Advice from the Trenches: Protecting Yourself in a Contract Dispute

April 25, 2017

Gregory D. Call
Nathaniel P. Bualat
Kathleen Jason-Moreau
Contract Disputes Do Arise

- Product or services do not meet standard
- Payments withheld or reduced
- Performance stopped
- Performance does not make sense
Why Disputes Arise

- Expectations differ
- Circumstances change
- A party uses dispute to press advantage
- A party wants a dispute
Ways to Protect Yourself in a Contract Dispute

- Find a business solution
- Contract provisions
- Litigation strategy
Find a Business Solution

• Most contract disputes settle
• Always an alternative
• Terms of settlement depend on leverage of the parties
  – If litigation is no alternative, settlement will be difficult.
Contract Provisions

- Dispute resolution clauses
- Anti-waiver clauses
- Limitation of liability clauses
- Stipulated damages
Dispute Resolution Clauses

• Dispute Escalation Clauses
  – Can slow the filing of an action.
  – Reduce possibility of surprise.
  – Do they really increase probability of settlement?
Dispute Resolution Clauses

• **Arbitration vs. Litigation**
  – For major commercial contracts not clear that arbitration faster or less expensive
    • Motion practice more limited in arbitration
  – Very limited appeal in arbitration
  – Can spell out how arbitration works to increase speed and reduce expense
Dispute Resolution Clauses

• **Choice of Law and Forum**
  – There are differences in state substantive law that can matter. (Damages and Parole Evidence)
  – Procedural issues such as summary judgment process and jury votes.
  – In age of LLC’s diversity jurisdiction uncertain. Federal court might be preferred.
Contract Provisions

- Non-waiver clauses
Non-Waiver Clauses

• How Your Emails Become Waivers
  – Innocuous emails spawn waiver claims
    • Party A emails Mr. Smith, tells him that its development is a little delayed, and makes excuses. Mr. Smith says nothing.
Typical Non-Waiver Clause

No Waiver: No provision of this Agreement shall be waived except by a writing duly executed by the Parties. No delay, failure or waiver by any party to exercise any right or remedy under this Agreement, will operate to limit, preclude, cancel, waive or otherwise affect such right or remedy. No course of dealing among any or all of the parties hereto shall operate as a waiver of the rights hereof.
Non-Waiver Clauses Can Be Waived

• “Even a waiver clause may be waived by conduct.”

• “It has long been the rule that parties may waive a ‘no-waiver’ clause.”
Elements Of A Waiver Claim

- Waiver is the intentional relinquishment of a known right after full knowledge of the facts.
- It depends upon the intention of one party only—no act or conduct by the other party is required.
- Excuses performance of an obligation—does not modify the terms of a prior agreement.
- Does not require consideration.
- Must be proven by “clear and convincing evidence.”

*DRG/Beverly Hills, Ltd. v. Chopstix Dim Sum Cafe & Takeout III, Ltd.*, 30 Cal. App. 4th 54, 59 (1994);
Affirmative Defense - Waiver

336. Affirmative Defense—Waiver

[Name of defendant] claims that [he/she/it] did not have to [insert description of performance] because [name of plaintiff] gave up [his/her/its] right to have [name of defendant] perform [this/these] obligation[s]. This is called a “waiver.”

To succeed, [name of defendant] must prove both of the following by clear and convincing evidence:

1. That [name of plaintiff] knew [name of defendant] was required to [insert description of performance]; and

2. That [name of plaintiff] freely and knowingly gave up [his/her/its] right to have [name of defendant] perform [this/these] obligation[s].

A waiver may be oral or written or may arise from conduct that shows that [name of plaintiff] gave up that right.

If [name of defendant] proves that [name of plaintiff] gave up [his/her/its] right to [name of defendant]’s performance of [insert description of performance], then [name of defendant] was not required to perform [this/these] obligation[s].
Example: Nice Guys Finish Last

- Owner of two hotels consistently delayed paying its licensing fees to Holiday, the franchisor of the brands.
  - Holiday had the right under the contract to terminate the license upon notice.
  - But in practice, it gave a 60-day grace period for over 8 years.
- In April 1999, Holiday ended informal policy with notice.
  - Owner fails to comply with payment of arrears by May deadline.
  - Holiday extended deadlines while Owner made only partial payments.
- In February 2000, hotels were removed from reservation system and Owner obtains TRO to restore hotels.
- Held: Holiday waived its right to terminate on the April 1999 payment simply through its delay in enforcing.
Limited Retraction Of Waiver

• Waiver can be withdrawn by written notice, with a reasonable opportunity for compliance
  – Consider our *Holiday* example
• Unless the conduct has resulted in an estoppel
  – “Having permitted [Owner] to become addicted to payment delays, Holiday could not simply cut them cold turkey.”
Effect Of Waiver Claim

- Waiver based on conduct or oral representations likely weak claim at trial
  BUT
- Requires extensive discovery
- Creates a credibility dispute that kills summary judgment
- Increases expense of litigation
Practice Tips

• Continue to include non-waiver clauses in your contracts.
• Take notes of phone calls describing problems in performance.
• Evaluate risk of whether a waiver may have occurred.
• Send a no-waiver email or letter?
• Enter a non-waiver agreement?
• Preserve the business relationship.
LIMITATION OF LIABILITY
Limitation of liability provisions limit a party’s exposure in the event of a dispute.

Parties may limit:

- Total amount of damages
- Types of damages (e.g., consequential or punitive damages)
- Nonmonetary relief
Each party’s liability, whether in contract, tort, otherwise, arising out of or in connection with this Agreement ... shall not exceed the amount of the License Fee.

IN NO EVENT SHALL EITHER PARTY BE LIABLE FOR ANY SPECIAL, INCIDENTAL, PUNITIVE, CONSEQUENTIAL (INCLUDING LOST PROFITS) OR TORT DAMAGES ARISING OUT OF OR IN CONNECTION WITH THIS AGREEMENT...
Courts generally enforce liability limitations in claims for breach of contract and negligence.

- May not be enforced for intentional torts
- Limitations for “gross negligence” subject to challenge

Compare City of Santa Barbara v. Superior Court, 41 Cal. 4th 747, 758 (2007) and ABRY Partners V, L.P. v. F&W Acquisition LLC, 891 A.2d 1032 (Del. Ch. 2006).

- NY courts define gross negligence more like intentional misconduct.
- Other issues include statutory violations and active negligence.

The language of the limitation is “strictly construed.”

Litigation often results over the language used.
Categories Of Damages

• There are different categories of damages that contracts identify:
  – Direct
  – Consequential / Special
  – Incidental
  – Punitive
Limiting Direct Damages

• Direct damages “follow from the type of wrong complained of.”
  – Black’s Law Dictionary 446 (9th ed. 2009).

• Courts generally uphold caps on direct damages to the amount paid under the contract.

• Caps of less than the amount paid under the contract may also be upheld.
Intentional Breach

• Limitation on direct damages upheld for intentional breach of contract.
  – **Example**: in a services agreement, the limitation of liability is $100,000. The cost to perform increases by more than $100,000. The vendor stops performing.
  – **Result**: Customer’s direct damages limited to $100,000.

An “economically motivated decision cannot, as a matter of law, rise to the level of malice or intentional wrongdoing necessary to invalidate” a limitation of liability provision.


– **Caution**: The contract may also include a specific performance clause, which could also be invoked.
Consequential Damages

• Consequential damages are “[l]osses that do not flow directly and immediately from an injurious act but that result indirectly from the act.”
  – Black’s Law Dictionary 446 (9th ed. 2009).

• Courts generally uphold limitations on consequential damages.

• Consider whether to define direct or consequential damages.
Avoiding Ambiguity

• The line between what is a direct damage and what is a consequential damage is blurry, at best.

• One way to avoid ambiguity is to clearly define direct damages:

For the avoidance of doubt, the following shall be considered direct damages and Vendor shall not assert that they are indirect, incidental, consequential or special damages to the extent they result from Vendor’s failure to perform in accordance with this Agreement: (a) commercially reasonable costs and expenses of restoring or reloading any Client Data that is lost, stolen or damaged due to Vendor’s failure to safeguard the Client Data and (b) reasonable expenses incurred by Client, including overhead allocations for employees, wages and salaries of employees, travel expenses, overtime expenses and similar charges, due to a failure of Vendor to provide all or a portion of the Services.
Key Question

Are “lost profits” consequential or direct damages?
Lost Profits

• Lost profits may be categorized as either consequential damages or direct damages, or both.

• A contract that does not cap direct damages but excludes consequential damages invites litigation over the availability of lost profit damages.

Incidental Damages

• Incidental damages are:
  – Losses reasonably associated with or related to actual damages.
  – A Seller’s commercially reasonable expenses incurred in stopping delivery or in transporting and caring for goods after a buyer’s breach.
  – A buyer’s expenses reasonably incurred in caring for goods after a seller’s breach.”
    • Black’s Law Dictionary 446 (9th ed. 2009).
• Example:
  – Reasonable expenses, such as shipping or storing charges incurred in coping with the other party’s breach.
• Incidental damages may be disclaimed.
Vendor’s liability for all damages, whether in contract, tort or otherwise arising out of or in connection with this Agreement, including from any and all claims related to the breach of this Agreement or nonperformance by Vendor. . . shall not exceed the amount of the License Fee.

Without limiting the foregoing, in no event will Vendor be liable for any lost or prospective profits, indirect, incidental, consequential, special, exemplary or punitive damages, arising out of or in connection with this Agreement . . .
Punitive Damages

• A contractual elimination of punitive damages is of limited utility.

• Punitive damages are not available for a breach of contract claim, but . . .

• Requires a showing of “oppression, fraud, or malice.”

• Liability limitations unlikely to be upheld for the kind of intentional misconduct that is a prerequisite for the imposition of punitive damages.
“Unconscionable” Limitations

• Courts will not enforce “unconscionable” limitation of liability provisions.

• Requires a showing of severely unequal bargaining power (e.g., “take it or leave it” form contract) and substantive unfairness.

• Unlikely to exist in commercial contracts.
Fraud In The Inducement

• Defense to enforcement of limitation of liability: claims of fraud in the inducement of the contract.

• Delaware: Liability limitations invalid where representations and warranties contained intentional and material misrepresentations.
  

• California: Entire contract invalid where induced by any misrepresentations.
  
  – Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Ass’n, 55 Cal. 4th 1169 (2013) (“when fraud is proven, it cannot be maintained that the parties freely entered into an agreement reflecting a meeting of the minds”).
Drafting Considerations

- Consider whether to include a direct damage cap.
- Choose a reasonable amount for the cap.
- Define lost profits as either direct or consequential damages, or both.
- Ensure that the limitation of liability covers all available forms of potential liability.
- Consider whether there are any claims (such as indemnifiable third party claims or breaches of confidentiality) that should be outside the limitation of liability.
STIPULATED DAMAGES
## Types Of Stipulated Damages

<table>
<thead>
<tr>
<th>Type</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidated Damages</td>
<td>Sets damages for breach before the breach occurs.</td>
</tr>
<tr>
<td>Termination Fees</td>
<td>Permits parties to terminate an agreement early by paying a fee.</td>
</tr>
<tr>
<td>Take-or-Pay</td>
<td>Requires a buyer to either purchase the contractually agreed quantity of goods or pay the value of those goods to the supplier.</td>
</tr>
<tr>
<td>Breakup Fees</td>
<td>Permits a party to terminate a merger agreement by paying an agreed fee.</td>
</tr>
</tbody>
</table>
Purpose

• Provides a reasonable measure of compensation in the event of a breach

• A clause designed to prevent breach by coercing performance, or to punish breach after it occurs, is void as a penalty.

Presumption Of Validity

- **CA:** Stipulated damages presumed valid unless:
  - The party seeking to invalidate establishes that the provision is unreasonable, or
  - One party is a consumer (in certain consumer transactions).

*Cal Civ. Code § 1671.*
Compensation v. Penalty

- Courts will look to the proportionality of stipulated damages to actual damages.

**Majority View**: Stipulation must be reasonable in light of anticipated damages at the time of contracting (California, New York)

**Minority View**: Stipulation must be reasonable in light of damages after breach (Indiana, Kentucky, New Hampshire)
Unreasonable Approximation: The Shotgun Approach

• “Shotgun” Clauses: A ‘shotgun’ or ‘blunderbuss’ clause is one that fixes a single large sum for any breach without regard for the severity of the breach.
  – These clauses are unenforceable even in the case of a substantial breach, because they are not a reasonable forecast of an insubstantial breach.

3 Farnsworth, Contracts § 12.18 (2d ed. 1998).
Damages Difficult To Estimate

- Employment/Non-Compete Agreements
- Merger Agreements
- Minimum Purchase Agreements
- Early Termination
- Exclusive Rights to Market or Sell
- Disclosure of Confidential Information
Avoid the word “penalty.”
Carefully consider actual damages:
  - A provision setting graduated damages based on length of delay or quantity of defective goods is more likely to pass muster.
  - Courts are less likely to enforce a “shotgun” approach setting a single lump sum for every breach.
Include an upper limit as well as a lower limit on recovery.
Use a deposit approach clearly identifying the deposit as the liquidated damages amount and allowing the holder to retain the deposit as liquidated damages.
Make a condition, not a covenant.
LITIGATION STRATEGY
Litigation Strategy

• Investigation of potential claims
  – Internal group or department
  – Audit by outside counsel or accountants

• Logistical considerations
  – Organize records and documents

• Outside counsel
  – Hourly v. contingency basis

• Consider if can still make evidence
Litigation Strategy

• Early Case Evaluation and Development
  – Should be done early and repeatedly revisited
    • Ideally before filing a lawsuit
    • Identify and interview key witnesses (or story tellers)
  – Identify ultimate goals
    • Early compromise at what level?
    • Maintain relationship?
    • Renegotiate relationship?
    • Extricate company from relationship?
    • Obtain significant recovery or judgment, even if trial is necessary?
  – Get buy-in and commitment from management and business people
Litigation Strategy

• Develop Strategy and Tactics to Achieve Goals
  – Focus on how win case.
  – Focus on various “settlement moments”
    • Pre-litigation
    • After early discovery (especially after depositions of key witnesses)
    • Before and after key motions (particularly summary judgment motions)
    • At the courthouse steps
    • During trial
Litigation Strategy

• Develop Strategy and Tactics to Achieve Goals (cont’d)
  – Focus on what is necessary, not everything
    • What claims and defenses?
      – Change the question.
    • What evidence?
      – Focus on depositions of key witnesses, not every small player
      – Focus on documents you need, not entire universe of arguably relevant materials
    • What tasks?
      – Early depositions of key witnesses before other side develops its story.
Litigation Strategy

• Develop Leverage
  – Make a persuasive and compelling case to develop leverage for favorable settlement or verdict
  – Convince the other side will pursue the case through trial if necessary
Litigation Strategy

• Develop and Tell a Story
  – Identification of key witnesses and who will tell the story
    • Story will be told through witnesses. Ideally, a limited number of people (maybe even just one) should tell the entire story.
    • In a bet-the-company case, executives can make excellent witnesses. The court and jury will want to hear from them.
    • Witnesses have to be polite and professional, be firmly on your side, and be prepared to tell the story.
    • The danger of “I don’t recall.”
Litigation Strategy

• Tell the Court Your Plan.
  – Use status conference statement to do so.
  – Can use to get procedures you need (trial timing for example).
Litigation Strategy

• Develop and Tell a Story (cont’d)
  – Role of experts
    • Get experts early
    • Use experts to emphasize themes and legal points and to retell story by using evidence as basis for opinion
    • Can be used to beat summary judgment
  – Mock juries
    • Wise investment
    • Will learn what arguments work.
    • Will learn characteristics of good/bad jurors.
Questions?