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Drafting or Reviewing a Commercial Contract

by Practical Law Commercial Transactions
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A Practice Note discussing general drafting and negotiating concerns for use when drafting or reviewing a commercial agreement. This Note provides information on the standard elements of a commercial contract, including the preamble, recitals, definitions, term and termination, representations and warranties, indemnification, limitations on liability and miscellaneous and boilerplate provisions.

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This Note is a guide to issues to consider when drafting or reviewing a commercial agreement. It focuses on the provisions that are generally included in contracts for the supply of goods and services, but may be applicable to many types of commercial agreements. Not all commercial contracts include each of the provisions discussed in this Note. Counsel should select the provisions that are appropriate for a specific transaction.

Contract interpretation is governed by applicable state law. This Note contains information that is general and not jurisdiction-specific. All references to the UCC refer to the pre-2003 model **Uniform Commercial Code**. The UCC enacted in a particular state may be different than the model code.

Factors Influencing the Drafting and Negotiation Process

Many factors influence the process of drafting and negotiating a commercial agreement, including:

- The relationship between the parties.
- Each party's relative negotiating leverage.
- The size and scope of the transaction, including territory and whether the arrangement is exclusive or non-exclusive.
- The creditworthiness of the buyer or service recipient.
- The reputation of the seller or service provider.
- Each party's risk tolerance.
- The degree of contract standardization for the selected transaction.
- Any relevant antitrust considerations, such as vertical, horizontal and price discrimination issues.
- Which party, by role or other factors, is more likely to breach the agreement.
- The potential interplay between the agreement and other contractual arrangements, for example, compliance with loan covenants.

Before drafting or reviewing any contract, counsel should consider these factors and review all key agreed and desired deal terms with the appropriate business executives.

It is important to consider the cascading effects that making a change to one provision may have on other provisions in the agreement, and to discuss any resulting effects of a proposed change with the appropriate business executives.

For more information on negotiating commercial agreements, see *Practice Note, Contract Negotiations: Business Briefing*.

Building Blocks of a Commercial Contract

The structural components of a commercial contract are used to construct the provisions of an agreement. Contractual building blocks are used to:

- Express the fundamental terms of the contract.
- Allow each party to realize the benefits that it bargained for.
- Allocate risk between the parties.

The most common types of contractual building blocks are:

- **Representations and warranties.** A representation is an assertion of fact given by one party (the maker) to induce another party (the recipient) to enter into a contract or take other action. A warranty is a promise that the assertion of fact is true, supported by an implied promise of indemnity if the assertion is false.
- **Covenants.** A covenant, also know as an agreement, is a promise made by one party (the obligor) to another party (the

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obligee) to take or refrain from taking certain actions.
- **Rights.** A right is the inverse of a covenant. It is the benefit of the obligor's promise to act or refrain from acting that is owed to the obligee.
- **Conditions.** A condition is a fact that must be true or an event that must have occurred before a party's obligations or rights under the agreement are triggered.
- **Mutual Statements of fact.** A mutual statement of fact is a declaratory and informational statement (such as a definition or choice of law provision) that does not operate independently, but functions by clarifying, expanding or limiting the meaning of the representations and warranties, covenants, rights and conditions that relate to or incorporate the definition or other statement.

For more information on representations and warranties, covenants, rights and conditions, see *Practice Note, Representations, Warranties, Covenants, Rights and Conditions*. For more information on the relationship between each of the key contractual building blocks, see *Practice Note, Relationship between Representations, Warranties, Covenants, Rights and Conditions*. For information on how to allocate risk throughout a contract, and how changes in one provision may affect another, see *Practice Note, Risk Allocation in Commercial Contracts*.

Preamble

Commercial contracts generally begin with a description of the agreement that sets out the title, parties and effective date.

Title

For ease of identification, the title of the agreement should appear at the top of the first page, generally in bold typeface, and should reflect the type of agreement the parties are entering into.

Parties

A short description of the parties to the contract typically appears in the preamble. Ambiguity in the description of the parties may jeopardize the enforceability of the contract. For example, an incorrectly named subsidiary may not have the power to convey the assets or pay the price required by the transaction. Drafters can ensure the proper identification of parties by:

- Determining the appropriate entities, including:
  - identifying the appropriate counterparty; and
  - considering whether related parties, such as subsidiaries, parent entities or affiliates, should be included.
- Using the full legal name of each party.
- If there are multiple parties, stating whether party liability will be joint or joint and several.
- Including each party's business address and the state of incorporation of each legal entity.

Effective Date

The preamble should specify the date on which the parties intend the agreement to become effective. The parties should consider whether the agreement will become effective:

- On execution.
- As of a specified past or future date.
- On satisfaction of certain conditions.

In some agreements there are two types of effective dates. The first is usually specified in the preamble and refers to a general contract date. The second is specified in a separate provision that identifies the date on which one or more material aspects of the contractual relationship should occur (for example, the start of the term under an exclusive distribution agreement or the date a sale is expected to close).

Recitals

Recitals are an explanation of the purpose of the agreement that provide helpful background information. Drafters should avoid inconsistency and ambiguity between the recitals and the main body of the contract.

When drafting a commercial agreement:

- Determine whether or not to include recitals, and how detailed to make them.
- If including recitals, consider what they should accomplish. If the audience for the agreement consists of only the parties and their lawyers, the recitals may be brief or omitted. However, if the anticipated audience is wider, consider drafting more detailed recitals that explain the agreement's background and the parties' intent.
- Ensure that the recitals are drafted to avoid ambiguity. For example, the parties should:
  - not include language in the recitals that adds legally binding obligations or contradicts the wording contained in an operative provision of the contract;
  - ensure that facts stated in the recitals that pertain to the parties' past relationship are accurate; and
  - consider stating facts in chronological order.

Definitions

Defined terms are a crucial part of any commercial contract. They enable the drafter to:

- Tailor the meanings of certain terms to the subject of the transaction or relationship.
- Expand or limit a party's rights or obligations based on the way that certain definitions are drafted.

Definitions are also important in preventing ambiguity and inadvertent changes in the operative language of the agreement. When drafting a definitions section, identify the words or phrases that need to be defined to create clarity and prevent ambiguity in the agreement.

When drafting or negotiating a defined term, the drafter can:

- Expand or limit the dictionary meaning.
- Clarify the meaning of a specific word or term that may be ambiguous (for example, "business day").
- Explain the meaning of a technical word or phrase by listing either:
  - all of the things to which it refers; or
  - its characteristics.
- Express a concept that is specific to the transaction.

Ensure that consistency is maintained throughout the document once a term is defined. After each round of revisions, the parties should review the definitions carefully to see if any terms have been added or deleted or if any cross-references have changed.

Term and Termination

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Term and termination provisions set out:

- The length of time that a commercial agreement will last.
- The rights of one or more parties to terminate the agreement early.
- The rights and obligations of each party on or after termination.

For more information on using term and termination provisions to allocate risk when drafting or reviewing a commercial contract, see *Practice Note, Risk Allocation in Commercial Contracts*.

Term

The term provision sets out the amount of time that the agreement will govern the parties' relationship. Agreements that intend to terminate on the consummation of a one-time transaction, such as an acquisition that signs and closes simultaneously, may not require a term provision. When drafting a term provision:

- Define the length of the agreement, which may be:
  - time-based;
  - project-based; or
  - dependent on a related agreement.
- Determine whether either or both parties have the right to renew the agreement. If so:
  - include any condition to renewal;
  - determine if the renewal will be automatic or "evergreen";
  - consider how renewal rights may effect renegotiation of the agreement; and
  - decide whether to build in automatic price adjustment for renewal periods.

For more information on drafting renewal terms, see *Standard Clause, General Contract Clauses: Term and Termination: Drafting Note: Renewal*.

Termination

A termination provision allows a party to end the contractual relationship under certain circumstances. Parties often heavily negotiate termination rights because termination of a contract ends the parties' relationship entirely. Termination provisions are generally either for:

- Cause, requiring the terminating party to identify a specific breach by the other party.
- Convenience, allowing a party to terminate at any time without providing a reason to the other party.

Termination provisions should set out:

- The events or actions that trigger a party's right to terminate (for example, for material uncured breach or on the occurrence of a change of control).
- The termination procedure, including any required notice period.
- Each party's obligations on expiration or early termination, including any obligations to make a termination payment, render a final accounting or accelerate outstanding payments.

For more information on term and termination provisions, see *Standard Clause, General Contract Clauses: Term and Termination* and *Standard Document, Notice of Termination*.

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Operative Provisions

In most commercial contracts there are various operative provisions that express the parties' principal rights and obligations under the agreement. These provisions are transaction-specific. In addition to core financial and risk allocation clauses, there are various substantive provisions that address the specific operational aspects of the commercial arrangement. Examples of key operative provisions that are commonly used in supply of goods and services agreements include:

- Appointment of seller, distributor or service provider (or other similar provision addressing the parties' agreement to buy and sell goods or services), and terms relating to:
  - exclusivity; and
  - territory.
- Description of the goods or services.
- Ordering procedures.
- Project management.
- Shipment, delivery, acceptance and inspection (in a supply of goods agreement) or scheduling of deliverables (in a services agreement).
- Change orders.
- Non-financial obligations of the buyer or service recipient. For example a customer's ability to:
  - comport with editorial or marketing guidelines; or
  - maintain the condition of service provider's equipment left in the customer's possession.

When drafting and negotiating all types of operative provisions, each party should:

- Broaden or limit the scope of each clause to best support its transactional goals.
- Comprehensively draft each clause to unambiguously address its rights and the other party's obligations.
- Consider whether to include express contractual remedies for the breach of these obligations (see *Express Contractual Remedies*).

For examples of deal-specific operative provisions from selected commercial contract types, see Standard Documents:

- *Distribution Agreement (Pro-seller)*.
- *Promotion and Marketing Agreement*.
- *Equipment Lease: UCC True Lease (Pro-lessor Long Form)*.

Price and Payment

Price and payment provisions determine the key financial terms of the agreement. These sections should address the questions of who is paying what to whom, when, why and how.

Price

Pricing terms describe the fees to be paid for goods or services provided, and what the fees will be or how they are calculated. Pricing terms depend on the type of transaction. For example, in a contract for the sale of goods, pricing may:

- Be fixed for the duration of the contract.
- Be based on a formula, sometimes volume-related.
- Vary according to specified factors, like quantity or frequency of purchase.
- Be adjustable to reflect changes in seller's costs or other market factors.
- Include costs such as shipping, insurance or taxes.
- Be subject to a **most favored nations provision** that protects the buyer against paying higher prices than the seller's

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other customers. (See, *Standard Clause, General Contract Clauses: Most Favored Customer*.)

For more information on pricing terms in contracts for the sale of goods, see *Standard Clauses, General Contract Clauses: Pricing Terms (Sale of Goods, Pro-buyer)* and *General Contract Clauses: Pricing Terms (Sale of Goods, Pro-seller)*.

In a contract for the provision of services, the drafters should determine whether pricing (often referred to as fees) will be calculated on a:

- Time and materials basis.
- Fixed price basis.
- Combination of time and materials and fixed price bases.

For more information on pricing terms in services contracts, see *Standard Clauses, General Contract Clauses: Pricing Terms (Sale of Goods, Pro-seller)* and *General Contract Clauses: Pricing Terms (Services, Pro-customer)*.

Payment

Payment terms relate to how and when the customer or buyer pays the fees for the goods or services provided. Any delay or acceleration of required payments impacts each party's available cash and risk of default. Parties can shift and manage this risk by allowing payments to be either deferred or advanced.

The key subjects that payment terms should address are:

- When payment is due, including whether it is tied to a pre-determined schedule or contingent events (for example, on receipt of invoice or on completion of services).
- Any invoicing requirements.
- Invoice dispute resolution procedures.
- Method of payment (such as check or wire transfer) and currency.
- Any seller or service provider protections against late payment or non-payment, including:
  - interest charges;
  - purchase money security interest (PMSI);
  - letters of credit;
  - mandatory advances;
  - guaranties (from a larger, more secure parent or investor); or
  - surety or performance bonds.
- Whether the buyer or service recipient is allowed to set off any amounts it owes to the seller or service provider against any amounts owed to it by the other party.

For more information on drafting payment terms, see *Standard Clause, General Contract Clauses: Payment Terms*.

Representations and Warranties

Representations and warranties in commercial contracts allocate risk between the parties by:

- Apportioning exposure to potential losses and shifting risk from one party to another.
- Creating a direct claim against the maker if representations are inaccurate or warranties are breached.
- Serving as a basis for the parties' indemnification obligations.

In most commercial contracts each party makes standard representations and warranties to the other party about:

- The parties to the contract.
- The contract itself.
- The subject matter of the contract.

Either party may also make representations and warranties specifically tailored to the facts of the transaction. When drafting and reviewing a commercial contract, makers of representations and warranties should try to:

- Limit or qualify the effect of representations and warranties by:
  - narrowing their scope;
  - disclosing exceptions and adding materiality and knowledge qualifiers;
  - limiting their survival period;
  - including an anti-sandbagging clause;
  - making indemnification the exclusive remedy for inaccuracy; or
  - including contractual limitations on liability, such as caps and baskets.
- Disclaim representations and warranties that are not expressed in the written contract and include acknowledgement of non-reliance on any extra-contractual representations and warranties.
- Ensure consistency of representations and warranties with other contract provisions, especially:
  - product warranties;
  - termination rights; and
  - indemnification provisions.

Recipients of representations and warranties should:

- Maximize the effect of representations and warranties by:
  - retaining broadly worded representations and warranties and resisting those that are overly qualified or limited; and
  - negotiating a sufficient survival period.
- Resist including disclaimers and acknowledgements of non-reliance.
- Preserve the right to rely on representations and warranties known to be inaccurate by:
  - resisting inclusion of an anti-sandbagging clause; and
  - trying to include a sandbagging provision.

For more information on drafting and negotiation representations and warranties, see *Standard Clause, General Contract Clauses: Representations and Warranties*.

Product or Service Warranty

Product and service warranties are specialized provisions that combine the concepts of representations, warranties and covenants. Under *UCC Section 2-313*, a seller of goods provides an express warranty if it makes a representation or covenant that becomes part of the basis of the bargain, whether provided:

- In writing (including any description of the goods in the agreement).
- Orally.
- In the form of a sample or model.

The UCC also provides for certain implied warranties such as merchantability (*UCC Section 2-314(1)*), fitness for a particular purpose (*UCC Section 2-315*) and no-infringement (*UCC Section 2-312(3)*).

Although Article 2 of the UCC generally applies only to the sale of goods, some courts have in certain circumstances applied Article 2 principles to services contracts, including:

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- The scope of any express warranties.
- The imposition of implied warranties.
- The effectiveness of any disclaimer to limit the scope of any express or implied warranties.

Therefore, warranties included in services contracts should be drafted and negotiated in a similar manner to those included in a contract for the sale of goods.

Drafting and Negotiating Product or Service Warranties

Sellers of goods and service providers usually try to:

- Limit express warranties to specific language stated in the contract.
- Conspicuously disclaim all other warranties, including:
  - any express warranties that are not included in the agreement, such as guarantees and other language contained on a website or other documentation that could be construed as a warranty; and
  - all implied warranties.
- Expressly limit the customer's remedies for breach of product or service warranties.
- Identify any conditions precedent to the buyer's entitlement to any remedies.
- Specify any conditions that will invalidate an express warranty, such as failure to give timely notice.

Buyers try to limit their risk exposure by negotiating a broader product or service warranty, for example by:

- Negotiating more comprehensive warranties (for example, by including requirements that goods conform to product specifications).
- Including express warranties, such as:
  - fitness for a particular purpose;
  - merchantability;
  - non-infringement;
  - accuracy; or
  - completeness.
- Providing third-party beneficiary rights for the buyer's successors in interest and customers.

For more information on drafting and negotiating express and implied warranties, see *Practice Notes, UCC Article 2 Express Warranties* and *UCC Article 2 Implied Warranties*.

Express Contractual Remedies

In addition to setting out the terms of the parties' relationship, commercial contracts include provisions that work together to address remedies available if a party fails to fully perform. When contemplating the remedial scheme in an agreement, parties should consider:

- The interaction of operational provisions with remedial provisions.
- The effect of any express contractual provisions on the parties' statutory and common law remedies.

In many commercial contracts, the provisions forming the overall remedial structure address:

- Indemnification obligations (see, *Indemnification*).
- Termination rights (see, *Termination Rights*).

- Limitations of liability (see, *Limitation of Liability*).
- The availability of remedies (see, *Availability of Remedies*).
- The consistency of remedial provisions with other contract provisions (see, *Consistency of Remedial Provisions*).

Indemnification

An indemnity provision is an express agreement by one party to compensate another party for agreed costs and expenses. It often includes a duty to defend and hold the indemnified party harmless. Although indemnity may be implied by state law, most commercial agreements contain an express indemnification provision so that the parties can customize their indemnification rights and obligations.

These provisions are used primarily as risk-shifting tools and are designed to address liability between the contracting parties for third-party claims, although they may also be drafted to cover direct claims between the parties.

If the contract contains mutual indemnification obligations, each party should consider whether it is more likely to be the indemnitor or indemnitee and craft these provisions accordingly.

For more information on drafting and negotiating indemnification provisions, see *Practice Note, Indemnification Clauses in Commercial Contracts* and *Standard Clause, General Contract Clauses: Indemnification.*

Defining the Indemnification Obligation and the Indemnified Persons

When defining the indemnification obligation, parties must consider whether it should:

- Be unilateral, mutual or contain separately defined reciprocal provisions, which may include different rights and obligations.
- Include the obligations to defend and hold harmless.
- Only benefit the opposing contractual party or extend to nonparties to the agreement such as the opposing party's:
  - employees, officers and directors;
  - affiliates;
  - representatives; and
  - customers.

Defining the Scope of Recoverable Losses and Indemnifiable Events

When defining the scope of recoverable losses, parties should address whether:

- They are limited to losses from third-party claims or also include direct claims between the parties.
- They are limited to actual losses or include unpaid liabilities.
- They include losses from alleged wrongdoing or only actual adjudicated wrongdoing.
- If there is no duty to defend, attorneys' fees are covered.

Consider the nexus phrase used to dictate the required relationship between the triggering event and an indemnified party's ability to recover damages. The nexus phrase may be limiting ("losses solely resulting from the indemnifiable event") or broad ("all losses relating to the indemnifiable event").

Many covered events arise from or relate to the indemnifying party's:

- Breach of:
  - representations and warranties; and

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  - covenants.
- Infringement of intellectual property.
- Acts or omissions.
- Failure to comply with law.

Parties should also consider how to narrow the scope of indemnification, for example, by:

- Specifying exceptions to indemnification coverage, including losses resulting from a party's:
  - gross negligence or willful misconduct;
  - failure to mitigate losses; or
  - acts or omissions.
- Including contractual limitations on liability (see *Limitation of Liability*).
- Negotiating materiality and other indemnification qualifiers.
- Including a contractual statute of limitations for indemnity claims.

Parties should also consider whether these limitations will impact an existing defense obligation.

Establishing an Indemnification Procedure

Indemnification procedures should address:

- The process for delivering notice of claims.
- Control of litigation resulting from indemnified third-party claims.
- The required cooperation of indemnified parties.

For more information on drafting and negotiating indemnification provisions, see *Standard Clause, General Contract Clauses: Indemnification*.

Termination Rights

Termination provisions often grant parties the right to terminate the agreement as a remedy for, among other things:

- Inaccurate representations and warranties.
- Uncured covenant breaches.
- Unsatisfied conditions.
- A party's insolvency.
- A change of control of a party.

Parties should draft any other remedial provisions of the agreement consistently with these rights. For more information on termination provisions, see *Termination*.

Limitation of Liability

Many commercial contracts include limitation of liability clauses to circumscribe the scope and magnitude of the parties' contractual liabilities. Limitation of liability provisions are important risk allocation tools and are therefore often extensively negotiated.

Most limitation of liability provisions include a waiver of indirect damages and a liability cap.

The scope of a limitation of liability provision varies depending on the type of transaction and a party's role in the transaction. Parties should tailor a limitation of liability clause to meet their needs. For example, limitation of liability provisions can apply to:

- The contract as a whole.
- Only specific contract terms.
- Individual transactions.
- One or all parties to the agreement.

Waiver of Indirect Damages
Many limitation of liability provisions limit the scope of recoverable damages to direct damages, excluding indirect damages such as:

- Consequential damages.
- Incidental damages.
- Special damages.
- Punitive damages.

Parties often subject the waiver of indirect damages to carve-outs for fraud, intentional or reckless misconduct or a party's indemnification obligations relating to third-party claims. The parties should also consider that lost revenues or profits and diminution in value may be deemed direct damages. Therefore, by including them in a waiver of indirect damages provision the parties may inadvertently exclude some direct damages.

Liability Cap
A liability cap, also know as a maximum liability provision, is a clause that limits a party's maximum liability for all damages relating to the contract to:

- A flat dollar amount.
- Multiple fees paid or payable under the contract.
- A percentage of fees paid or payable under the contract.

A party may wish to carve out certain exceptions from the limitation of liability clause. For example, a customer in a sale of goods transaction may wish to expressly exclude certain cost-sensitive obligations of the seller (such as indemnity) to off-set the liability cap on the amount of direct damages it may receive from the seller.

For more information on drafting limitation of liability clauses, see *Standard Clause, General Contract Clauses: Limitation of Liability*.

Availability of Remedies
To fully articulate the remedies available to parties to a commercial contract, many agreements limit or extend the scope of contractual and judicial remedies that apply to the contractual relationship. To achieve these goals, parties often include a combination of the following provisions.

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Cumulative Remedies
A cumulative remedies clause states the parties' intention that the rights and remedies set out in the agreement are in addition to any implied rights or remedies provided by law or equity, and not in substitution for them.

For more information on cumulative remedies clauses, see *Standard Clause, General Contract Clauses: Cumulative Remedies (with Exclusive Remedies Carve-out)*.

Equitable Remedies
An equitable remedies clause states the parties' intention that monetary relief is inadequate to fully compensate either or both parties for losses suffered due to breach of the agreement by the other party. It grants the non-breaching party the right to obtain equitable remedies such as specific performance or an injunction in addition to any remedies available at law.

For more information on equitable remedies, see:

- *Practice Note, Contracts: Equitable Remedies*.
- *Standard Clauses, General Contract Clauses: Equitable Remedies*.
- *Standard Clauses, General Contract Clauses: No Equitable Relief*.

Liquidated Damages
A liquidated damages clause requires the breaching party to pay a pre-determined fixed amount or an amount based on a pre-determined formula to the non-breaching party as exclusive compensation for the breaching party's failure to perform a specific task or comply with a particular obligation. Parties typically negotiate a liquidated damages clause where it may be difficult to estimate the damages that the non-breaching party would suffer if a specific term is breached (for example, a seller's obligation to make timely delivery of goods in a sale of goods agreement).

For more information on drafting liquidated damages provisions, see *Standard Clause, General Contract Clauses: Liquidated Damages*.

Sole Remedy
A sole remedy provision states that a particular remedial clause is the only remedy available to an aggrieved party. For an example of a sole remedy provision, see *Standard Document, Manufacturing Supply Agreement (Pro-seller): Section 10.5*.

Choice of Law
Choice of law provisions allow the parties to select the substantive law of an appropriate state to apply to the contract and, if drafted more broadly, to extra-contractual matters such as tort, fraud and statutory claims that relate to the contract.

For more information on drafting choice of law provisions, see *Practice Note, Choice of Law and Choice of Forum: Key Issues* and *Standard Clause, General Contract Clauses: Choice of Law*.

Choice of Forum

Choice of forum provisions express the parties' intention to confer personal jurisdiction on a specified state or federal court to adjudicate disputes that arise under the contract.

For more information on drafting choice of forum provisions, see *General Contract Clauses: Choice of Forum*.

Entire Agreement

An entire agreement clause, also known as a merger or integration clause, expresses the parties' intention that the agreement is final and integrates all previous negotiations, representations and warranties.

For more information on drafting entire agreement clauses, see *Standard Clause, General Contract Clauses: Entire Agreement*.

Waiver

Waiver provisions affirm that:

- Waiver of a right must be in writing.
- Delay in exercising a right is not a waiver of that right.
- Waiver of one right does not serve as a waiver of other rights.

For more information on drafting waiver provisions, see *Standard Clause, General Contract Clauses: Waivers*.

Consistency of Remedial Provisions

Counsel should consider an agreement's remedial provisions together with other contract terms to ensure consistency and avoid ambiguity. Where needed, parties should carve out exceptions for conflicting contract provisions. Carve-outs may be needed for certain types of losses or obligations, including for example:

- Indemnification obligations.
- Intellectual property breaches.
- Confidentiality breaches.
- Losses due to gross negligence or willful misconduct.
- Liabilities that one party has assumed, for example, liability for pending litigation.

Intellectual Property Rights

Many commercial agreements involve the use or development of **intellectual property** (IP). These agreements generally include specific, heavily negotiated provisions governing the ownership, use and protection of IP rights.

The main areas to consider when drafting an IP provision are:

- Which party owns the applicable IP rights (including if they are jointly owned).
- Each party's rights to use the other party's IP rights.
- Any obligations related to the use of the other party's IP rights.

Ownership of IP Rights

In certain types of services and supply of goods arrangements (for example, in software development agreements and manufacturing agreements), one or both parties uses its IP to create the goods or perform the services. In addition, one or both parties may develop new IP under the contractual relationship, whether or not it is incorporated into products or deliverables. The parties negotiate ownership of these rights, often distinguishing between:

- **Background IP rights.** Background IP rights pertain to IP that is used in the performance of the transaction, but was developed before and separate from the contractual relationship. Depending on their negotiating leverage, most parties stipulate that they will retain exclusive ownership of all background IP rights.
- **Foreground IP rights.** Foreground IP rights pertain to IP that is developed under the contractual relationship. Provisions allocating ownership of IP rights vary based on the circumstances of the transaction and the negotiating leverage of the parties. When drafting or negotiating foreground IP ownership rights, parties should consider:
  - the nature of the goods or service deliverables, and whether they are unique or if they are standardized goods or products (often referred to as "off-the-shelf") that are sold generally to many customers; and
  - each party's anticipated future use of the newly-developed IP.

In addition to designating IP ownership, when one party is developing any foreground IP for ownership by the other party, the agreement should also address whether:

- The creator is merely assigning the foreground IP rights to the other party or if the foreground IP rights are being created as a **work made for hire** for the other party.
- There are any carve-outs from the IP being assigned or created as a work made for hire, which the creator or other third party is merely licensing to the owner for this particular product or deliverable.

Use of IP Rights

When either party is given the right to use the other party's IP rights, the contract should address the terms applicable to the use of the other party's rights. The scope and nature of these terms depends on:

- The type of commercial arrangement, including the nature of the product or deliverables.
- The extent to which each party requires use of the other party's IP.
- Each party's bargaining leverage.

For example, in a manufacturing agreement for the seller's off-the-shelf goods, the buyer only needs to have the right re-sell the goods or incorporate them into another product, which does not require a significant IP grant. However, in a distribution agreement, the buyer may require the right to use the seller's **trademark** for advertising and marketing purposes. Therefore, distribution agreements often include a trademark license (see, for example, *Standard Document, Distribution Agreement (Pro-seller): Section 13*.

When drafting or negotiating an IP license agreement, the parties should consider:

- The beneficiaries of the license (for example, whether it is limited to the buyer or customer, or whether it is sub-licensable to its affiliates or downstream customers).
- The license term, and whether it is perpetual or for a specific time period.
- Whether it is exclusive or non-exclusive.
- Whether any license fees or royalties are payable.
- Its geographic scope.
- Any limitations on use.
- Other user obligations (for example, obligations to protect the IP and to assign goodwill derived from the use of the covered rights).
- The user or licensee's indemnification rights for third-party claims of infringement.

For an example of an IP provision in a services contract, see *Standard Document, Professional Services Agreement: Section 8*.

For an example of an IP provision in a contract for the sale of goods, see *Standard Document, Manufacturing Supply Agreement (Pro-seller): Section 12*.

For an overview of the various types of IP rights arising under US law, see *Practice Note, Intellectual Property: Overview*.

Confidentiality

Confidential information is often exchanged by contracting parties while negotiating and performing under the contract. Disclosing parties generally want to protect their confidential information by restricting the disclosure and use of the information by the receiving party.

Confidentiality obligations can be mutual or unilateral and can be set out in:

- Free-standing confidentiality agreements (also called nondisclosure agreements or NDAs).
- Provisions in agreements that cover larger transactions.

Parties to commercial agreements often include confidentiality provisions even where the parties previously entered into a separate confidentiality agreement during the negotiation phase of the transaction. The confidentiality clause should state whether it supersedes the pre-contractual NDA.

A confidentiality provision should:

- Define confidential information under the agreement, including any exceptions to that definition (such as for information in the public domain or information that is independently developed).
- Specify the obligations of the receiving party, including those related to:
  - non-disclosure of confidential information, including any exceptions (such as to affiliates and representatives or to comply with legal requirements);
  - treatment and care of confidential information; and
  - use of confidential information (for example, solely for exercising rights and performing under the agreement).
- Include instructions for the destruction or return of confidential information (see, for example, *Standard Clause, General Contract Clauses: Confidentiality (Short Form): Return or Destruction of Confidential Information*), including:
  - when the obligation is triggered (automatically or at the discloser's request);
  - whether the confidential information must be returned or destroyed, and at which party's discretion;
  - any time frames for compliance; and
  - any rights to retain any confidential information, and on what terms.
- Provide equitable remedies for breach of the confidentiality provision (if not provided for elsewhere in the agreement).

For more information on the protection of confidential information see *Practice Note, Confidentiality and Nondisclosure Agreements*. For more information on drafting and negotiating confidentiality provisions in commercial contracts, see *Standard Clause, General Contract Clauses: Confidentiality (Short Form)*.

Audit and Inspection Rights

Audit and inspection rights provide the parties to a contract with access to each other's facilities, books, records and

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inventory that are related to the subject matter of the transaction.

Right to Audit Books and Records

Audit rights allow the holder of the rights to ensure that the counterparty remains in compliance with the terms of the agreement. Depending on the type of transaction contemplated by the agreement, they permit the counterparty to determine:

- Accuracy of payments.
- Accuracy of pricing.
- Compliance with exclusivity provisions.
- Compliance with recordkeeping obligations, particularly if the parties are subject to the **Sarbanes-Oxley Act of 2002**.
- If goods or materials are being used according to the terms of the agreement.

Right to Inspect Premises

Some commercial agreements address inspection rights, sometimes called access rights, in addition to or instead of, audit rights. Inspection rights are often included in supply and distribution agreements, for example if the supplier wants the ability to inspect or have access to:

- Products in the buyer or reseller's inventory.
- Retail stores where the supplier's goods may be sold.
- Materials needed to fulfill the obligations contained in the agreement.

The buyer may also include inspection rights to access its own inventory of parts or finished goods stored on the supplier's premises.

Drafting and Negotiating Audit or Inspection Provisions

If audit or inspection rights are acceptable in the transaction's context, the parties should negotiate:

- The books, records, files and products that are subject to audit or inspection.
- The period of time during which the books, records and files must be maintained for auditing.
- The frequency of the auditing party's right to conduct physical inspection of the materials.
- How the audit must be conducted.

The party subject to the audits and inspections should insist that the rights be subject to reasonable limitations, for example by:

- Negotiating meaningful notice rights.
- Limiting the frequency of the counterparty's right to conduct physical inspections.
- Requiring that audits and inspections be conducted on business days.
- Obtaining a reciprocal right to audit the counterparty's operations.
- Requiring that audited information be kept confidential according to the agreement's confidentiality provision.

For an example of how audit and inspection rights are used in a product reseller agreement, see *Standard Document, Product Reseller Agreement (Pro-supplier): Section 14*.

For an example of how audit rights are used in a services agreement, see *Standard Document, Professional Services Agreement: Records; Audit*.

For an example of how access rights are used in a promotional marketing agreement, see *Standard Document, Promotion and Marketing Agreement: Provision of and Access to Client Materials*.

Insurance

Although most companies maintain basic levels of insurance in the ordinary course of business, parties may need to obtain additional coverage to cover transaction-related liabilities. Some commercial contracts include covenants requiring one or both parties to maintain specific levels of insurance coverage to:

- Mitigate an obligor's financial exposure to the risk of a specified liability by shifting the risk to an insurer.
- Limit an obligee's risk that the obligor does not have the financial capacity to cover its financial liabilities under the contract.

The type and level of insurance coverage generally depends on the parties and the nature of the transaction. Some insurance covenants are general, simply affirming that the party has and will continue to have sufficient insurance coverage to cover its contractual liabilities. Other insurance covenants specify the type of coverage a party agrees to maintain.

Negotiating expanded coverage with an insurer can complicate a transaction. When contemplating the inclusion of an insurance covenant, parties should consult with risk management and insurance specialists to assess:

- The need for deal-related insurance coverage beyond existing coverage.
- The scope of acceptable contractual insurance obligations for each party.
- The optimal and minimal contractual insurance requirements for the counterparty.
- Whether the covenant should be mutual or unilateral.

Determining the Scope of an Insurance Covenant

When drafting an insurance covenant, the parties should address:

- The period of time during which the insuring party must maintain insurance coverage.
- The type or types of coverage required, in addition to commercial liability.
- Which insurance companies may issue the policies, either by naming the companies or requiring companies with a specific rating from a corporate rating agency.
- For each policy required by the provision, the minimum amount of coverage acceptable for each occurrence and the aggregate amount.
- Whether the insured party must:
  - provide the obligee with evidence of insurance;
  - designate an obligee as an additional insured on the policy; and
  - notify the obligee within a specified period of time if there is a cancellation or material change in its insurance policy.
- Exclusions for self-insurance.
- Requirements for waiver of subrogation rights.

For information on drafting insurance covenants, see *Standard Clause, General Contract Clauses: Insurance Covenant (Sale of Goods)*. For more information on insurance policies and coverage, see *Practice Note, Insurance Policies and Coverage: Overview*.

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Dispute Resolution

Many commercial contracts address dispute resolution mechanisms. The consequences of omitting a dispute resolution clause, or including one that is ambiguous, can result in expensive and time consuming arbitration or court proceedings. Dispute resolution options range from simple to complex and the choice of which clauses to use depends on the type of transaction contemplated by the agreement and the parties' relationship.

Escalation Clauses

Some contract provisions attempt to resolve disputes without resulting to litigation or **arbitration** by implementing a series of steps that parties must take before pursuing a binding form of dispute resolution. This type of provision, sometimes referred to as an escalation clause, can:

- Provide the opportunity to resolve disputes in a less adversarial setting.
- Preserve ongoing commercial relationships.
- Save significant amounts of time and money.

In addition, the possibility of arbitration or litigation can incentivize parties to reach an amicable arrangement.

A typical escalation clause might require parties attempting to resolve a dispute to take the following steps:

- First, refer the dispute to specified operational executives.
- If the matter cannot be settled by the operational executives, submit the dispute to specified senior executives.
- If the dispute cannot be settled by the senior executives, it may be subject to **mediation**.
- If all previous steps fail to resolve the dispute, then the parties may engage in binding litigation or arbitration.

For an example of an escalation clause in a distribution agreement, see *Standard Document, Distribution Agreement (Pro-seller): Section 21.18*.

Arbitration

In some instances, parties waive the right to sue each other and agree to submit disputes that arise under the contract to binding arbitration.

Drafting arbitration clauses often requires specialist advice and the requirements tend to be transaction-specific. There are various arbitral institutions to choose from, and the choice of seat, the number of arbitrators and the language together with a suitable choice of governing law must be appropriate to the situation.

For more information on drafting arbitration clauses, see *Standard Clauses, Standard Arbitration Clauses for the AAA, ICDR, ICC and UNCITRAL*.

Parties should carefully consider the pros and cons of litigation and arbitration before committing to one or the other. For more information on the advantages of each mechanism, see *Practice Note, Avoiding and Managing Commercial Disputes in the US: Overview: Arbitration Versus Litigation*.

Miscellaneous and Boilerplate

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All commercial contracts contain various miscellaneous clauses, sometimes referred to as boilerplate. Although these clauses are often not controversial and are generally non-substantive, they have significant practical and legal implications. Counsel should draft them narrowly to suit the needs of the agreement. Examples of these clauses include:

- Amendment and Modification (see *General Contract Clauses: Amendments*).
- Assignment (see *General Contract Clauses: Assignment and Delegation*).
- Force Majeure (see *General Contract Clauses: Force Majeure*).

For more information on miscellaneous and standard clauses, see *General Contract Clauses Toolkit* and *Standard Clauses, Boilerplate Clauses*.

Signatures

Signatures are not always required to create a binding contract. However, counsel should include signature blocks in commercial contracts to avoid unintentional consequences that may result from a failure to include the appropriate information. For example, an individual who signs a contract may unintentionally incur personal liability if they fail to include the name of the corporation that was intended as the obligor to the contract.

At a minimum, the signature block for each party should include:

- The full legal name of the party.
- The signature of the individual signing on behalf of the party.
- The printed name of the individual signing on behalf of the party.
- The title of the individual signing on behalf of the party.

Parties should also consider including:

- The business address of each party.
- The date on which each individual signs the contract.

Many commercial contracts are governed by state law Statute of Frauds or the UCC and must be in writing and signed to be enforceable (see *Practice Note, Signature Requirements for an Enforceable Contract*.)

Attachments

Many commercial agreements reference various external documents that are related to the agreement. These documents often play a role in governing the parties' relationship and form a part of the contract itself. Attachments typically consist of schedules and exhibits. Counsel should ensure that any documents referenced in the agreement are physically attached to the end of the agreement.

Schedules

Schedules are usually attachments that require a party to list certain information or facts. Examples of documents that may be attached as schedules include:

- A schedule of goods.
- A trademark list.
- Countries included in the territory.

- Exceptions to representations and warranties.

Exhibits

Exhibits usually contain:

- Copies of existing documents or illustrations.
- Forms of ancillary or supplementary agreements.
- Additional contractual provisions that may only apply under certain circumstances.

Examples of documents that may be attached as exhibits include:

- Specifications.
- Trademark policies.
- A form of confidentiality agreement for auditors.

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