it's just a contract claim. The judge doesn't want to have to piece together what should have been in the contract and all the rest of it. It's supposed to be laid out, that's why big firms and competent lawyers are hired.

Now, if you have got parties arguing over the sale of a farm written while drunk on the back of a restaurant check—Okay, then we have got something that people may care about—that's *Lucy vs. Zehmer*,<sup>3</sup> if anybody cares—but the standard that we really need to reach in our contracts is that somebody who has reasonable intelligence and has been elevated to the bench and is working with a law clerk in her first year out of law school can understand what's going on and resolve the matter in your favor. On the first reading.

That is who we are writing for, if it comes to that. I have talked with people, some of them are money-center lawyers who say, “you know, I write really complex deals and there is no way to write them in plain English and make them easily understandable.” And I think, “okay that's great, tell it to the judge because that's where the rubber hits the road, that's the ultimate audience for this stuff in the end.”

This is my unhappy truth: More likely than not, after the contract is negotiated and signed, the next thorough review of its provisions will likely be by someone trying to break the contract or sue over the transaction. Especially, in this day and age when contracts are chopped, sliced, diced, packaged, bundled with others and sold or assigned to an indenture trustee or other functionary whose job it is to seek enforcement at a later date, and none of the original people involved are going to be around. They will have all moved on, they will have left for other pastures, they will have taken other jobs, they will have been fired, they will have

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<sup>3</sup> *Lucy v. Zehmer*, 84 S.E.2d 516 (Va. 1954).

been indicted, they may be dead—whatever—and we are left with having to enforce what's on the page, and somebody is going to be trying to break that contract. So the document has to stand up on its own to that hostile critical review, which takes me to the three principle purposes of the contract is as I see them.

**CONTRACT DRAFTING IS MAKING A RECORD OF THE PARTIES' DEAL AND  
CREATING THE MECHANISMS TO:**

- Foster Agreement,
- Foster Performance, and
- Provide for Enforcement and Dispute Resolution.

These goals are in a state of conflict and must be balanced. Contract drafting and negotiation, really, is first about fostering agreement and making a record of that agreement first of all. Afterwards, the contract has to foster performance. There have got to be enough little sticks and paddles and rewards built into the contract so that people will want to perform their side of the deal. We are not talking just about the events of default and remedies sections. We want little things, conditions, for instance—provisions that say you don't get the quarterly interest payment if you haven't done these other things. Conditions can be built in to foster voluntary performance. If we do need to go ballistic, we have the nuclear option in our events of default and remedies. Overall, though, we want to provide for enforcement and dispute resolution on our terms and not the ones that are provided by the statutes or the common law and if we can avoid it. We want to have control over how that's going to play out, hopefully in favor of our client.

**THE MOST IMPORTANT TAKEAWAY FOR PRACTICE**

- When using a form or a prior document, never leave in a provision because you do not understand its purpose, and never take out a provision because you do not understand its purpose.
- Figure out its purpose, then determine if it should be retained, deleted, or modified.
- Prior docs have been negotiated, so unnegotiate them for a new negotiation and transaction.

***The switches need to be reset.***

There is an uncanny power that documents from prior, successful deals have. Students must understand that prior documents that they find are not perfect, even

those from the lions of Wall Street that are available on line through the Securities and Exchange Commission's EDGAR database. They might not even have been perfect for the deal that they were part of—They are negotiated documents we need to un-negotiate them before using them as exemplars and floating them to the other side. One attorney put it very nicely to me: "I like to find a form in which the side that I now represent had the most leverage in the prior transaction, because then I know, if anything, it's all slanted towards my client." I like the approach, but I also like to think about just resetting the switches to start and then you take it in that direction yourself before you turn it over to the other side, rather than going with the preset switches. Too much often gets left in the end from prior deals that has no bearing on this deal, and there is the tendency for law students, first-year associates, even third-year associates, to think, "well, this looks like a very efficient provision. I have seen it or something like it in other documents. I will just leave that in there. I don't know what it means, but it looks official." This is a mistake. Figure out the purpose of the provision and then determine if it should be retained, deleted, or modified.

If you need to ask somebody what is the provision is for, you can ask the other side. It's not that much of a sign of weakness. The conversation goes something like this: "Why do you have this in here? We never have that." It's amazing how many times I have asked that question of opposing counsel and they have been unable to give a good answer to the question. That's indicative of something, at least something which needs to have some attention paid to it.

### FUNDAMENTAL POINT

You do not want to have to sue for *breach* of contract. You want to be able to sue to *enforce* the contract. *Your house, your rules, your remedies.*

I think I have made this point earlier, but this tends to put it in language that students can easily absorb, so it bears repeating. You don't want to have to sue for breach—breach of contracts actions are no fun at all. You want to be seeking specific performance—you want performance of your contract, and of its terms. You draft consequences into your contract. You use your transactional tools like representations, warranties, covenants, conditions, cut off provisions, go-shop provisions, no-shop provisions, best efforts clauses, defined terms, bring down certificates, events of default, specific remedies, choice of forum, law, and adjudicator, and the like. We are providing a road map for enforcement by the court and there is nothing that a court likes better than a contract that gives it that road map because it's an easy contract case to rule on.

### ANOTHER FUNDAMENTAL POINT

*When drafting provisions, you need to know the applicable law, and then draft directly into or around it. If you see a safe harbor, sail in cleanly and clearly. If you see a hazard, steer clear around it. Example: Do you call them liquidated damages or penalties? It depends on if you want them to be enforced or not.*

This is such a basic point that for years I never made it to anybody. I thought they all knew it. When you know the default law that's out there, either draft your provision to match it or draft your provision to get around it. The example that I use usually as an opener for them is a liquidated damages remedy. First of all, if you want to create an unenforceable liquidated damages provision, what's the first thing you do? You label it a "penalty," maybe in a nice heading: "penalty for non performance." Believe it or not people do slip those in intentionally for just this effect—if you have not read the great Dow Chemical settlement case,<sup>4</sup> you should. Conversely, if you see a clear, safe harbor, sail right into it: recite the valid liquidated damages standard for the applicable jurisdiction; have the parties agree about factual representations that support their agreement that damages in case of breach are very difficult to predict at the time of contracting but they have tried and have come up with a reasonable estimate, which is found in the following formula, etc.

My final thoughts from this segment and I will turn it over to Tina. When my contract drafting students come out of the experience, I want them to be thinking about contracts as if they are blueprints, as if they are engineering specifications, as if they are a design for a machine that's going to work, to swap consideration and provide remedies. It's a very mechanical view of what the contract does. It's one that, on the other hand, the students can grasp—they can understand blueprinting and charting something because that makes it less abstract. You don't just go and start building a house, right? You want a three-bedroom-two-bathroom house. Well, you are going to study some drawings, plans first, right? You are going to see how the house is supposed look and work and then you (or your contractor) are going to go and build the house. Imagine what would happen if you contracted with a contractor for a three-bedroom-two-bathroom house that would be acceptable to you with no detailed specifications. That's no way to draft or build anything.

To close, I will share a war story that seems to work well to capture what one wants to avoid when drafting a contract and the danger of grab-and-go form

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<sup>4</sup> Bear Stearns Gov. Securities, Inc. v. Dow Corning Corp., 419 F.3d 543 (6th Cir. 2005).

practice. At the end of the 1980s or early 1990s, when the cold war had been “won” and the defense industry was getting smaller, I had a matter involving a large machine shop lease San Diego. My client was the tenant, and he had these huge machines—gantry mills—that he had sunk into the concrete of the floor of the machine shop. The machines operated like this: they were hooked up to some computer-aided manufacturing units and, at the close of the business day he would put a big slab of titanium on the mill bed, set the computer, close all the doors, and walk away and, in the morning, there would be cruise missile nose cones and the like that would get cleaned up and shipped to General Dynamics. When he entered into the lease of his machine shop, he needed a lawyer for the lease and he turned to a friend. He said, “could you do the lease for me for this,” and his friend said, “no problem,” grabbed a lease from his drawer, which happened to be a commercial office lease in which the landlord had provided the tenant improvements for the building and which provided that all fixtures, including trade fixtures, would be retained by the landlord upon the tenants’ termination of the lease—meaning that under the terms of the lease, \$300 million worth of gantry milling machines were going to be surrendered to the landlord upon the tenant’s departure. The matter came to me when the tenant needed to downsize, quickly, and we filed a chapter 11 case and proceeded to reject the lease. That is when the landlord—not the original landlord, mind you, but someone that had bought the fully leased up building and taken an assignment of the lease—took the position that the gantry mills stayed behind in the building. This was clearly not the intent of the parties (the original landlord would probably have so testified, but he was unavailable), but we did manage to litigate that for approximately two years to the tune of approximately \$500,000 on our side alone, including appeals. That story sometimes gets the message across: *remember, the other deal was different.*

#### TINA L. STARK

What I am going to focus on today is the translation skill that I mentioned in my earlier talk. Just briefly, the translation skill is the analytical skill that deal lawyers use. It differs from the analytical skill that litigators use. Litigators take the law and apply it to the facts to create a persuasive argument. Deal lawyers start with the business deal. Those are our facts, and they’re dynamic facts because they keep changing as the parties negotiate. Deal lawyers must take each aspect of the business deal and determine which contract concept best expresses it. Only then can they think about drafting.



**TRANSLATING THE BUSINESS DEAL INTO CONTRACT CONCEPTS**

- The litigators analytical skill: applying the law to the facts
- The deal lawyer’s analytical skill: determining which contract concept best expresses the business deal

To teach the translation skill, essentially what I’ll do is to re-teach the basic contract concepts, but from the deal lawyer’s perspective. I’ll focus on representations and warranties, covenants, rights, conditions, discretionary authority, and declarations.

I have asked two of Emory’s new adjuncts to help me out. Toby, you are going to be a buyer of a used car. If you follow my lead, this will be easy, and that is exactly what I tell my students. David, I see you hiding back there. David, you are going to be the seller. To begin, please choose your fantasy car and tell us which make it is.

**DAVID**

Mini Cooper.

**TINA L. STARK**

Mini Cooper. Okay, Toby are you ready to buy? Please say “no.”

**TOBY**

No.

**TINA L. STARK**

Perfect. Okay, before you buy, you probably want to know something about the car. So please ask David some questions about the car and he will answer them. David?

**DAVID**

Sure.

**TOBY**

I would like to know how old the car is.

**DAVID**

2002 model.

**TOBY**

I would like to know whether the car had any accidents.

**DAVID**

No.

**TOBY**

I would like to know if it has been taken to the dealership for periodic checkups and maintenance.

**DAVID**

All scheduled maintenance has been performed.

**TOBY**

Mileage?

**DAVID**

57,000 miles.

**TINA L. STARK**

Be sure to ask him about the color.

**TOBY**

Color?

**DAVID**

Red.

**TINA L. STARK**

So, what has happened now is that through her questions, Toby has found out that David has a 2002 Mini Cooper that hasn't been in any accidents. It has had all its checkups, been driven 57,000 miles, and it is red. She has found out all this business information and is relying on this business information to make her decision whether to buy the car. You are relying on it, right?

**TOBY**

Yes.

**TINA L. STARK**

To keep things moving, let's assume Toby decides to purchase and that she and David have negotiated a price of \$12,000. Now, at this point you turn to the class and say something like the following: Toby comes to the rest of you and she says, "It's been awhile since I took my contracts course, but I know one thing for sure: I want this deal in writing because it's a lot of money for me, and I want the contract to reflect that I relied on this information that I was just told. What contract concepts will you use in the contract to do this?" After that question, many of you will experience the "look-down" phenomenon. That is, everybody looks down and eye contact is impossible. The reason is that most students won't know that the answer is representations and warranties, and even if they know that, they won't know the difference between the two. I think it's important to understand the difference because it can make a huge difference in litigation.

## **REPRESENTATIONS AND WARRANTIES**

### Representation

- Statement of fact
- As of a moment in time
- Intended to induce reliance
- (Justifiable reliance is required for a cause of action for misrepresentation)

A representation is a statement of fact as of a moment in time intended to induce reliance. Statement of fact: The car has been driven 57,000 miles. It's being made as of this moment in time. Had we asked David a year ago what the mileage was, the car could have had 46,000 miles on it, and if we asked him a year from now it could have 68,000 miles. You always measure the truthfulness of a representation by going back in time to when the representation was made and comparing it to the facts at that time. Also, to be able to sue for a misrepresentation, you must have reasonably believed that the statement was true. If the representation is that the car is red and you're standing in front of it and it's blue, you couldn't have a cause of action for misrepresentation because you could not have justifiably relied on that representation.

### Warranty

- Technical definition
  - A promise that a statement is true
- Real world definition
  - A promise that the maker of a statement will pay damages to the recipient of the statement if the statement isn't true and the recipient suffers damages
- There is no reliance component.

Now, a representation differs from a warranty. A technical definition of warranty that you will sometimes see is that it's a promise that a statement is true. That's not very informative. A more real world way of looking at it is this: a maker of a statement is promising to pay the recipient of the statement damages if the recipient suffers damages because the statement was not true. So, a warranty is a promise to pay damages if another is damaged because the statement was untrue. The big difference from a representation is that warranty liability has no reasonable reliance requirement. So, if the contract says the car is red and you are standing in front of the car and it is blue, you would have no cause of action for misrepresentation because you would have had no justifiable reliance. But you would have a cause of action for breach of warranty if you were damaged because the statement was false.

Now, does this really matter at all in the real world? Is this just an academic distinction? It's not. It makes a significant difference in terms of remedies. Back in 1990, New York's highest court decided the *CBS v. Ziff-Davis* case. I am going to give you the very truncated version of this case. CBS wanted to buy the magazine division of Ziff-Davis, so they entered into an acquisition agreement and just like

most acquisition agreements, the representation and warranty article began with “The Seller represents and warrants as follows:” When you put those two words together—represents and warrants—every single sentence, every statement, that follows is both a rep and a warranty. Deal lawyers don’t generally say I want a rep for this and a warranty for that. They may say I want a rep, but they are speaking colloquially. They really mean they want both. So what did CBS get a rep on? They got a rep on the division’s financial statements, that they accurately stated the division’s financial condition. From a deal lawyer’s perspective, this is the most important rep of all because the purchase price was based upon an analysis of those financial statements. So if the financial statements overstate the value of the company, the buyer is paying too much money.

CBS signed and proceeded with their due diligence. They sent in their own accountants to look at the financial statement work papers, and the accountants reported back that the financial statements overstated the division’s value. CBS was, of course, most unhappy and made its concerns quite clear on the day of the closing. In response, Ziff-Davis wrote them a letter: “Dear CBS: We told you in the agreement that the rep was true. We are telling you now again it is true. If you don’t close, we are suing you.” CBS, of course, had to write back: “Dear Ziff-Davis: “Based on what you said in the agreement (setting up their reliance on the rep) and based upon what you said in your letter (setting up their reliance on the statements in the letter) and because we have already spent so much money on this transaction (setting up the claim for damages), we are going to close, but we reserve all of our rights.”

After the parties closed, CBS sued, but it lost in New York’s two lower courts. Both courts held that CBS had no cause of action for misrepresentation because CBS’s own accountants had told them that the financial statements were inaccurate. Therefore, CBS could not have reasonably relied on the representation. That left CBS with only way to win: a breach of warranty claim. In New York’s Court of Appeals, Ziff-Davis argued that reasonable reliance was an element of a cause of action for breach of warranty, and, that as CBS could not have reasonably relied on the financial statements, it had no cause of action for breach of warranty. In essence, Ziff-Davis conflated misrepresentations and breaches of warranty, arguing that the two were the same.

Ziff-Davis lost. The court held that the contract concepts were distinct. While misrepresentation requires reasonable reliance on a statement, breach of warranty does not. The only kind of reliance required in the case of a warranty is that a party bargained for the warranty and was relying on it to provide a remedy. Bottom line: the difference between reps and warranties matters.

### REMEDIES FOR MISREPRESENTATION AND BREACH OF WARRANTY

The difference matters not only because using both creates an additional cause of action, but also because the remedies differ.

#### Remedies for Misrepresentations

Honest or negligent, if material

- Avoidance
- Restitutionary recovery

Fraud

- Choice between:
  - Avoidance and restitutionary recovery and
  - Damages
    - Out-of-pocket
    - Benefit of the bargain
    - Punitive

The remedies for misrepresentation: If it was an honest or negligent misrepresentation, and it was material, a plaintiff can get avoidance; that is, the transaction can be rescinded, unwound. In addition, a plaintiff can get restitutionary recovery, enough money to bring it back to where it started. Now, if the misrepresentation was fraudulent, that is, the defendant lied, then, a plaintiff has a choice of remedies. It can get avoidance and restitutionary recovery (as with an honest or negligent misrepresentation) or as an alternative, it can get damages.

#### MEASURES OF DAMAGES FOR FRAUDULENT MISREPRESENTATIONS

- Purported worth .....\$2500
- Paid .....\$1000
- Actual worth .....\$250
- **Out-of-pocket**
  - \$1000 minus \$250 .....\$750
- **Benefit of the bargain**
  - \$2500 minus \$250 .....\$2250

Now, here is where it gets a little slippery. There are two different measures of damages: out-of-pocket damages and benefit of the bargain damages. (Of course, there are also punitive damages, but we'll put those aside for a moment.) That there are these two different measures of damages is, you will see, another reason to obtain both reps and warranties. So, here is an example. Imagine you go to the store and you are super-splurging. You find a flat panel TV for \$2,500 that has been reduced to \$1,000, the exact amount of your tax refund. You decide to blow the whole refund on the TV and then you get it home and determine that it is only worth \$250. So what are your damages?

Well, it depends on in which state you live. New York is what's known as an out-of-pocket jurisdiction. If you took \$1,000 out of your pocket to pay for the TV, but received only \$250 in value, your damages would be \$750. That's the minority rule. The majority of states use the benefit of the bargain measure of damages. You thought the TV you bought was worth \$2,500, but it was only worth \$250, so your damages were \$2,250—significantly greater than the out-of-pocket measure of damages. In either case, if the facts were appropriate, you might be able to get punitive damages.

*The remedy for breach of warranty is always the benefit of the bargain.*

## REASONS TO RECEIVE BOTH REPRESENTATIONS AND WARRANTIES

### Why Receive Both Representations and Warranties

- **Representations**
  - Avoidance and restitutionary recovery
  - Punitive damages
- **Warranties**
  - No reliance component—additional cause of action
  - Benefit of the bargain damages
  - No need to prove defendant's scienter

Now, why receive both reps and warranties? First, with warranties, there is no reliance component, so you get an additional cause of action. Second, you can always get benefit of the bargain damages. This means if you are suing in an out-of-pocket state, you might get a better recovery claiming a breach of warranty rather than a misrepresentation. Finally, it's easier to win a breach of warranty claim than a claim for fraud. To prove fraud, you have to prove that the defendant intentionally misstated the truth, that he or she lied. You must prove a state of mind, and that is

hard to do. With a breach of warranty claim, all you have to prove is that the statement is false.

Why do you want representations? Two reasons: First, so that there is the possibility of rescission and restitutionary recovery and, second, so that there is the possibility of punitive damages if there is fraud.

With this background on the legal aspects of reps and warranties, it's time to change focus.

### **REPRESENTATIONS AND WARRANTIES AS A RISK ALLOCATION MECHANISM**

For students to learn to draft, they must understand that representations and warranties have a business purpose. All of the contract concepts have a business purpose and the business purpose of reps and warranties is to act as a risk allocation mechanism.

#### Risk Allocation

- Flat representation
  - Unequivocal
  - Without wiggle room
- Qualified representation
  - Hedged

Deal lawyers talk about two kinds of representations: flat reps and qualified reps. A flat rep is a statement that is made unequivocally. It's a very high risk rep because there's no room for error. For example, let's use the rep: The car has been driven 57,000 miles. That statement establishes a standard of liability. If it is not true, the seller is liable. This rep is high risk because the standard of liability doesn't allow for any mistake; it's flat. High risk for the seller, low risk for the buyer, because if the seller is even a little bit wrong, the buyer gets to sue. Maybe the buyer wouldn't be able to collect so much, but it can certainly sue and cause some trouble.

Now, how can the seller reduce the risk? The seller can reduce the risk by qualifying the rep, by changing it, by changing the standard of liability. Instead of the car having been driven 57,000 miles, it could have been driven *approximately* 57,000 miles. So we have changed the standard. Here is how it helps. Suppose the car has been driven 57,100 miles. The buyer says, "Aha, your representation was wrong. You said 57,000 miles." The seller says, "No. What I said was *approximately*



57,000 miles and that extra 100 miles, that's within the band of what *approximately* intended." So now the seller has an argument it can make and before it didn't. The buyer is in a worse position because now the buyer has to argue that the extra 100 miles is outside the band of what *approximately* meant.

Now, this kind of negotiation, a risk allocation negotiation, can get very sophisticated. Let's look at a simple example, but one that is more real world. I am going to take you through this very, very quickly. These are representations from an acquisition agreement.

### 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.

The first rep, no litigation is pending or threatened, that's flat and high-risk because it is undoubtedly untrue—most corporations have litigation. The way to deal with that is through disclosure, telling the buyer about pending and threatened litigation. So what you see in the Paragraph 2 is a schedule where the seller would list all of the known litigation and all of the threatened litigation that it knew about. But "known" is the key word. A savvy general counsel would worry about the threatened litigation she didn't know about—the little, old lady sitting in her lawyer's office complaining about the company product that blew up in her face. That general counsel's view would be that it's not fair to allocate that risk to the seller because it couldn't disclose it because it didn't know about it. Instead, that risk should be allocated to the buyer. To accomplish this, the parties would insert a

knowledge qualifier immediately preceding “threatened.” Now, if that little, old lady eventually sues, the buyer has no cause of action because the seller’s statement was true. It didn’t know that the little, old lady was threatening to sue. The seller’s risk would have gone down and the buyer’s risk up.

So what you see is that there’s a back and forth between the parties about what the rep should say. A few more variations. Once the parties agree that a knowledge qualifier is appropriate, our general counsel could begin to worry, what’s knowledge of the seller? The seller is a juridical entity. It’s formed when a piece of paper is filed with the Secretary of State. Well, maybe what we need to do is to limit whose knowledge the seller is responsible for—say, the seller’s officers. So, then the standard of liability is changed so that the seller is only on the hook if one of its officers knew. The seller’s risk goes down, but the buyer’s risk goes up. If anyone in the company knew, other than an officer, the seller does not breach the standard of liability because no officer knew of the threatened suit. An aggressive seller might want to limit knowledge of the seller even more, to knowledge of the executive officers. A buyer could reasonably conclude that this would reduce the seller’s risk too much. The seller’s officers could have blinders on, say like Ken Lay or Jeff Skilling, and know nothing. To reallocate the risk, the buyer could insist on an imputed knowledge standard as in paragraph 6.

It’s important for students to understand the risk allocation role of reps and warranties. They need to understand that even though they are not negotiating a provision that includes a dollar sign, in fact, they are negotiating money because they are negotiating the likelihood of being sued or being able to sue. Any questions?

### COVENANTS AND RIGHTS

All right, so let’s return to our car hypo. Let’s assume there is going to be a gap between the time the contract is signed and between the time Toby is going to buy the car. She is waiting to inherit some serious money. Now, Toby and David will have very different views about what should be done with the car during this gap period. Toby would prefer to have the car shrink-wrapped and put in a heated garage, while David would like to drive it as much as he wants. Neither will get what he or she wants. So, they will have to negotiate some compromises, and David is going to have to make some promises about how he will deal with the car. He will promise not to drive the car more than 500 miles. He will promise not to paint the car. He will promise to maintain it. Deal lawyers refer to these promises as covenants. A covenant is a promise to perform, either a promise to do something or a promise not to do something. It creates a duty to perform.

### Covenant

- A covenant is a promise to perform. It can be a promise to do something or a promise not to do something.
- It creates a duty/obligation to perform.

### Right

- A right is the flip side of a covenant.
- I.e., if I have an obligation to pay you \$100, you have a right to my performance. For example, if Sam is obligated to perform in favor of Keesha, Keesha has a right to Sam's performance.

It's important to have students understand this technical meaning of "right" for two reasons. First, "right" is often misused as in "X has the right to do something." That's really discretionary authority, which we're about to get to. In addition, students often have trouble dealing with anti-assignment provisions because they don't understand that the provision is dealing with a right to a performance that is created by a covenant. If you can show them at this point how a right is the flipside of a covenant, teaching assignment and delegation becomes that much easier. It also prevents confusion when teaching students how to draft discretionary authority provisions.

## CONDITIONS TO AN OBLIGATION

The next contract concept I want to talk about is conditions.

Although the Restatement only talks about one kind of condition, from a drafting perspective, there are three kinds of conditions. (For these purposes, we're putting aside "conditions subsequent.") A good definition of a condition to an obligation is "a state of facts that must exist before a party has an obligation to perform." It's an if-then chronological, temporal sequence, first this, then this. So, in our car hypo, the parties could agree to a condition to Toby being obligated to buy the car. *If David performs his covenants, then Toby is obligated to buy the car.*

Here is another example: *If the Retailer notifies the Manufacturer that it requires additional merchandise—now here comes the then—then the Manufacturer shall ship the merchandise no later than three days after it receives the notice.* The Manufacturer has no obligation to ship unless the Retailer notifies it and says it needs additional merchandise. So, you have the condition to the obligation, *if* the Retailer notifies the Manufacturer, and then you have the obligation, *then* the Manufacturer shall ship.

When you have a condition, it's always going to be paired with something else. If it's a condition to an obligation, it's going to be paired with an obligation. Now, what you will notice about this condition is that if the condition never arises, the parties' relationship continues on. It's just a provision of the contract that's not relevant at this time, but all the other provisions are in effect and the parties' relationship continues on. So I call it an *ongoing condition* to distinguish it from a walk-away condition—a condition that you would most commonly see in acquisition agreements and in loan agreements. Here's an example from an acquisition agreement.

The following are conditions to the Buyer's obligation to perform:

1. The Buyer must have received an opinion from the Seller's counsel, substantially in the form of Exhibit A.
2. The Seller must have obtained all the consents listed in Schedule 3.14.

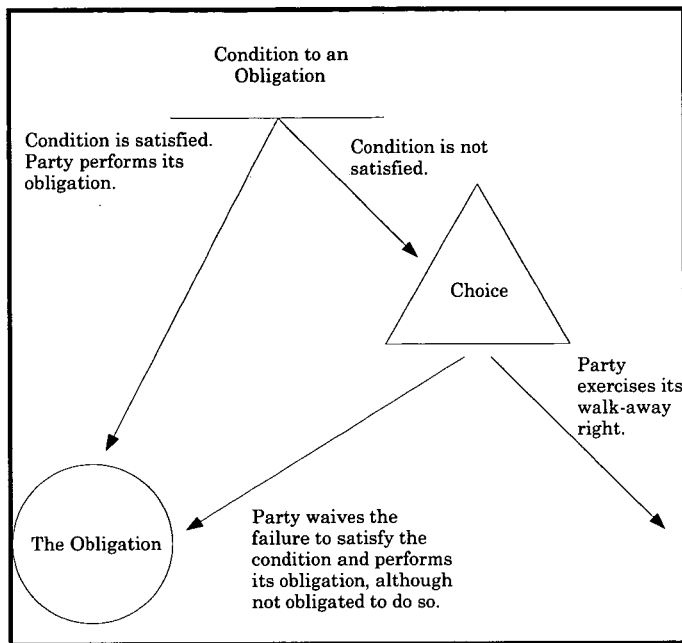
Here, rather than being phrased in an if-then sequence, the provision is a flat-out statement that these are the conditions to the buyer's obligation to perform. You can set it up as an if-then proposition:

*If* the Buyer receives the opinion and *if* the Seller has obtained the consent, *then* the Buyer is obligated to perform.

It's very useful when you are working with students to make them frame a condition as an if-then proposition because it helps them get in their mind the temporal sequence.

Now, the consequence of the nonsatisfaction of one of these conditions differs from the nonsatisfaction of the condition in the Retailer/Manufacturer provision. Let's say the opinion is never received. In that case, the buyer is not obligated to perform. So that means the buyer could end the parties' relationship by just walking away without ever performing. And if it did that, it would not be in breach because it never had an obligation to perform. Because the buyer can walk away without being in breach, I call this a walk-away condition. A buyer, of course, could choose to waive the failure to satisfy the condition and perform anyhow. This choice arises as a common law consequence of the failure to satisfy the condition.

I have found the following diagram to be useful in explaining walk-away conditions to students:



The rectangular box represents the condition to a party's obligation to perform. If it is satisfied, the party must perform the obligation—represented by the circle. If the condition is not satisfied, then the party has a choice, represented by the triangle. Again, this choice arises as the common law consequence of the failure to satisfy the condition. The party may exercise its walk-away right and not perform (and not be in breach), or it can waive the failure to satisfy the condition and perform its obligation, even though it was not obligated to do so.

### DISCRETIONARY AUTHORITY

Discretionary authority gives a party a choice. Here are two examples:

- Either party *may* terminate this Agreement at any time by sending written notice to the other party.
- The Borrower shall not invest in any Person, except the Borrower *may* invest in any wholly-owned subsidiary of the Borrower.

In the first provision, either party may choose if and when to terminate the contract. In the second provision, the Borrower has permission to act in a limited circumstance. Discretionary authority regularly appears in this context, as a limited permission following a general prohibition. That permission is a choice. A party is not obligated to take advantage of it.

Students sometimes have trouble recognizing discretionary authority when they see it in a contract because the provision is couched in terms of a party “having a right” or being “entitled to” do something.

As I mentioned earlier, in contract drafting, there is more than one kind of condition. Just as there can be a condition to an obligation, there can be a condition to the exercise of discretionary authority.

A classic example arises in loan agreements where an event of default must exist before a bank can exercise its remedies. When an event of default occurs, a bank need not exercise its remedies. It could instead, for example, waive the default. The bank has a choice. That’s the discretionary authority. The condition to its exercise is the occurrence of the event of default.

Once students learn about discretionary authority, they sometimes think a walk-away condition is discretionary authority. The problem is that they are focusing on what happens when the condition to an obligation is not satisfied. The key is to point out to them that the choice whether to perform or walk away is the common law consequence of the unsatisfied condition. You can go back to the diagram and use it to show them that the contract concept is the condition and that the choice, the discretionary authority, flows from the condition not being satisfied. The discretionary authority does not exist as a stand-alone contractual provision to which the parties have agreed.

### DECLARATIONS

Let me now turn to the final contract concepts. A declaration is a rule that the parties have agreed will govern their contract. No rights or remedies flow from a declaration. A party cannot sue to enforce it. The parties may dispute its meaning or application, but they cannot sue for damages. Some declarations have legal effect on their own, but no substantive effect, until they are inserted into another provision; other declarations have a substantive effect on their own.

All definitions are declarations. These declarations have no substantive effect on their own. They must be kicked into action by being incorporated into another provision. Here is a simple example:

- “Purchase Price” means \$200,000.

Although the parties have declared a legal result by including the definition in the contract, standing alone, the definition of Purchase Price has no substantive

consequences. But, those consequences are created when the defined term is inserted into the covenant where the buyer promises to pay the purchase price.

Policy statements are also declarations. Unlike definitions, they have substantive legal effect on their own. For example, here are two policy statements:

- The laws of Ohio govern all matters relating to this Agreement, including torts.
- An assignee of a limited partnership interest cannot become a Limited Partner unless the General Partner gives its consent.

The first is classic boilerplate. It's a policy that governs the contract's interpretation. It's drafted in the present tense because it's a policy that always applies. However, no rights or remedies flow from it. Of course, a party could claim that a different state's laws should govern, and litigate that. Similarly, the second provision is a policy; it's a rule that governs all assignments of limited partnership interests whenever they occur during the life of the contract.

Sometimes, a policy does not have substantive consequences unless there is a trigger, in essence a condition to a declaration. For example:

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

This provision establishes a policy for the life of the contract, but it is of no consequence to the parties unless the condition occurs. As with other declarations, it imposes no duties and provides for no remedies.

## QUESTIONS AND ANSWERS

### QUESTION

My question is, for every representation, should there be a warranty?

### TINA L. STARK

Generally, yes. That's why you see in contracts "The parties hereby represent and warrant." Parties want to take advantage of the qualities of both reps and warranties.

**GEORGE W. KUNEY**

Let me just jump in here really quickly, with a point. There are a number of contracts where we make representations that are subject to due diligence review by parties before closing. That representation may terminate at closing and not be coupled with a warranty that survives the closing. So, I make a statement to you to induce you to come on a date with me and you rely on that statement to come out to dinner and check out the possible bigger deal. If you find out it's not up to snuff, doesn't match the representations made at our first meeting when I induced you to dinner to learn more, at this phase you could walk away and we don't have to close and have a relationship, but if you do close and there is no warranty you have assumed that risk of what you get.

**QUESTION**

I am curious how many students you teach in each class and what you recommend in terms of enrollment numbers.

**TINA L. STARK**

I would recommend 12. I have taught anywhere between 6 and 40. When I taught 40, I think it was the third year I taught, we were so inundated with students who wanted to get into the class, we expanded the class size. When I taught it, I had two research assistants. I wouldn't recommend it, but you can do it—but you would probably need No-Doze to get through all those papers.

**GEORGE W. KUNEY**

For me the magic number for our adjuncts is no more than 12 unless they ask for more, and even then I try and counsel them against it, because more than 12 leads to adjunct professor burn out. To me, in a perfect world, eight would be great. Eight or nine, but that's not happening, on the limited budgets that I face, at least.

**TINA L. STARK**

One point on teaching methodology. Virtually all of the work that my students do in class is collaborative. If they have to draft a provision as an in-class exercise, they get into groups of two or three and work on it together. I do that for several reasons. First, it gives students the opportunity to test out their ideas on somebody who is not grading them. Second, if they have tested their ideas, they are more likely to participate in class because they are more secure; third, working



together is fun, so students are more actively engaged; and fourth, they are actually beginning to learn to negotiate when they take a position on a contract provision and defend it. So, you can work on all different kinds of skills in a contract drafting class, and collaborative work and team building are really two of the most important.

One final point. I strongly encourage class participation. Indeed, part of my grade is class participation. Some students are not comfortable with this because they do not regularly participate in class discussions. What I tell them is that I understand that some of them are reticent, but if they are going to be deal lawyers, they need to be able to talk in a room full of people. So, I urge them to use law school as an opportunity to learn how to do this before they're confronted with it in practice.

#### **GEORGE W. KUNEY**

Just a quick follow up on a tangent from that remark. One of the things that I found over the years is that students become some of the most confused when they learn about covenants, conditions, reps, warranties and the like. They make the mistake of thinking that each clause can only be one of these things and that they are mutually exclusive categories. The classic point of difference is a pre-closing covenant that's also a condition to closing. I don't know where the covenant disconnect comes, but in my contracts class I think 33% to 43% every year don't get it until just before the final if they get it at all.

#### **QUESTION**

I have a question for George. You were talking about "shall," "may," or "must" and I teach my students that "may not" is a vigorous term and you actually said it might be stronger than "shall not."

#### **GEORGE W. KUNEY**

This is where you get into the authorities and the angels on the head of the pin. There are some who make the case that the word "may" provides an option or a power and, therefore, the words "may not" deny that option or power and that is stronger than "shall not," which is merely a duty and a negative duty at that. I am not sure I really buy that—but it is a distinction that is out there, so I tend to encourage the students to adopt my solution: "shall" and "shall not."

As an example of the difference between "may not" and "shall not," consider an anti-assignment clause: If you draft the anti-assignment clause using "may not,"

and you believe that “may not” is stronger than “shall not,” you would not need to say “any assignment in violation of this clause is void.” Under that interpretation, the “may not” denies the party the very power to assign. Conversely, an anti-assignment clause drafted with a “shall not” would need this consequence included in order for the assignment to be ineffective if made in violation of the clause.

### QUESTION

If I say “George may not go to the dinner today,” I might mean that you might not.

### GEORGE W. KUNEY

Sure. Well put. “May” is used in different senses, as a power or option, on the one hand, and in a predictive sense that is less positive than “shall” or “will,” on the other hand. Bottom line: I suggest choosing one form and using it consistently and then providing some sort of a consequence if I show up at dinner, anyway. Perhaps, I will not be served: “and if he does he will not be served and management shall escort him from the room.”

### TINA L. STARK

One little caveat. If the subject of the sentence is a negative subject, such as “no person,” then the proper word is “may.” Otherwise, the sentence reads “No person shall not” and that just doesn’t work. One other technical drafting point: Ordinarily, we tell students to write in the active voice, but there are situations when the active voice is wrong. I’ll give you two reps: One rep, “The seller has driven the car 50,000 miles.” That’s the active voice. Other rep, “The car has been driven 50,000 miles.” If you are the buyer which do you want? You want the second one because it’s covering everyone who could have driven the car—all the actors. You don’t want to cover just the owner. So when the focus is the action, not the actor, the passive voice is correct.

### QUESTION

Where is the appropriate place in your view, in the curriculum or in the course, to teach the skills of negotiation?

**TINA L. STARK**

I have students do some negotiating in my contract drafting course. I want them to see the relationship between negotiation and drafting. But I don't teach negotiation skills in my course. I think that should be in a separate course, and I think that contract drafting should be a prerequisite. You can't teach students to negotiate a contract if they don't know how to put one together.

**GEORGE W. KUNEY**

We do not teach students negotiation skills in Contract Drafting in the sense of a negotiation class, but we do have a small negotiation component. Going back to my analogy about relationships: I like to let students see what the entire courtship dance looks like. That way, for example, they can understand that when one party asks for a flat provision (much like Tina's example here) and then a qualification comes back saying "no, no, we can't say that—we have to have a knowledge qualifier" and then the other side says, "well, who's knowledge?" The CEO never knows anything, right? The big picture people on the board don't know about all the little claims filed or threatened against the company; I want to hear from the chief risk management officer and probably someone who reports to her. That's how we do the dance of meaningful stuff. So it's more a negotiation of a workable mechanic and a good provision than negotiating real value. I agree with Tina that, after they have gotten that sort of concept, they understand the evolution of the provision—the courtship dance that gets you there—then they are ready for the negotiation courses and simulations that start after contract drafting where they are given client objectives and they design strategies and tactics to try and achieve them.

