Chapter 4

Principles of Effective Drafting

§ 4:1 Introduction

Contract drafting is different from all other types of writing, including other types of legal writing. In high school and college (and in most law school and college writing classes) we learned a style of writing that organizes and presents facts, states positions, and makes arguments. The primary purpose of this type of writing is to convey information or a point of view to the reader. Stephen King characterizes such writing as a means of telepathy: a device allowing one person (the reader) to get into the mind of another (the writer).[1]

A contract is different. It represents the efforts of one person (the draftsperson) to accurately convey the agreement of two or more other persons (the parties to the contract). The primary audience for this writing is the parties and their counsel. The agreement may have additional readers, such as regulators, creditors and others interested in

1. STEPHEN KING, ON WRITING, Pocket Books 2001.

the contractual relationships and obligations of the parties. In the worst case, the ultimate audience will be a judge or a jury.

Let's examine the differences between the two basic forms of legal writing. Here is a sentence from a brief by counsel to a plaintiff in a personal injury action:

> These thoughtless actions of the defendant, taken without regard to either the basic standards of human decency or the minimal standards of care described in the cases cited above, resulted proximately and immediately in severe harm to the plaintiff.

The writer is expressing positions both as to questions of fact and of law: the actions of defendant were as described in the previous portion of the brief; these actions violated the applicable standard of care; the plaintiff suffered injury as a direct result; and the injury was serious. Defendant's brief will take contrary positions on some or all of these points. The primary goal of these writings is to persuade the reader—the judge—that the position being conveyed is the correct one. Persuasion is more art than science. It requires that the writing is tailored to the reader, and may employ rhetorical devices and the creative use of language.

Now let's take a well drafted contract provision:

> This agreement will terminate at 12:00 noon on June 30, 2002, unless before such time Buyer shall have delivered to Seller a letter of credit in the form of Exhibit A attached hereto.

Note that there are no rhetorical flourishes, no adjectives, no imprecise terms. Every word serves a precise purpose. Assuming that it accurately reflects the understanding of the parties, it is successful because it is drafted in a way that is clear and unambiguous.

Writing a contract involves two processes: determining what the parties have agreed to, and reducing that agreement to words. Each of these presents its own set of difficulties. The dynamics of negotiations often yield uncertainty rather than certainty: the hesitancy to make concessions, the tendency to slough over disagreements or contentious points, the emotional reaction to being told "no," the intrusion of personal abrasion, all stand in the way of consensus. The substantive complexity of the points under discussion, intersecting with the complexity of human psychology, can make the negotiation of contracts challenging. It is the lawyer's first task to extract the actual

agreement of the parties. This is not a passive endeavor: the lawyer must insert herself into the process, explore inconsistencies, challenge positions, battle ambiguities, and raise uncomfortable issues, in order to best extract a meaningful and comprehensive agreement.

§ 4:2 Precision

The lawyer then faces the challenge of putting words on paper that precisely reflect the agreements of the parties. (This is not to suggest that negotiation and drafting are separate and distinct. They are inextricably entwined. For one thing, the mere act of putting a concept into words often leads to further discussion and refinement.) The difficulty is crafting language accurately describing what the parties have agreed that will be interpreted by all subsequent readers (including the contract parties) to have the exact same meaning.

A well-written contract provision is one that provides no traction for either party or their counsel to argue that something else was intended. In order to fully understand this point, it is helpful to imagine the position of a litigator asked to review a contract. The litigator will look for every weakness in the contract language that can be raised for his client's benefit. A responsible litigator will not take positions that have no basis, but *will* identify every issue for which there is a credible argument.

Consider the weaknesses a litigator could exploit in the following provision from a real property management contract:

> Owner, by notice to Manager, may terminate this agreement, if Owner asserts a breach by Manager of the terms and conditions hereof, to the extent Manager is given a reasonable time to cure such breach.

Owner and manager have had a series of increasingly heated conversations over several months regarding a problem in the property's plumbing system that has damaged some furnishings. Owner refers to a section of their contract that requires manager to make all necessary repairs promptly. Manager hires a contractor to repair the plumbing, but the contractor fails to complete the work in a timely fashion. To manager's surprise, owner sends manager a written notice terminating the management contract. Each party calls its lawyer. Each lawyer separately advises its client that the following arguments may credibly

be asserted by owner and would probably survive a motion for summary judgment:

- The phone conversations in which owner asserted that manager failed to comply with the contractual requirement to promptly make the repairs constituted the required notice of termination.
- Manager is not entitled under the contract to the defense that it promptly hired a responsible third party to make the repairs and that the delay was attributable to the third party and not within manager's control.
- The period of time commencing on the date that owner first complained about the failure of manager to make the repairs and ending on the date that owner sent the notice of termination constitutes a reasonable cure period.

Although manager justifiably feels misused by owner, his lawyer advises him that a judge or jury could very well determine that the contract supports the action taken by owner. The result would have been different had the provision been drafted with more care:

> If (a) Manager breaches any of its obligations hereunder, (b) Owner delivers a written notice to Manager stating that it is a "Notice of Termination" which identifies such breach, and (c) Manager fails to cure such breach within 30 days after the date of such notice, this Agreement shall terminate, provided, however, that if the cure of such breach reasonably requires the action or cooperation of a third party, no termination shall occur so long as Manager is using its diligent efforts to cause such third party to act or cooperate.

This improved language demonstrates two important lessons. First, it is always possible to make contract language more precise and thus more resistant to the attempts of a party to assert aggressive or spurious interpretations. Second, it is often difficult to craft language so precise that some "gray area" doesn't exist: under the improved language owner can still argue that manager has not employed its diligent efforts to make the third-party contractor perform.

Precision must always be a goal of the contract draftsperson. A precise provision doesn't lend itself to competing interpretations. One principle of contract interpretation to be kept in mind in this context is that an ambiguous provision will be construed against the draftsperson. Common sources of imprecision include:

§ 4:2.1 Use of Antecedents

Do not use a pronoun unless it is clear who or what is being referred to. An example of the failure to follow this rule:

> If by December 31, 2001, Contractor fails to deliver the Certificate of Occupancy to Owner, it shall promptly give written notice to Lessee of such failure.

Who has the obligation to give the notice to Lessee? It is not clear because the pronoun "it" as used in the quoted provision is imprecise. It could be a reference to either owner or contractor. It may be that the context provides some clues about which party is being referred to, but why not write the sentence clearly in the first place:

> If by December 31, 2001, Contractor fails to deliver the Certificate of Occupancy to Owner, Owner shall promptly give written notice to Lessee of such failure.

Stylists may be concerned that the use of the word "Owner" twice in such close proximity is inartful and awkward. Inartful, perhaps, but remember that art is not the goal; precision is.

§ 4:2.2 Time References

A contract provision calling for one party to perform an action or to make a payment must be clear as to when such payment or performance is required. Failure to provide properly for the timing component may create confusion:

> Vendor shall provide Vendee with copies of its annual audited financial statements.

When is this delivery required? There may be a longstanding course of conduct between the two parties that these annual statements are delivered 90 days after the end of vendor's fiscal year. The failure to specify this in the contract, however, allows vendor to argue for more time than the parties may have intended.

If an action must be taken by a certain time, the provision would be drafted as follows:

> Borrower shall deliver a borrowing base certificate no later than the fifteenth day of each month.

Conversely, if the action is to be taken after a certain time, the following approach is used:

> Seller may sell the Topeka Warehouse at any time after April 1, 2003.

What if an action is required to be taken between two dates? The way to draft this is by defining the relevant period:

> Lessee may provide a notice of renewal during the period beginning on October 31, 2001 and ending on December 31, 2001.

In some cases, the parties may want to be even more precise and specify the *hour* that performance is required on a specified day. This is often the case where the provision calls for the payment of money. If payment is to be made by wire transfer, for example, payment will be required during the hours that wire transfers can be effected. If this level of precision is used, it is important to specify the applicable time zone, *e.g.*, Eastern Standard Time. Contracts drafted by New York lawyers, with characteristic hubris, often refer to "New York City time."

Sometimes this level of precision is not possible or does not reflect the deal between the parties. Often contracts will use phrases such as "promptly" or "as promptly as practicable" instead of a specific deadline or time period. These are more subjective standards that can give rise to differing interpretations. Another formulation is: "promptly, but in any event not later than the fifteenth day of the month." This puts an outer limit on how late performance may be and still be considered prompt.

Another important concept in the precise drafting of timing requirements is the distinction between business days and non-business days. A business day is usually defined to mean a day that banks are open for business in a particular area or jurisdiction. This is an important distinction in provisions requiring payment. A contract that requires a payment to be made on the first day of each fiscal quarter but does not address what happens if such day falls on a non-business day will be impossible to perform if a payment falls due on a Saturday or a Sunday. For that reason, there is usually a provision to the effect that any payment that is due on a day other than a business day will instead be due on the next (or previous) business day.

§ 4:2.3 Legalese

Lawyers are often accused of writing in "legalese" instead of plain English. It is true that too much legal writing is obfuscatory, wordy, dense and stilted. Many lawyers seem to believe that sounding like a lawyer is as important as the subject matter being communicated. A frequent result is that the effectiveness of the communication suffers.

In the context of complex commercial contracts, however, much that might be criticized as legalese by the uninitiated observer is instead completely appropriate. Effective writing consists of clear communication of the subject matter to its intended audience. The audience for commercial contracts is sophisticated business people and their lawyers. The notion that commercial contracts should be written in plain English so as to be understood by people who would never be expected to read them is an unreasonable extension of the plain English movement, which is aimed at helping consumers and other unsophisticated parties.

The following sentence from an acquisition agreement is clear and precise. It contains no unnecessary words and expresses its points in a way that readers of acquisition agreements will readily understand.

> Seller shall use, and shall cause each of its subsidiaries to use, commercially reasonable efforts to obtain from each of their licensees (except licensees under licenses with annual base royalty payments of less than $200,000), a consent to assignment substantially in the form of Exhibit S (or in such other form as Buyer may reasonably approve), no later than 10 days prior to the Scheduled Closing Date.

No one would ever suggest that a report whose audience consists of medical doctors should avoid medical terminology that could not be understood by the layperson. By the same token, a contract that embodies a complex commercial transaction will contain specialized diction and vocabulary familiar to its audience. Any attempt to avoid this would make the contract much longer, certainly, but of less utility to its readers.

All of the terms defined in this book's glossary are terms that are not self-evident to the uninitiated and could therefore be incorrectly referred to as legalese. On the contrary, these are terms with specialized and precise meanings that function to streamline contracts and make them more useful to their intended audience.

The next example, on the other hand, illustrates truly bad legalese.

This sentence is filled with unnecessary words, phrases and rhetorical throat-clearing devices and is marked by a generally bombastic tone.

> It is hereby agreed among the parties hereto that upon the occurrence of each and every failure by Borrower to comply and perform in all respects with the covenants, restrictions and limitations set forth in Article 6, Lender shall have and be entitled to exercise, and shall be deemed to have, and be entitled to exercise, the right and privilege to cause the termination and extinguishment of the Loan Commitments, provided, however, that delivery of prior notice of said termination and extinguishment be made to Borrower.

This can be rewritten more clearly, simply and precisely as follows:

> If Borrower shall breach any covenant in Article 6, Lender may terminate the Loan Commitments upon notice to Borrower.

§ 4:2.4 Conveyance Provisions

One type of provision requiring a high degree of precision is a provision conveying or granting an interest in property. Applicable property law requirements must be followed. For example, a security interest isn't created under Article 9 of the Uniform Commercial Code unless the agreement provides for a present grant of the security interest, and language effecting a conveyance of real property must comply with the relevant real estate law.

§ 4:3 Simplicity

Each point in a contract should be expressed as simply as possible. The benefits of simplicity are many. Simple provisions are easier to read and understand. Simple provisions in a draft agreement are easier to negotiate and rewrite. Simple provisions are less likely to be imprecise or unclear, and are therefore less susceptible of competing interpretations.

Unfortunately, there are a variety of factors that can make simplicity difficult to achieve:

- The increasingly hurried pace of transactions—as a result of which, lawyers may not have the time to edit and simplify excessively complicated provisions.

- The increased complexity of transactions—as deals become more and more complex, it becomes harder to keep the agreements governing them simple.
- Creative solutions—the tendency of transaction participants to come up with solutions that are creative and complex. These solutions to one problem often create a set of additional problems that must be addressed.

On the other hand, the majority of overly complicated contract provisions could easily be simplified by the use of proper drafting and editing techniques.

§ 4:3.1 Keep Sentences Short

Often an unduly complicated sentence can be simplified by dividing it into several sentences. This old chestnut from every writing class and writing book is equally true in the context of contract drafting. Here is an example of an unfriendly sentence:

> In the event Lessee fails to obtain insurance as required in this section, Lessor may obtain such insurance without any obligation to give Lessee notice thereof, which insurance may provide the minimum levels of coverage described above or such increased coverages as Lessor reasonably deems appropriate, and the premium payments in respect of which shall be for Lessee's account.

Notice that the following rewrite, which breaks the above language into three sentences, is much easier to follow:

> In the event Lessee fails to obtain insurance as required in this section, Lessor may obtain such insurance without any obligation to give Lessee notice thereof. Such insurance may provide the minimum levels of coverage described above or such increased coverages as Lessor reasonably deems appropriate. The premium payments in respect of such insurance shall be for Lessee's account.

Sometimes an overly convoluted sentence needs to be broken up, even at the expense of creating more words:

> Seller shall not disclose Confidential Information to any Person, except its professional advisors to the extent necessary in connection with their work on the Transaction, and the Seller's lenders, and

sonable, but the cumulative effect is a hodgepodge. This problem is compounded by the tendency of a busy draftsperson to tack new concepts to the end of a provision and not harmonize the old and new parts with an overall rewrite. Let's look at four successive versions of a covenant in a note purchase agreement, blacklined to show the changes made in each version.

> Issuer shall not pay any dividends or make any distributions in respect of Capital Stock, or repurchase, redeem or otherwise acquire for value any Capital Stock.

> Issuer shall not pay any dividends or make any distributions in respect of Capital Stock (except for dividends paid in additional Capital Stock), or repurchase, redeem or otherwise acquire for value any Capital Stock.

> Issuer shall not pay any dividends or make any distributions in respect of Capital Stock (except for dividends paid in additional Capital Stock), or repurchase, redeem or otherwise acquire for value any Capital Stock, provided, however, that Issuer may repurchase Capital Stock from members of management in an amount not to exceed $1 million in any year.

> Issuer shall not pay any dividends or make any distributions in respect of Capital Stock (except for dividends paid in additional Capital Stock), or repurchase, redeem or otherwise acquire for value any Capital Stock, provided, however, that Issuer may repurchase Capital Stock from members of management in an amount not to exceed $1 million in any year, and provided, further, that such repurchases shall not be permitted at any time an Event of Default has occurred and is continuing.

This is not a terrible provision, but it can be simplified by putting the two exceptions together in serial form and changing the second proviso to a condition, as follows:

> Issuer shall not pay any dividends or make any distributions in respect of Capital Stock or repurchase, redeem or otherwise acquire for value any Capital Stock, except for (i) dividends paid in additional Capital Stock, and (ii) so long as no Event of Default has occurred and is continuing, repurchases of Capital Stock from members of management in an amount not to exceed $1 million in any year.

§ 4:4 Consistency: Learn to Love the Hobgoblin

According to Ralph Waldo Emerson, a foolish consistency is the hobgoblin of little minds. However, when it comes to drafting contracts, there is no such thing as too much attention to consistency. Why is consistency so important? Inconsistent contract provisions can be a breeding ground for differing interpretations.

Consider the following two sentences from the same asset purchase agreement, the first providing for the payment of the purchase price at closing, the second for a post-closing purchase price adjustment payment:

> On the closing date, the Seller shall pay the Purchase Price to Buyer's Account in immediately available funds.
>
> The Seller shall pay the Purchase Price Adjustment on the fifth Business Day following the delivery of the Closing Date Balance Sheet.

Under the second sentence, can the seller pay the Purchase Price Adjustment by check, because there is no reference to "immediately available funds"?[2] It is unlikely that the parties intended the payment mechanics to be different for these two events. However, the treatment of similar requirements in an inconsistent manner allows the seller to take the position that the second payment may be made by check. The buyer's protests that there was no mutual understanding that payment could be made in this manner will be unavailing: the plain words of the contract govern.

Inconsistent use of individual words can also create a potential booby trap. Consider these two sentence from the same guarantee:

> Guarantor guarantees the full payment and performance when due of all liabilities owing by Debtor to Creditor, whether now existing or hereafter arising.
>
> Guarantor shall not be obligated to make any payments hereunder in respect of indebtedness of Debtor to Creditor at any time that Debtor's Net Worth is at least $20 million.

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2. The term "immediately available funds" means cash or a deposit or credit to a bank or investment account that can be immediately drawn.

A credible argument could be made that the word "liabilities" has a broader meaning than the word "indebtedness" and that therefore the second sentence suspends less than all of guarantor's guarantee obligations.

Draftsmen must also be wary of inconsistency in the use of word strings:

> Seller shall indemnify Buyer for all damages, liabilities and expenses to the extent arising from Seller's breach.
>
> Buyer shall indemnify Seller for all damages and liabilities to the extent arising from Buyer's breach.

The omission of the word "expenses" in the second provision could be quite significant. If Seller is sued by a third party as a result of Buyer's breach, any damage award against it would be covered by Buyer's indemnity, but not its legal expenses.

Another area where consistency should be the goal is in the numbering of a contract's articles, sections and subsections. Any system chosen for this task is fine, but the draftsperson should take care to follow the same system throughout. Thus, if a subsection in Article 1 is "Section 1(a)(5)," a subsection in Article 3 should not be numbered as "Section 2.b.4" or "Section 2(B)(4)." Will the failure to follow the same numbering system throughout the agreement really create any problems? Probably not, but an attention to this kind of detail demonstrates that the draftsperson cares about her work product and its readers.

Many transactions involve a number of related agreements that are executed and delivered at the same time. To the greatest extent possible, the draftsperson should avoid inconsistencies among related agreements of this kind. For example, it will avoid confusion if the parties are referred to consistently. If a party is referred to as "Borrower" in one agreement, "Debtor" in another and "Assignor" in yet another, confusion may be the result.

Another source of inconsistency in the context of related agreements is in their boilerplate provisions. Take an acquisition transaction where the seller agrees to provide transition services to the buyer and to grant an easement in respect of the property to be sold. The draftsperson chooses to cover these matters in separate agreements. It is not at all unlikely that the boilerplate provisions, such as the governing law, notice, assignment and consent to jurisdiction provisions,

will be different in form (and perhaps in substance) in each of the precedents. The draftsperson should work at making these provisions consistent.

§ 4:5 Clarity

The ultimate goal of contract drafting is clarity. Clarity is not a separate technique but flows directly from the application of the other principles advocated in this chapter. If a contract is written with precision, simplicity and consistency, it will be clear. If it is clear, it will accurately reflect the agreement of the parties in a way that will be understood in the same way by all readers.

A rule of thumb to determine whether a contract has been clearly written: If a contract cannot be understood reasonably well by a reasonably intelligent judge who spends a reasonable amount of time reviewing it, the draftsperson has failed.

It is easy to get swept up in the vortex of a transaction, to succumb to the tunnel vision that legal specialization produces, and to revel in the ability to draft thickets of overly complicated contract language. One should not, however, lose sight of the primary goal of drafting: to create an agreement that is precise, simple, consistent and clear—in other words, an agreement that is user-friendly.

Chapter 5

Drafting Techniques

§ 5:1 Introduction

The previous chapter explored the general principles of good drafting. These precepts are broad and abstract. This chapter digs a little deeper, by examining a number of the most commonly-used concepts, techniques and phrases that are unique to contracts. Facility in using the matters covered in this chapter will not by itself make you a good draftsperson. On the other hand, these items represent some of the basic tools of the trade—you can't draft contacts effectively without them.

§ 5:2 Softening the Edges

One of the main themes covered in the preceding chapter was the need for precision in the drafting of contracts. There are many circumstances, however, where one or both parties will want to limit contract language that would otherwise be inflexible or absolute. In some cases, this can be achieved by means that result in no loss of precision: for example, the creation of a basket that permits a party to engage in a restricted activity, up to a certain dollar amount or value.

The addition of flexibility cannot always be achieved with such precision, however. The drafting tools explored in this section are all somewhat subjective standards which necessarily introduce a "gray area" into the provisions in which they are used.

§ 5:2.1 Materiality/Material Adverse Effect

The concept of materiality is used to modify provisions that would otherwise be too absolute. Consider the following covenant from the first draft of a credit agreement:

> Borrower will not violate any laws, rules or regulations.

This covenant prompts the following negotiation between a borrower and a lender:

Borrower: Under this covenant as written, we would be in breach if one of our employees were given a speeding ticket while driving a company vehicle on company business. Come on, that makes no sense, does it?

Lender: Okay, we'll carve out that situation.

Borrower: Don't be ridiculous, that's just one example. What if we violate a regulation where our maximum exposure is a $1,000 fine? Surely you don't think we should be in default if that happens?

Lender: Fine, we'll carve out violations giving rise to a fine or penalty not exceeding $1,000 in each case.

Borrower: Look, its impossible to conjure up all the possible scenarios where there is some violation of law that shouldn't trouble you. We understand that you want a remedy if we have violated the law in a manner that impairs your position in a significant way. By the same token, we don't want to worry about being in default due to some de minimis infraction, and by the way, you don't want that result either. You don't want to be pestered with numerous requests for waivers of inconsequential events.

Lender: Alright, you win, we'll put in a materiality standard.

The above discussion illustrates that softening concepts like materiality are used when more precise techniques of creating flexibility are not effective. These create flexibility at the cost of introducing a certain level of uncertainty to the interpretation of the provisions in which they are used, because concepts such as "materiality" are not

defined in case law in a definitive way. Here are a number of examples in which materiality qualifications are appropriately used:

> The Company shall not default in its obligations under any material contract.

> Party A shall provide Party B with copies of all material notices received by it under the Receivables Purchase Agreement.

> Set forth on Schedule I is a list of all material litigation to which the Lessee is a party.

In many cases, however, materiality qualifications like this don't do the trick. Let's go back to the negotiation of the covenant requiring compliance with laws. The lender grudgingly changes the covenant in the next draft as follows:

> Borrower will not violate any material laws, rules or regulations.

This approach is still unsatisfactory to the borrower. She argues: "What if we violate the tax code (which is clearly a material law) in a minor way resulting in no significant loss or penalty? This would trigger a breach under the covenant as rewritten!" Unable to refute this logic, the lender offers this version:

> Borrower will not violate any laws, rules or regulations in any material respect.

The borrower is not satisfied with this approach, either. What does it mean, she asks, for a law to be violated "in a material respect"? In the case of the speeding employee, could it be argued that a ticket for doing 35 in a 40-mph zone is an immaterial violation, whereas one for doing 65 would be material? Shouldn't the materiality standard focus on the effect on the borrower instead of the quality of the infraction? Finally, the parties agree to this wording:

> Borrower will not violate any laws, rules or regulations in a manner that could reasonably be expected to have a material adverse effect on Borrower's business or financial condition.

"Material adverse effect" is a standard that is often employed in the softening of contract provisions. It is often used in more than one provision in a contract, and as a result may be separately defined:

> "Material adverse effect" means any material adverse effect on the Borrower's business, assets, liabilities, prospects or condition (financial or otherwise).

In order to fall within the ambit of this definition, the matter in question must be both *material* and *adverse* to the party. Materiality is a subjective concept; a change that would be reasonably likely to affect the other party's evaluation of the transaction will generally be viewed as material. The change must also be *adverse*. Obviously, if it's a change for the better, it isn't covered.

The definition refers to the areas where the material adverse effect has occurred: the party's business, assets, liabilities, financial condition and prospects. Let's look at examples of each of these. The loss of a customer that represented 40% of the borrower's earnings would have a material adverse effect on its *business*. An uninsured casualty loss in respect of the borrower's primary manufacturing plant would have a material adverse effect on its *assets*. The entering of a judgment against the borrower for damages in an amount equal to its total annual sales would have a material adverse effect on its *liabilities*. A loss of sales resulting in a diminution in cash flow that impairs the borrower's ability to pay its operating expenses would have a material adverse effect on its *financial condition*. Lastly, the development of proprietary technology by a competitor that allows it to produce goods at a more favorable price may have a material adverse effect on the borrower's *prospects*, because it may be forced to reduce its profit margins.

Inclusion of the word "prospects" as a component of the definition of material adverse effect is almost always a point of contention. The party to whom the material adverse effect standard is applicable will argue that the use of prospects gives the other party too much room to speculate about the future impact of an event. The other party will argue that its counterparty's future condition and performance is important to it, and the party should not be required to wait until a reasonably foreseeable bad result has occurred before having any remedies.

Closely related to material adverse effect is material adverse change, referred to colloquially as "MAC." It is used most often to measure the present condition of a party against its condition at a previous time. This representation provides an example:

> Since December 31, 1999 there has been no material adverse change in the business, assets, liabilities, financial condition or prospects of the Company.

In determining whether it can make this representation, the company will not evaluate the materiality and adversity of individual events that have occurred since December 31, 1999. Instead, it will compare two "snapshots" of itself: one on December 31, 1999 and one on the date that the representation is made. Let's assume that the company lost one-third of its net worth in March 2000 due to an uninsured tort judgment, but brought its net worth back up to the original level over the next four quarters through increased profits. On March 31, 2001 the company could make the representation, because on a net basis its position had not worsened.

"Material adverse change" and "material adverse effect" are often used interchangeably. The following usage creates a potential pitfall, however:

> Since the Closing Date, no event, act or condition has occurred that could reasonably be expected to have a material adverse effect on the Company.

The company discussed above whose net worth dipped and then recovered would not be able to make this representation as written. The reduction in net worth was an event that had a material adverse effect at the time that it occurred. The increase in sales that subsequently counteracted it is irrelevant. The representation written in this fashion identifies individual events, not overall changes from one point in time to another.

§ 5:2.2 Reasonableness

The reasonableness standard is the device most frequently used to soften the hard edges of contract provisions. It turns an absolute requirement into one that is subject to the test of what a "reasonable person" might do or require. An example:

> The Company shall reimburse the Agent for all of its reasonable out-of-pocket expenses arising in connection with its activities hereunder.

Without the term "reasonable" in this sentence, there would be no limit on reimbursable out-of-pocket expenses: officers of the Agent could travel to meetings on a chartered jet, for instance. By virtue of the reasonableness standard, the provision must be interpreted in the

context of what would be reasonable under the circumstances (such as the use of commercial flights as opposed to chartered jets).

Another common appearance of the reasonableness standard is where one party has the ability to exercise its discretion in making a decision or reaching a conclusion under a contract provision. The party who has the right to make the decision will want to be able to make it in its "sole discretion" or its "sole judgment." If the provision is written this way, whatever it decides may not be disputed by the other party. The party who isn't making the decision will push for a "reasonable discretion" or "reasonable judgment" standard, which would give it the right to object to the decision of the other party on the basis that the decision was not reasonable.

§ 5:2.3 Consent Not to be Unreasonably Withheld

This is a specific use of the reasonableness standard in a contract provision that requires the consent of one of the parties to some specified action. Look at the underlined language in this sentence:

> Party A may not consummate any Prohibited Transaction without the consent of Party B.

As a technical matter, the underlined language is unnecessary, because Party A always has the ability to ask Party B to consent to something that is prohibited by their contract. Party A, however, may anticipate taking actions for which consent will be required, and may want to soften Party B's absolute right to deny its consent. The way it does this is to use the "consent not unreasonably withheld" concept:

> Party A may not consummate any Prohibited Transaction without the consent of Party B, which shall not be unreasonably withheld.

Under this provision, Party B may not withhold its consent to a proposed transaction without a reasonable basis for doing so. If there is a concern that the party whose consent is needed may drag its heels in responding to request for a consent, the phrase can be written as:

> without the consent of Party B, which shall not be unreasonably withheld or delayed

§ 5:2.4 Best/Reasonable Efforts

Sometimes a party may be uncertain whether it will be able to satisfactorily perform one of its contractual obligations. This issue usually arises in the context of a requirement that some third party's action or cooperation be obtained. For example:

> The mortgagor shall, no later than November 15, 2007, cause each of its insurance policies to be modified to contain the endorsements described on Exhibit 5.

The mortgagor anticipates stiff resistance from its insurers to the required language. It knows that it doesn't have the leverage to force the insurance companies to make the changes. Under the language written above, the mortgagor would be in breach if any one of its insurers refuses to provide the requested endorsement. It argues, therefore, that it should not be in breach of the covenant as long as it has diligently pursued getting the changes made:

> Mortgagor will use its reasonable efforts to cause each of its insurance policies to be modified to contain the endorsements described on Exhibit 5.

The mortgagor's obligation under this provision is not to obtain the policy changes, but to exert reasonable efforts to do so. From the mortgagee's standpoint, this is obviously a much weaker and more subjective requirement. If, as a business matter, the mortgagee feels it must have these endorsements, it will either insist on the original absolute requirement or make the policy endorsements a condition to closing.

Although the case law on the subject is mixed, most practitioners take the view that an obligation to use best efforts includes the obligation to make every possible effort, and to use all possible financial resources, to achieve the desired goal. If the mortgagor in the above example were required to use best efforts to obtain the policy endorsements, it would be required to pay any fee or premium demanded by the insurer. For this reason, a "best efforts" standard is often resisted. Sometimes, the following approach is utilized in order to impose the more stringent "best efforts" standard without creating open-ended financial risk:

> Mortgagor will use its best efforts (without being required to pay any additional fees, premiums or other amounts) to cause each of its insurance policies to be modified to contain the endorsements described on Exhibit 5.

§ 5:2.5 To the Best of Its Knowledge

Compare the following two variations of the same representation in an acquisition agreement:

> Seller is not in violation of any Environmental Law.

> To the best of its knowledge, Seller is not in violation of any Environmental Law.

The first representation is a statement as to a *fact.* The second representation is a statement about the representing party's *awareness of a fact.*

What if, after the closing, the buyer discovers a pre-existing violation of environmental law relating to the purchased property that results in significant economic harm to it? Its posture as against the seller would be markedly different under these two provisions. Under the first provision, the existence of the pre-existing violation makes the representation untrue, providing the buyer with a claim against the seller for breach. Under the second provision, however, the buyer's claim for breach of representation will only succeed if the buyer can demonstrate that the seller *knew* of the violation at the time that the representation was made. Obviously, it is much more difficult to prove a party's state of awareness of a fact than it is to prove the fact itself.

The seller may make the following argument to support its need for this knowledge qualification: "Our business consists of assets that were obtained in numerous acquisitions over the last few years, so we may not know about all previous events that may continue to give rise to potential environmental violations. How can you ask us to make a rep that we don't know is true?"

This argument usually falls on deaf ears. One of the primary purposes of representations is to allocate risk between the parties. In the above example, the buyer will respond: "We don't care whether you know the statement is true or not. What we want is recourse against you if the statement turns out to be wrong. Your failure to do ade-

quate environmental due diligence when you bought properties in the past should be your problem, not ours."

§ 5:2.6 Substantially in the Form Of

Sometimes a contract will refer to another agreement that is expected or required to be similar to another agreement or to an exhibit to the contract. For example, a condition to closing may require a party to execute and deliver another agreement, the form of which has been negotiated and which is attached as an exhibit. Or, there may be a requirement that if Party A enters into an agreement with a third party in the future, it must enter into the same agreement with Party B. In cases like this, the phrase "substantially in the form of" is an important one. Without it, performance of the condition or covenant may be thwarted due to immaterial inconsistencies between the two documents. Such inconsistencies may be necessary, for example, to properly identify the parties, to correct typographical errors, and the like. Read the following condition precedent from a lease both with and without the underlined word to understand its substantive effect:

> As a condition to the effectiveness of this Lease, the Lessee shall execute and deliver a solvency certificate substantially in the form of the solvency certificate delivered by the Lessee to XYZ Realty Co. on September 20, 2005.

§ 5:2.7 To the Extent Permitted by Law

A contract should never require a party to violate the law. There are two approaches to address the possibility that a party will have to violate the law by complying with a contract provision. First, the law at issue can be researched and the provision modified to ensure that compliance would not result in a violation. A broader approach is to modify the provision with the phrase "to the extent permitted by law." This also has the advantage of addressing potential conflicts with new or changed laws. Here is an example:

> Company shall, to the extent permitted by law, close facilities and reduce employee headcount by January 31, 2008 so as to reduce its aggregate expenses on an annualized pro forma basis by at least $2 million.

§ 5:2.8 Promptly

This term is employed to create a modest degree of flexibility in the time required for performance of a contractual requirement. It is used where some time may be needed for performance and where a precise number of days for performance may be difficult to specify. The "promptly" standard may also be imposed with an outside date for the specified performance. Examples:

> The Borrower shall notify the Lender promptly of any notice of default received by it under the Mezzanine Notes.

> Following the Lender's request, the Company shall promptly, but in any event within 30 days, provide the Lender with appraisals of the Specified Real Estate.

Often, the concept of promptness is a negotiated compromise from first drafts which requires some action to be taken *immediately.* This term should be used sparingly; very few things can be made to happen immediately.

§ 5:2.9 In Form and Substance Satisfactory

This phrase is used to give a party the right to be satisfied with a particular document. Compare the following two provisions:

> The Contractor shall deliver a plumbing subcontract to the Owner.

> The Contractor shall deliver a plumbing subcontract in form and substance satisfactory to the Owner.

Under the first provision the contractor has satisfied its obligation by delivering a plumbing subcontract to the owner, regardless of whether it is correctly drafted, or whether it is otherwise satisfactory to the owner. In the second provision, the contractor's obligation is not satisfied unless the owner is satisfied with both the form and substance of the document. If the contractor believes that this gives too much discretion to the owner, it would insist on the insertion of a reasonableness standard:

> The Contractor shall deliver a plumbing subcontract in form and substance reasonably satisfactory to the Owner.

Sometimes a distinction should be drawn between the *form* and the *substance* of a document. For example, a bank agreeing to issue a letter of credit on behalf of its customer may not have an interest in the terms or substance of the letter of credit but may have an interest in its form or appearance. In such a case, the relevant provision would read as follows:

> The Bank will, at the request of the Borrower, issue one or more letters of credit in a form satisfactory to the Bank.

§ 5:2.10 Substantially All/Substantial Portion

Two parties are negotiating a covenant restricting asset sales. The parties have agreed that only extremely significant asset sales will be restricted, but are not willing to agree to a precise dollar limitation. Therefore, they agree on this language:

> The Company may not sell or otherwise dispose of all or substantially all of its assets.

A slightly looser version would be as follows:

> The Company may not sell or otherwise dispose of all or any substantial portion of its assets.

A draftsperson employing these phrases should be aware of case law that suggests that these standards are not as loose as they may appear.[1]

§ 5:2.11 In the Ordinary Course of Business

This phrase is used in restrictive provisions to permit activities that are customary and typical for the restricted party. Take, for example, the following provision in a note purchase agreement involving a construction company:

> The Issuer may not incur any contingent liability in respect of surety bonds, except for those obtained in the ordinary course of business.

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1. *See, e.g.*, Gimbel v. Signal Cos., Inc., 316 A.2d 599, 606 (Del. Ch. 1974); Sharon Steel Corp. v. Chase Manhattan Bank, 691 F.2d 1039 (2d Cir. 1982), *cert. denied*, 460 U.S. 1012 (1983); Katz v. Bregman, 431 A.2d 1274 (Del. Ch. 1981).

The issuer is routinely required to provide surety bonds in connection with its construction contracts. This language permits it to continue that practice. But the provision would not permit the issuance of a surety bond to secure the payment of a financial obligation (as opposed to the performance of its obligations under a construction contract), because at the time that the agreement was signed the issuer did not regularly use surety bonds for such purposes. The ordinary course of business standard is used to prevent flexibility granted to one of the parties from being used by it in an unusual or unanticipated way.

§ 5:2.12 Consistent with Past Practice

Unlike "in the ordinary course of business," which focuses on *whether* a specified action is customary for a party, this phrase puts more emphasis on *how* an action is taken. Here is an example:

> Guarantor shall not make capital contributions to its foreign subsidiaries, except in a manner consistent with past practice.

If the guarantor over the last five years had made capital contributions to its foreign subsidiaries only to the extent necessary to satisfy local minimum capitalization rules, this provision would prevent the guarantor from making capital contributions to its foreign subsidiaries to acquire machinery and equipment. If the applicable standard were "in the ordinary course of business" rather than "in accordance with past practice," the guarantor would have an easier time arguing that it was customary for it to make capital investments to its foreign subsidiaries, and therefore that it could do so even for new purposes.

§ 5:2.13 Not More Restrictive

This phrase and its variations are used in provisions that impose limitations on a party's ability to agree to restrictions under other agreements. This may come up, for example, where the contract permits one party to incur indebtedness in order to refinance existing obligations. Rather than try to outline the specific terms that an acceptable refinancing would include, the parties agree on the following language:

> Debtor may incur Indebtedness the proceeds of which are used to repay the Senior Notes, so long as the agreement governing such Indebtedness is not more restrictive to Debtor than the Senior Notes.

The difficulty with this approach is that it is not clear how it is applied. If one out of 15 covenants in the refinancing agreement is tighter while the other 14 are looser, has the requirement been satisfied? This concern can be addressed, to a certain extent, by modifying the phrase to read "not more restrictive, taken as a whole."

§ 5:2.14 Would vs. Could: Levels of Probability

Party A is reviewing a first draft of an agreement prepared by Party B that requires Party A to give "notice of the commencement of any action, suit or proceeding that could result in a material adverse effect on Party A." The following discussion ensues:

Party A: As you know, the nature and scope of our business results in us being the subject of several hundred lawsuits every year, 95% of which are either unmeritorious or settled for small amounts. However, virtually every one of these lawsuits asserts a multimillion dollar claim for damages. Any of these, if successful, could be material to us. We can't conclude at the outset of these cases that the plaintiff has absolutely *no* chance of success. Therefore, we would have to disclose all of these to you because, technically, they all "could" result in a material adverse effect.

Party B: Don't make such a fuss. We understand your concern. What would you like to do?

Party A: Why don't we say "would have a material adverse effect" instead?

Party B: That brings it much too far in the other direction. Under that standard, you would only have to disclose to us if there was a *certainty* of a material adverse effect. Just as a "could" standard casts too wide a net, a "would" standard doesn't cast a wide enough net.

Party A: How about "would reasonably be expected to"?

Party B: Done.

This negotiation illustrates the difference between the use of could/would/reasonably be expected to. (A word of warning: the fewer dis-

cussions among the lawyers on this particular topic a client hears, the better. Notwithstanding the important substantive result that is at stake, the typical client, perhaps not understanding the issue, may view it as a ridiculous (and costly) legal cul-de-sac.)

§ 5:3 Trumping Provisions

Contracts often contain inconsistent provisions. A general restriction in one provision may conflict with another that requires some specific action. Broad principles that generally apply to the entire contract may need to be overridden in specific circumstances. The careful draftsperson will always note these possible inconsistencies and employ trumping provisions to indicate which provision overrides the other. Otherwise, confusion and potential disputes are the result.

§ 5:3.1 Provisos

A proviso is a clause that begins with either "provided" or "provided, however." Often these words are underlined, which is done merely to make the proviso stand out from the rest of the sentence. The purpose of a proviso is to override the concept that immediately precedes it:

> Seller shall deliver sales reports to Buyer on the last business day of each week, provided, however, that such delivery may be made on the first day of the following week if the number of business days in the week covered by the report is less than five.

Here, the proviso creates an exception to the general rule that the report be delivered on the last business day of the week.

Provisos are sometimes incorrectly used as a substitute for the terms "to the extent that" or "if":

> Seller may enter into leases with respect to the Subject Assets, provided, however, that Seller's interest under such leases is transferable to Buyer.[2]

2. The use of the word "provided" as a synonym for "if" or "on the condition that" is acceptable, but it should not be underlined. "Provided, however" may not be used this way.

The proviso in the above sentence does not override the concept that the Seller can enter into leases; it creates a condition to the Seller's right to do so. A better rendition of this sentence would be:

> Seller may enter into leases with respect to the Subject Assets if Seller's interest therein is transferable to Buyer.

Here is another example of the incorrect use of a proviso, with a modification correcting the error:

> Employee shall be entitled to reimbursement for Covered Expenses provided that it produces reasonably satisfactory documentation thereof.

> Employee shall be entitled to Covered Expenses to the extent that it produces reasonably satisfactory documentation thereof.

§ 5:3.2 Notwithstanding Anything to the Contrary

The several variations of this phrase each acts as a signal that what follows will be inconsistent with (and trumps) other contractual provisions. One such variation, the phrase "notwithstanding the foregoing" has the same effect as the proviso, in that it trumps the immediately preceding concept. For example, the sentence:

> Borrower shall pay accrued interest on the last business day of each month, provided, however, that on up to three occasions during the term of this agreement, Borrower may, by prior notice to Lender, delay such payments by a period not to exceed in each case 5 business days.

could be expressed equally well as follows:

> Borrower shall pay accrued interest on the last business day of each month. Notwithstanding the foregoing, on up to three occasions during the term of this agreement, Borrower may, by prior notice to Lender, delay such payments by a period not to exceed in each case 5 business days.

Unlike the proviso, this phrase can be used to trump sentences other than the one in which it is contained. Consider a stock purchase agreement containing covenants that restricts the target's ability to engage in a variety of transactions. The parties agree that the target may engage in a specific joint venture transaction, different aspects of which would be blocked by several of the restrictive covenants. This potential con-

flict could be addressed by either (a) adding an exception for the joint venture to each of the relevant covenants, or (b) more simply, by adding the following at the end of the covenant section:

> Notwithstanding anything in this Section 5 (Covenants) to the contrary, Target shall be permitted to enter into the Portuguese Joint Venture.

This tool can also be used to trump inconsistent provisions appearing throughout an entire agreement. In the above example, the parties may be concerned that there may be other provisions in the contract that would restrict the target's ability to enter into the joint venture. They could therefore use the above language, modified to refer to "anything in this agreement to the contrary. . . ." Since this refers to the entire agreement, the placement of this language is irrelevant: it could be placed at the beginning, the middle or the end of the agreement.

§ 5:3.3 Except as Otherwise Provided

This phrase is used to indicate that the provision in which it is included is trumped by other provisions in the agreement. Often, a provision that includes this phrase directs the reader to the specific provision that overrides it:

> Except as provided in Section 4, the Shareholder may not transfer any of the Preferred Shares.

Another use of this phrase is to indicate that a general statement is subject to being overridden by other, more specific provisions, without specifically referring to such other provisions. An example would be an agreement which generally provides that all payments thereunder are to be made in dollars, but with several specific provisions requiring payment in euros. The general provision would read as follows:

> Except as otherwise provided herein, all payments made hereunder shall be made in U.S. dollars.

Thus, it is not necessary in this agreement to specify in each payment provision that payment is to be made in dollars. That is taken care of by the above general language; only the payment provisions requiring euros need to be specific.

§ 5:3.4 *Without Limiting the Generality of the Foregoing*

One rule of contract interpretation is that the specific overrides the general. A concern may arise that where the statement of a general principle is followed by a specific application of that principle, the general principle may be ignored. This may arise in the context of a provision like this one:

> Debtor shall maintain insurance at levels and with deductibles consistent with customary business practices in Debtor's industry. Debtor's insurance for casualty losses in respect of its Deerfield plant shall at no time be less than $5 million.

This provision raises the concern that, at least as it relates to casualty insurance, the second sentence trumps the first. The provision could be rewritten as follows:

> Debtor shall maintain insurance at levels and with deductibles consistent with customary business practices in Debtor's industry. Without limiting the generality of the foregoing, Debtor's insurance for casualty losses in respect of its Deerfield plant shall at no time be less than $5 million.

This change prevents Debtor from arguing that it has complied with the covenant by insuring the Deerfield plant for $5 million, even if industry standards would suggest a larger amount of coverage is required.

§ 5:3.5 *Inconsistency Among Agreements*

Sometimes a concern will arise that one or more agreements among the same parties may be inconsistent with each other. If it is clear where the conflict lies, one of the methods referred to above can be used. For example:

> Notwithstanding anything to the contrary in Section 5.4 of the Stockholders Agreement, the Company may not transfer any of its Shares to an Affiliate without prior written notice to XYZ Inc.

In other cases, the concern about conflicts may be more general. This calls for a more general trumping provision:

> To the extent there is an inconsistency between a provision in the Credit Agreement and a provision in any of the Transaction Agreements, the provision in the Credit Agreement controls.

These only work to the extent the parties to the agreement that is being overridden are parties to the agreement containing override language. A provision in a contract between Party A and Party B that purports to override a provision in a contract among Parties A, B and C is not enforceable against Party C.

§ 5:4 Accounting Terms/Terms of Measurement

It is easy for a lawyer faced with a numerical or accounting issue in a contract to disclaim: "I'm a lawyer, not a numbers person—have the accountants look at this." There are situations where this is appropriate. To the extent the resolution of an issue or the proper drafting of a contract requires complex calculation or an understanding of the effect of GAAP or other accounting rules, the lawyer should defer to accounting or financial experts.

On the other hand, a lawyer's claim of a complete lack of numbers skills is often a cop-out. Most contracts are, to one extent or another, about money. Complex commercial contracts involve complicated treatment of monetary and other numerical issues: how payments are computed, how financial condition is tested, how permitted economic activities are measured. The skillful business lawyer must master the basics of accounting and the ability to express quantitative ideas in words.

§ 5:4.1 Formulas

Contracts often contain mathematical formulas expressed in words. The key issue here is clarity; the provision must clearly specify the mathematical functions and their order. Let's say the parties to a contract want to provide that one party will make a payment to the other equal to half of certain asset sale proceeds that aren't required to be paid to the recipient's banks. The provision could be written as follows:

> Party A shall pay to Party B 50% of (a) an amount equal to the excess of (i) the proceeds of the Allentown Sale received by Party A over (ii)

> the amount of such net proceeds that Party A is required to pay its lenders under Section 5.02 of the Credit Agreement.

This could be rewritten in algebraic style as follows:

> payment=.50 × (proceeds of Allentown Sale –proceeds used to pay the lenders)

Why is the phrase "an amount equal to" included? The purpose of the sentence is to create a device to compute the amount of a required payment, not to identify the actual money that will be paid. Money is fungible; Party B wants to be paid the required amount but doesn't care whether it receives the money actually paid in connection with the asset sale.

Here is an example of a formula that needs to clarified by the use of appropriate numbering:

> The amount of capital expenditures that Borrower may make in any fiscal year is an amount equal to 10% of Borrower's net income for such fiscal year plus the amount of all capital contributions received by Borrower in such fiscal year.

Does the 10% apply to only the Borrower's annual net income or also to the capital contributions that it has received? Without numbering, the provision is fatally unclear. Here is a revised version that makes it clear that only the net income is subject to the 10% multiplier:

> The amount of annual capital expenditures that Borrower may make in any fiscal year is an amount equal to (i) 10% of Borrower's net income for such fiscal year plus (ii) the amount of all capital contributions received by Borrower in such fiscal year.

A common element of formulas is the quantification of some amount by reference to the passage of a certain amount of time. Take, for example, a provision that provides for the payment of liquidated damages based on how long a seller delayed the closing of an acquisition:

> Seller will pay to Buyer as liquidated damages an amount equal to (a) Target's EBITDA for the fiscal year ending December 31, 2007, multiplied by (b) a fraction, the numerator of which is the number of days in the period beginning on the Expected Closing Date and ending on the actual closing date, and the denominator of which is 365.

This provision has the effect of prorating an annual number for a period of time that is less than a year. This formula could be expressed algebraically as follows:

$$2007 \text{ EBITDA} \times \frac{\text{number of days in a measured period}}{365}$$

§ 5:4.2 Floors and Ceilings

There are many circumstances in which a contract must set a floor or a ceiling—that is, a minimum or maximum amount. This device is used to create a maximum amount:

> On the tenth Business Day of each month Licensee will pay to Licensor an amount equal to the lesser of (a) $100,000 and (b) 30% of the gross sales of the Licensed Products during the prior month.

Under this provision, a maximum amount of $100,000 is required to be paid; if 30% of gross sales exceeds $100,000, only $100,000 is due. If the above provision is modified to change the word "lesser" to "greater," the effect of the provision is to set the amount of the *minimum* payment at $100,000.

This same approach can be used with respect to dates, where it is necessary to specify the latest or earliest date that a particular action may be taken:

> Seller shall complete the Post Closing Audit by the earlier of (i) March 31, 2008 and (ii) 30 days after the accountants have delivered the Preliminary Inventory Calculation.

§ 5:4.3 On a Consolidated Basis

"Consolidated" is an accounting term indicating that financial measurements are made to include both a parent company and its subsidiaries. If something is measured on a consolidated basis it is measured for an entity and its subsidiaries, taken as a whole, as if they were a single entity. One effect of this type of measurement is that intercompany transactions (such as intercompany investments, receivables and payables) are eliminated. Most financial statements (including those required to be disclosed by public companies) are prepared on a consolidated basis.

§ 5:4.4 On a Consolidating Basis

This phrase is used to describe financial statements that are broken out separately for an entity and each of its subsidiaries.

§ 5:4.5 Company and Its Subsidiaries, Taken as a Whole

This is a similar concept to "on a consolidated basis," but is used in non-accounting contexts. For example:

> Since December 31, 2007 there shall have occurred no material adverse effect on the financial condition of the Parent and its subsidiaries, taken as a whole.

This language is intended to ensure that the material adverse standard is not applied individually to the parent or any subsidiary. The effect of this could be unfair. Consider an example involving a parent that has one hundred subsidiaries of equivalent value. A 20% reduction in one subsidiary's annual net income would be material to the subsidiary, but immaterial to the consolidated group.

§ 5:4.6 Frozen GAAP

Financial computations in contracts are frequently required to be made in accordance with generally accepted accounting principles (GAAP). An issue that must be addressed in this context is how to treat changes to GAAP that occur after the contract is entered into. It is often agreed that such changes to GAAP will be ignored for purposes of making the computations. This issue is typically addressed with language along the following lines:

> Changes in GAAP after the Effective Date shall not be given effect for purposes of the calculations made under Section 4.4.

The benefit of this approach is that the parties' intent as to the operation of the covenant won't be undermined by a change in accounting methods. The disadvantage is that because a change in GAAP *will* have to be followed in the preparation of a party's financial statements, there will be a discrepancy between the financial statements and the covenant calculations. In this case, the party providing finan-

cial statements will usually be required to prepare and deliver a reconciliation, showing how the financial computations would have appeared had the change in GAAP not occurred.

§ 5:4.7 Outstanding

The use of the term "outstanding" can have a very important effect when used to describe the principal amount of indebtedness or other obligations. Compare the following two provisions:

> The Company may issue notes as consideration for acquisitions in an aggregate principal amount not to exceed $5,000,000.

> The Company may issue notes as consideration for acquisitions in an aggregate principal amount not to exceed $5,000,000 outstanding at any time.

Under the first example, if the Company issues a $5,000,000 note in connection with an acquisition, and then repays it, it will be unable to issue any further notes in connection with acquisitions. The introduction of the "outstanding" concept, on the other hand, results in the provision not restricting the amount of notes that have been issued over time, but instead the amount of notes that are outstanding at any particular point in time. If the Company issues a $5,000,000 note, and repays $1,000,000, it will have $4,000,000 of notes outstanding. Under this provision, it will then be permitted to issue another $1,000,000 of notes.

§ 5:4.8 Per Annum

This phrase is used in connection with rates of interest or other amounts that are measured on an annual basis. So, for example, an interest rate of "5% per annum" in respect of a principal amount of $100,000 would mean that for an entire year the accrued interest would be $5,000, for six months, $2,500, and so forth.

§ 5:4.9 Absent Manifest Error

This phrase is used where one party is permitted to make a calculation or determination that is binding on the other party unless the calculation or determination is incorrect:

> Investor's calculations of accrued and unpaid commitment fees shall be binding on Issuer, absent manifest error.

It is not entirely clear what the word "manifest" means in this phrase, but it suggests that the error must be demonstrably false. The use of this language places the burden of proving that a calculation or determination is false on the party not making the calculation or determination.

§ 5:4.10 In Arrears/In Advance

Payments that are made in respect of a specified period of time (for example, the payment of interest or the payment of a quarterly management fee) are paid either in arrears or in advance. Payment at the end of a specified period of amounts that have accrued during such period is payment in arrears. Payment in advance is made at the beginning of a period in respect of amounts that will accrue during such period.

Regardless of which approach is used, the draftsperson must address what happens if the contract is terminated between payment dates. In the case of a provision requiring quarterly interest payments in arrears, a termination of the contract on June 20 will leave the lender shortchanged for 20 days' of interest. Conversely, the party that receives quarterly management fees in advance will receive a windfall as to the fees already collected for the last 10 days of June. The drafting required to address each of these concerns is straightforward. The provision requiring payment quarterly in arrears should provide that accrued and unpaid interest should be paid on the date the agreement is terminated. Conversely, the agreement providing for the payment of management fees quarterly in advance may provide that if the agreement is terminated in the middle of a quarter, a proportionate amount of the last payment made must be refunded.

§ 5:5 Terms of Inclusion and Exclusion

Contract provisions often take the form of a general prohibition, subject to one or more exceptions, which in turn may have exceptions of their own. This tracks the way these issues are negotiated: one party suggests an absolute rule to be applicable to the other party, who in turn suggests numerous broad carveouts to the absolute rule, which may be accepted (subject to limitations) by the first party. Let's look at a hypothetical negotiation of a provision in a shareholders agreement relating to the ability of the minority shareholder ("Little Corp.") to transfer certain shares of stock. Counsel to the majority shareholder ("Big Corp.") has prepared a first draft of the shareholders agreement that reads: "Little Corp. may not transfer any Shares during the term of this agreement." The following discussion ensues:

Little Corp.: This provision is way too tight. We may need to move the shares around internally for tax or other planning purposes. The provision should freely permit transfers to affiliates.

Big Corp.: All right, you can transfer to affiliates, but not Medium Corp. The fact that you own 15% of Medium Corp. means it falls under the definition of "Affiliate," but since they compete with some of our business lines, we don't want to have them in this deal.

Little Corp.: We hear you, but if you're in default under the agreement we should be able to transfer our shares to anyone, including Medium Corp. And by the way, we think the definition of "Affiliate" is unclear as to whether Micro Co. would be included. That needs to be clarified in this provision.

Big Corp.: Agreed.

The resulting provision is as follows:

> Little Corp. may not transfer any Shares during the term of this Agreement, except for (i) transfers at any time to its Affiliates (including, without limitation, Micro Co.) other than Medium Corp., and (ii) so long as an Event of Default attributable to Big Corp. shall have occurred and be continuing, transfers to any Person (including, for the avoidance of doubt, Medium Corp.).

What follows below is a discussion of some of the terms of inclusion and exclusion that are necessary tools of the draftsperson's trade.

§ 5:5.1 Make Exceptions Consistent

Inconsistencies often arise as a provision is drafted and redrafted in the negotiation process. A common example of this is a representation or covenant subject to a list of exceptions. Particularly if the exceptions are added at different stages in the drafting process, they may not be expressed in a consistent or grammatical fashion. Here is an example:

> The Borrower may not incur or permit to exist liens on any of its assets, except:
>
> (i) mechanics' liens arising in the ordinary course of business;
>
> (ii) the Borrower may grant liens on equipment to secure indebtedness incurred to finance the purchase price of such equipment; and
>
> (iii) liens described in Schedule 1.04 shall be permitted.

The approach represented by each of these three exceptions is fine; the problem is that each of the approaches is inconsistent with the others and as a consequence the provision is more difficult to follow. The draftsperson should have either (a) made each exception conform with clause (i) (which has no verb phrase), (b) made each exception conform with clause (ii), by using "the Borrower may," or (c) made each exception conform to clause (iii), by using "shall be permitted." In the above example, the approach represented by clause (i) is preferable, because it eliminates unnecessary words.

§ 5:5.2 Specific Exclusions to Avoid Doubt

If it is unclear whether a particular matter is covered by a provision, it may be necessary to add clarifying language. For example, a draft employment agreement may contain the following provision:

> Employee will not engage in any outside activities that significantly reduce her attention to her responsibilities as Chief Executive Officer.

The employee is planning to write a book. She doesn't believe that this project will significantly reduce her attention to her job. Her lawyer, however, is concerned that a dispute may arise over this issue. To address this concern, the employer's lawyer proposes adding the following proviso:

> provided, however, that Employee may write a book about her experiences as a rising star in the plastics business

The employee is unhappy with this language, however. It suggests that her book *will* create a significant distraction. Her lawyer then proposes the following language, which both permits her book-writing project and acknowledges that it doesn't interfere with her job responsibilities:

> it being understood that Employee's writing a book about her experiences as a rising star in the plastics business will not constitute an outside activity significantly reducing her attention to her responsibilities as Chief Executive Officer

§ 5:5.3 Unnecessary Exceptions

Unnecessary exceptions may create ambiguities and confusion. If it is clear that the scope of a provision doesn't cover a particular event or circumstance, it is counterproductive to include an exception. Including the exception in this circumstance merely permits an argument to be made that the scope of the provision is really intended to be broader than it appears; otherwise why would the exception be necessary?

Let's look at an example. Here is a provision found in an equipment lease:

> Lessee will cause the Equipment to be kept in good operating condition, except that Lessee shall not be required to comply with any safety regulations to the extent such noncompliance is being diligently contested by Lessee.

The underlined language is unnecessary. Compliance with safety regulations is not required by the provision, but inclusion of this language creates the implication that compliance *is* required. It allows the lessor to argue that the covenant generally requires compliance with regulatory requirements; otherwise, why did the parties consider

this exception necessary? This example illustrates the kind of mischief that can result from the use of unnecessary exceptions.

This issue also arises frequently in connection with the preparation of disclosure schedules. Consider a representation in a loan agreement that there are no environmental issues that could reasonably be expected to have a material adverse effect on the borrower, except those that are set forth on a schedule. It is a normal reaction for the borrower to include as much information as possible on that schedule, in order to minimize the risk of making a misrepresentation by omission. However, this representation requires only the scheduling of items that could reasonably be expected to have a material adverse effect. There are many reasons why the borrower would not want to characterize immaterial matters as material. For example, such a disclosure could be harmful to it in litigation relating to the matters disclosed. Therefore, the disclosure should be limited to material items.

§ 5:5.4 Including Without Limitation

A frequently-used device to clarify the scope of a provision is the use of the phrase "including without limitation" followed by one or more specific examples of items that the draftsperson intended to be included. For example, look at the following provision from an asset purchase agreement:

> Seller will obtain all consents or approvals necessary in connection with the transfer of the Purchased Assets to Buyer, including without limitation (a) the consent of XYZ Landlord Co. to the assignment of the Paramus Lease from Seller to Buyer and (b) the consent of the Food and Drug Administration to the transfer of the Pharmaceutical Licenses from Seller to Buyer.

The addition of the underlined language doesn't change the meaning of the provision, because it merely lists items that are already included by virtue of the broad introductory language. So why use this technique? For one thing, in the example the buyer may want the underlined language included to act as a reminder to the seller of exactly what consents are required. (Of course, if there are others that are not enumerated, the seller is responsible for those too.) Furthermore, this technique can be used to clarify uncertainty as to what a particular provision is supposed to cover. In the above example, there may have

been discussions between buyer and seller as to which of them had the legal responsibility to obtain the consents. Specifically referring to them here resolves the question of allocation of responsibility.

What is the significance of the words "without limitation"? Arguably, the omission of these words creates the implication that the list that follows is a *complete* list of what the parties intend to cover. In the above example, this would mean that the two consents referred to were the only consents required. This is not a very convincing position, but to avoid any ambiguity, if the intent is to create a non-exhaustive list, use the words "without limitation." Some agreements provide explicitly that the use of the word "including" is to be interpreted as "including without limitation."

Never follow "including" or "including without limitation" with something that is *not* covered by the provision. An example of this would be the following:

> Company may not make any investments in its subsidiaries, including the payment of cash dividends by a subsidiary to Company.

The payment of dividends by a subsidiary to a parent is *not* an investment by the parent in the subsidiary. Without the underlined language, the payment of dividends would not be restricted. What is the result of the inclusion of this language? One argument would be that the payment of cash dividends *is* prohibited. If this view is correct, what about the payment of stock dividends? It could be argued either way. On the other hand, a position could reasonably be taken that the payment of dividends is not covered by the prohibition on investments, that the reference to it in the underlined language was done in error and should have no effect. What is the correct answer? There may not be one. Avoid making this mistake.

§ 5:5.5 Disorganized Exceptions

Sometimes a sentence will become subject to a number of exceptions and qualifications that do not work well together and are difficult to follow. Here is an example:

> Except for the issuance of additional options pursuant to the 1999 Option Plan, the Seller shall not increase the compensation of any employee (other than hourly workers) from the levels in effect on the Effective Date, provided, however, that increases in cash com-

> pensation may be made if the aggregate amounts paid in respect of such increases do not exceed $1 million.

This sentence will read much better if the basic point of the covenant—that the Seller may not increase compensation—is put at the beginning and all the exceptions are placed together in a series at the end:

> The Seller shall not increase the compensation of any employee from the levels in effect on the Effective Date, except that (i) the Seller may issue additional options pursuant to the 1999 Option Plan, (ii) the Seller may increase the compensation of hourly workers, and (iii) the Seller may increase cash compensation in an aggregate amount not exceeding $1 million.

§ 5:6 Miscellaneous Drafting Issues

§ 5:6.1 Incorporation by Reference

There are occasions when it is necessary for one contract to incorporate all or some of the provisions of another contract. There are two ways to achieve this: repeating the other provisions verbatim, or "incorporating by reference." Here is an example of incorporation by reference:

> The Company agrees to perform and be bound by all covenants in the Pittsburgh Lease Agreement that relate to it, and all such covenants are incorporated by reference as if set forth at length herein.

This language has the same legal effect as copying all of the covenants that appear in the lease that relate to the company, but is obviously easier from a drafting standpoint. This shortcut may make life more difficult in the future for someone reviewing this agreement, however, particularly if a copy of the Pittsburgh Lease Agreement is not readily available.

What if the draftsperson would like to incorporate provisions by reference that are close but not an exact fit for the purpose for which they are to be incorporated? For example, what if the goal is to have the company perform covenants that appear in another agreement that relate to a third party, as if they covered the company? In such a case, the provision would be written as follows:

> The Company agrees to perform and be bound by all covenants in the Buffalo Lease Agreement as if such provisions applied to it, and all such covenants are incorporated by reference mutatis mutandis, as if set forth at length herein.

The term "mutatis mutandis" means that the provision that is being incorporated by reference is deemed to be modified as necessary to fit the purpose described. So, for example, if one of the covenants that is being incorporated by reference is a covenant to maintain corporate existence, such covenant would be construed to refer to partnership existence if the company is a partnership instead of a corporation. (Warning: the use of "mutatis mutandis" is likely to elicit sarcastic comments from clients and other non-lawyers.)

§ 5:6.2 On an Arm's-length Basis

This phrase is used to describe a transaction with terms that are equivalent to fully negotiated market terms. It is usually used in the context of transactions that might not be fully and fairly negotiated. For example, here is a provision restricting transactions with affiliates found in many types of agreements:

> The Company will not enter into any transaction with an affiliate, except on an arm's length basis.

This provision would prevent the company from entering into a sweetheart deal with an affiliate.

§ 5:6.3 As Determined by the Board of Directors

Sometimes Party A will be willing to permit Party B to take an action only if the action is specifically approved by Party B's board of directors, or if Party B's board of directors makes some specific determination regarding the action. The basis for this approach is that a board of directors is less likely than an individual officer to stretch the limits of a particular contract restriction. For example, look at the following provision:

> The Company may not amend the provisions of any of its securities unless the Company's board of directors shall have determined that any such amendment does not adversely affect the interests of the Noteholders.

This provides the noteholders with an extra level of protection against an adverse amendment being agreed to, as a result of the entire board of directors looking at the issue and making the relevant determination.

§ 5:6.4 Upon the Occurrence and During the Continuance of an Event of Default

Many agreements provide that remedies may be exercised if there is an event of default. One must be careful in the way that this is expressed. Take, for instance the following provision:

> Lender may accelerate the Loans if an Event of Default has occurred.

Let's say that the borrower has failed to deliver its annual financial statements to the lender by the date it is required to do so under the contract. As a result, an event of default has occurred. Five days later, the borrower delivers the financial statements. Can the lender accelerate the loans two weeks after that? Under the language above, arguably it can. This language states that the remedy of acceleration is available to the lender if an event of default *has occurred*, even if subsequently cured. To avoid this undesirable result, the language should be revised as follows:

> Lender may accelerate the Loans if an Event of Default has occurred and is continuing.

§ 5:6.5 Gross Negligence and Willful Misconduct

An issue that comes up frequently in indemnification provisions is whether the indemnitee should be indemnified for the results of its own misbehavior. A common approach is to exclude costs that result from the indemnitee's "gross negligence or willful misconduct." In other words, costs incurred by the indemnitee as a result of its own gross negligence or willful misconduct are not subject to indemnification.

An example of this is the following. A company has indemnified an investor for all damages incurred by the investor "arising in any manner as a result of the investor's making the investment, except for damages arising from the investor's gross negligence or willful mis-

conduct." The investor and the company agree on a plan for the company to make an illegal payoff to a public official in order to win a government contract. The investor is fined for its participation in this scheme. It turns to the company for indemnification, on the basis that the payoff was made by the company with financing provided by the investor. The company is not responsible for making the indemnification payment under the "gross negligence and willful misconduct" carveout, because the investor's damages were the result of its own misconduct.

What if, under the above facts, the exclusion was worded as follows: "arising in any manner as a result of the investor's making the investment, except for damages arising solely from the investor's gross negligence or willful misconduct"? The inclusion of the word "solely" is often a negotiated point in this provision, and the example shows why. If the indemnification provision had been written this way, the investor would have a persuasive argument that it is entitled to indemnification, since the bad act was one which both the investor and the company participated in.

As an alternative to the use of the term "solely," a middle ground on this issue can be achieved by the following insertion:

> arising in any manner as a result of investor's making the investment, except for damages arising to the extent of the investor's gross negligence or willful misconduct.

This requires the comparative fault of the parties to be analyzed in determining the level of indemnification to be provided.

An issue that arises with respect to this provision is whether the proper standard should be gross negligence or merely negligence. Under the gross negligence standard, the indemnitee's claim for indemnification can only be denied if its behavior is grossly negligent. Clearly, the indemnitee will push hard for this standard because it requires indemnification even where the damages are the result of its ordinary negligence.

§ 5:6.6 From Time to Time

This phrase is used to clarify that an action is required or permitted more than once:

> Party A may from time to time require Party B to provide it with a certificate of insurance showing Party A as loss payee.

Without the underlined language, Party A may only request this certificate once. With the underlined language included, Party A may ask for the certificate as many times as it likes.

§ 5:6.7 As the Case May Be

This phrase is used in a sentence that presents more than one alternative, and indicates that the reader should apply the correct alternative. An example:

> Each of the Subsidiaries has been duly organized and is validly existing as a corporation or a limited liability company, as the case may be.

§ 5:6.8 Respectively

This word is used in sentences that contain corresponding series, and is used to indicate that the items in the second series correspond in order to the items in the first series:

> Company A, Company B and Company C may make political contributions in any fiscal year in an amount not to exceed $1 million, $2 million and $1 million, respectively.

§ 5:6.9 For a Party's Account

This phrase indicates that a certain cost or payment is to be borne by the specified party. For example, if a provision states "All of the costs and expenses of syndication shall be for the Issuer's account," it means that the issuer is agreeing to pay all such costs and expenses or to reimburse any other party for any such costs or expenses.