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Contracts 101

The "One-Page" Contract

Every lawyer, usually early in their career, comes face to face with the client who wants the *almost* impossible. Once upon a time, the CEO of a small technology outsourcer, who had already built a strong business using a rudimentary contract template, asked his legal counsel to redraft his "standard" contract. The encounter went something like this:

CEO: Now don't do anything fancy with this old agreement that we've been using. It's about 2 pages right now, and I'd like to get it down to one.

Young Lawyer (most anxious to help): What are the really important points that we should include in your new standard contract?

CEO: Well, we should tell the customer what we're going to do for them – process their data – and the price that we'll charge them. That's about it, I guess.

Thus, the quest for the elusive one-page contract begins.

Introductory Short Course

A contract is the legally enforceable obligation formed between parties when an offer is made, there is an acceptance of that offer and there is sufficient consideration to support the creation of the obligation. Offer, acceptance and consideration, these are the bare bones requirements for the formation of a contract. An offer must be definite and certain. The acceptance must be clear agreement to the offer's terms. There must be a bargained-for exchange among parties – the consideration.

A contract can be made in several ways. The most familiar is in a writing that evidences the agreements of the parties and their intent to be legally bound by them. Of course, contracts can also be formed by oral exchanges, by a single act or by a course of dealing among parties.

There are basically 2 kinds of contracts: A unilateral contract in which one party asks that the other party do some act in exchange for the stated consideration (often the payment of money). A classic example is the request of the boy next door, “Mow my grass, and I’ll pay you \$20.” The contract is formed when the boy mows the grass. A bilateral contract – the kind that typically exists in both technology licensing and outsourcing agreements – is formed when parties exchange promises (usually a promise to do something followed by a promise to pay).

Contracts are interpreted using principles set forth (1) in the *common law* – that set of legal principles exported by England to its American Colonies and then refined by their application here in court to real cases – and (2) in statutes, like the Uniform Commercial Code (applicable to the sale of goods). When parties (and their lawyers) either intentionally or unintentionally leave an interstice¹ in their contract, as long as they have included the essential elements to form a contract, the law will “do the rest.”

Drafting Approaches

There are really only 3 ways to approach the drafting of any contract. First, include only the minimum elements – offer, acceptance and consideration – and leave the rest to interpretation. Second, leave no stone unturned; and throw in everything, including the kitchen sink. Finally, carefully craft a contract that meets the parties’ needs; rely upon well-established legal principles rather than additional contract language where both accomplish the same end.

“Be Clear, Be Concise, Be Complete”

Ideally, every provision in a contract – other than those establishing the elements that are essential to contract formation – should serve at least one of 3 purposes: Vary the rule that the law would otherwise supply (*e.g.*, the law is likely to supply a *reasonable* time for performance if no other time for performance is specified in the contract). Establish a specific rule for a contract that the law might not otherwise imply (*e.g.*, one party indemnifies the other for claims made by third parties). Clarify law that is otherwise uncertain (*e.g.*, identify the state law that is to be used in interpreting and enforcing the contract because the facts do not clearly demonstrate a single jurisdiction in which the contract was made).²

The drafting of a “good” contract is an art form to which many aspire and that few practice. No doubt there is tension between being concise and being complete – 2 of the 3 simple rules toward drafting better contracts.

RECENT CLIENT NEWSLETTERS

Last month’s client newsletter “C³=The Right Word” provides 3 simple rules toward drafting better contracts

“Secrets of the Code”, the April 2005 newsletter explores the nature of source code and the risks inherent in its distribution in a proprietary business model.

The March 2005 newsletter presented the “dark side” of arbitration and suggested a mediation alternative that provides a viable alternative dispute resolution (ADR) mechanism that preserves the elements that distinguish the U.S. legal system.

Client newsletters are available at <http://www.carpenterlaw.net/newsletters/archivednewsletters.html>.

¹ An “interstice” is nothing more than a small omission in a contract. Small in the sense that the law will not make a contract where one does not exist; but it will supply from other sources terms that are necessary, consistent with public policy, to effect the intent of parties that have already formed a contract.

² Sometimes a party wants to set forth a legal rule because it does not know what the applicable law would require. While this may be a “safe bet,” it not only adds volume and complexity to a contract, but also may be confusing because of a conflict between what is written in the agreement and what the statutory and common law and public policy permit.

Applicable State Law

Here's an example of a technology contract provision that has been used for many years: "Customer may not assert any cause of action against Company of which the Customer knew or should have known more than two years prior to such assertion." This kind of qualitative limitation is often used in all sorts of contracts. It is clear, concise and complete; but is it enforceable? Does the applicable state law already provide the desirable statute of limitations for actions under the contract? The contract from which this claims limitation was taken provides that the laws of the State of Texas will govern its interpretation.

This is a thoughtful and informed provision. Company sought to vary the rule that Texas statutes would impose on limitations of actions based on contract claims, generally 4 years,³ and has chosen an alternative limitation that complies with applicable Texas law, which says,

Except as provided by Subsection (b) [which excludes the sale of certain businesses], a person may not enter a stipulation, contract, or agreement that purports to limit the time in which to bring suit on the stipulation, contract, or agreement to a period shorter than two years. A stipulation, contract, or agreement that establishes a limitations period that is shorter than two years is void in this state.⁴

If a company were to scale this limitations period back from the permitted 2 years, then that provision would be void and a claim could be made within 4 years from the date the claim accrued. Other states have similar rules governing the time by which claims must be brought before they are barred. Florida, for instance, prohibits such a provision from narrowing the statute of limitations to less than 5 years, so the same provision would be void under Florida law.⁵

In many situations, choosing an applicable law with well-developed and fair rules for commercial contracts will accomplish the objectives of being concise but yet complete, as well as offering desirable clarity.

Duplicative Agreements

Contracting parties can always agree to change the terms of their relationship. One of the most familiar additions to an outsourcing contract is an informal dispute resolution procedure in which the parties are legally bound to follow a prescribed procedure prior to filing a formal claim in court or a demand for arbitration (depending upon the contract's dispute resolution provisions). While it may seem like a good idea at the time to specify an informal procedure to resolve disputes, the law that will be used to interpret the parties' intent may well prevent, under certain circumstances, the formal filing of any claim.

Which purpose is being served by the inclusion of this informal procedure – *vary, establish or clarify*? Most likely, none of them is. (This is probably an example of the "kitchen sink" approach.) Parties to a contract can always talk and attempt a post-dispute informal resolution by any means that might work, no need to write this into the contract. By including a dispute escalation requirement, the result may well be an unintended one: The claiming party is barred from a formal forum, be it court or

³ See TEX. CIV. PRAC. & REM. CODE § 16.051 (Vernon 2007) available at <http://tlo2.tlc.state.tx.us/statutes/docs/CP/content/htm/cp.002.00.000016.00.htm#16.051.00>.

⁴ TEX. CIV. PRAC. & REM. CODE § 16.070(a) (Vernon 2007) available at <http://tlo2.tlc.state.tx.us/statutes/docs/CP/content/htm/cp.002.00.000016.00.htm#16.070.00>.

⁵ FLA. STAT. §§ 95.03, 95.11 (2007) available at http://www.flsenate.gov/Statutes/index.cfm?App_mode=Display_Statute&URL=Ch0095/ch0095.htm.

arbitration, because it failed to strictly follow the informal dispute resolution mechanism requirements; and its claim is now too old to start over again, this time correctly.

Best Practices

#1 Before you include any provision in your contract, know why it should be there. Is it an essential element to contract formation, or does it serve one of the 3 more esoteric purposes? Include only provisions that will achieve your objectives; that is, those that will vary the law applicable to the contract in a way that you intend, establish a rule that would not otherwise exist based on applicable law or clarify a rule of law that is not well-settled.

#2 To avoid unintended consequences, “know” the law that is applicable to the interpretation and enforcement of any contract to which you are a party – know not only which state’s law applies (and if any federal law might also apply), but also how it might substantively affect the agreements that you have reached with the other party.

#3 Insist that your contract be as clear, concise and complete as it can be. If you are not sure of what it means before you begin a legal relationship, you will never be sure.

OFFSHORE OUTSOURCING REVISITED

The November 2004 client newsletter called offshore outsourcing something that was “impossible to avoid or prevent” and “certain to happen.” And, in fact, outsourcing in all its forms has gained in popularity as companies respond to ever increasing competitive pressures.

Notwithstanding this, however, a recent survey – which notes the forward march of outsourcing – reports that outsourcing agreements in general are failing to achieve expected cost reductions, lack transparency and pose unforeseen risks to intellectual property and data security. These problems are most likely exacerbated in offshore arrangements.

This makes the November advice even more relevant to today’s arrangements:

The community-based financial institution that carefully chooses a vendor based upon a thorough due diligence, closely monitors the vendor’s use of offshore capabilities (including less risky and more direct foreign arrangements) and holds the vendor strictly accountable for its acts and those of its subcontractors can reduce risk in “indirect third party” offshoring.

The November 2004 client newsletter is available at http://www.carpenterlaw.net/images/Offshore_Outsourcing_Nov.2004_2007.pdf.

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