How to Draft Your First (or Next) Contract: Allocating Risks & Minimizing Client Liability

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November 2, 2026

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Overview of Presentation – Allocating Risk in Written Contracts

This presentation will address common issues related to allocating risk in a written contract, including typical risk allocation mechanisms and related practical considerations that might prove useful the next time you need to draft or update a written contract.

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Threshold Issue: What are the Risks?

What can go wrong for my client [in this transaction?] [in this relationship?]

- **What if my client fails to perform?**
- **What if the counter-party fails to perform?**
- **What if circumstances beyond either party's control render performance impossible?**
- **What if the value of performance or the specified consideration changes materially?**

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TYPE OF CONTRACT	EXAMPLES OF TYPICAL RISKS PRESENTED
Settlement Agreement	Non-performance/breach (payment etc.) Third-party claims or continued liability Public disclosure / reputational impact
Sale of Goods (UCC)	Defects Non-performance/breach (payment / delivery) Market risk – widgets go up; widgets go down
Services Contracts	Litigation / third-party claims Upfront investment of capital / resources
IP or Manufacturing Agreements	IP theft Litigation
Real Estate Contracts (e.g., Purchase Agreements)	Non-performance/breach Defects Third-party claims / liability
Employment Agreements	IP Theft Confidential information
Loans / Promissory Notes / Installment Contracts	Non-performance / breach (market vs. non-market) Title defects if collateral is pledged

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Typical Strategies to Allocate or Reduce Risk

1. Insurance
2. Force Majeure Clause
3. Representations, Warranties, and Covenants
4. Deposits / Collateral / Guarantors (Risks of Non-Payment)
5. Liquidated Damages Provisions
6. Remedy/Liability Limitations – e.g., Special Damages
7. Indemnification Provisions
8. Escrow Agents / Trusted (and Solvent) Third-Party Intermediaries
9. Other – The Product of Creative and Thoughtful Lawyers

Insurance as a Risk Allocation/Management Tool

- **By far and away, insurance is the most useful and common way to manage risks arising from commercial dealings**

- **Commercial contracts often include insurance requirements to protect the parties (*e.g.*, construction agreements, services agreements, etc.)**

- **While there is no general "breach of contract" insurance, there are many insurance products that cover losses arising from a circumstance, action, or event, that would otherwise constitute a breach of contract**

Insurance Requirements – Practical Considerations

- **Is the subject of the contract insurable and, if so, should my client be requiring the counter-party to maintain insurance that shifts risk from the parties to the insurer?**
- **What type(s) of insurance should be required and included in the insurance covenants? A well drafted insurance covenant will specify types of insurance that are tailored to the actual risks arising from the contract.**
  - **Commercial general liability**
  - **Errors and omissions**
  - **Cyber-security / data breach**
  - **Automobile**
- **Should the insurance requirement be a covenant, or a condition precedent to contract formation upon delivering proof of compliance?**

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Insurance Requirements – More Practical Considerations

- How much coverage should be required? Consider whether the insurance covenant should specify a minimum coverage requirement or instead impose a more general standard if the liability risk is difficult to measure or approximate (e.g., a "commercially reasonable amount of insurance").
- Should the insurance covenant require the counter party to add your client(s) or any other interested or related persons as additional or named insureds?
- Should the insurance covenant provide your client rights to control the insurance policy in question, including, for example, rights to communicate with and/or receive any notices from the insurance carrier directly?

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Insurance Requirements – Still More Practical Considerations

- **Is the subject of the contract insurable and, if so, should my client be requiring the counter-party to maintain insurance that shifts risk from the parties to the insurer?**
- **What type(s) of insurance should be required and included in the insurance covenants? A well drafted insurance covenant will specify types of insurance that are tailored to the actual risks arising from the contract.**
  - **Commercial general liability**
  - **Workers' compensation and employer liability**
  - **Errors and omissions**
  - **Cyber-security / data breach**
  - **Automobile**

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Force Majeure Clauses

- **Permitted by both the UCC and the Restatement (Second) of Contracts**
- **Excuses delinquent or non-performance for reasons outside a party's reasonable control (e.g., weather, fire, "acts of God," terrorist attack, war, labor strike, acts of government)**
  - **The parties may define the scope of the clause and what attendant rights and obligations exist if the clause is ever triggered**
- **If your client is doing the heavy lifting under the contract, then you want a broad force majeure clause; the opposite is true if your client is paying for or relying upon the other party's specific performance.**
- **The clause often requires the party seeking to invoke the provision to: (1) provide notice in writing of the event within a specified period, and (2) to use reasonable or best efforts to limit its impact on performance.**

Force Majeure vs. “Impracticability”

- **Force Majeure Clauses may be superfluous in some jurisdictions that already excuse performance when it becomes “impracticable.”**
- **UCC § 2-615 and Section 261 of the Restatement (Second) of Contracts excuse a party from performing when such performance is made impracticable *solely* due to the occurrence, or nonoccurrence, of an event where the parties relied upon the basic assumption that the event would or would not occur when forming their contract.**
- **If your client expects performance despite the occurrence or nonoccurrence of certain events beyond the counter-party’s reasonable control, then you should consider saying so expressly in the contract to avoid later disputes about the application of the impracticability doctrine.**

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Force Majeure Clause – Sample Language

“Neither party shall be held responsible or otherwise remain strictly obligated to perform under this contract if such performance would become unduly burdensome as a result of war, weather, strikes, lockouts, fires, acts of God, acts of terrorism, or any other superseding event or occurrence beyond its reasonable control.”

Your client may desire to add reference to other specific risks or events beyond its control that could materially impact the underlying assumptions and value of the contract, such as market fluctuations, cyber-security threats or hacks, or bankruptcy / material breach by a critical supplier or intermediary.

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Representations, Warranties, and Covenants

- **Representations, Warranties, and Covenants are commonly used to shift risks to a particular party, even if the subject of the rep/warranty/covenant is outside the control of either party.**
- **A specific representation, warranty, or covenant can operate as a practical counter to a "force majeure" or "impracticability" defense.**
- **Common examples of representations, warranties, and covenants:**
  - **UCC product warranties (UCC Sections 2-312 – 2-318 for the sale of goods), which can be express or implied and need not be recited in the contract by operation of the UCC (which is not the case for transactional reps./warranties, which do need to be recited).**
- **An express representation, warranty, or covenant, constitutes an enforceable promise or guarantee that some material fact, event, condition, or other circumstance is (or remains) true or not true.**

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Representations, Warranties, and Covenants

- **Because parties can make express warranties accidentally, you may want to include a provision disclaiming the existence of any other warranties other than those specifically enumerated in the contract.**

- **Take care in drafting the specific representations, warranties, and covenants because they can apply broadly**
  - **Temporal limitations – e.g., at the time of delivery/assignment vs. forever vs. for 12 months or some other defined period?**
  - **Knowledge limitations – e.g., rep/warranty as to seller's knowledge or awareness of a problem or defect versus rep/warranty as to the non-existence of the problem or defect altogether regardless of seller's knowledge?**
  - **Disqualifying limitations – e.g., misuse, faulty repair, etc.?**

Representations, Warranties, Covenants

- **Should you include a provision expressly describing the remedies available for any breached or untrue representations, warranties, and/or covenants?**
- **"If any of the foregoing specific representations, warranties, or covenants made in connection with [client's] procurement of [X] is breached or untrue or is otherwise later alleged by any person, including [client], to be breached or untrue, then seller shall be obligated to repurchase [X] from buyer within 30 days of receipt of a written demand that identifies the subject representation(s), warrant(y)(ies), or covenant(s), the bases for [client's] demand, and the [X] subject to repurchase."**
- **Note* -- in this example, if the other party fails to timely repurchase or cure, then that may give rise to a claim for breach of contract.**

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Risks of Default and Nonpayment

- **Many contracts present risk that the other party will fail to deliver payment or might otherwise receive the benefit of your client's performance for free.**
  - **E.g., retail sales installment contracts, promissory notes, contracts for the sale of goods, distribution agreements, real estate purchase agreements, settlement agreements in litigation, etc.**
- **There are ways to avoid or mitigate these types of risks, including, for example, conditions precedent, specific payment terms, guaranties, security/collateral agreements, or deposit or escrow provisions.**

Risks of Default and Nonpayment, Continued

- **Payment Terms and Guaranties**
  - **Advance payment obligations (money up front before delivery or performance, or as a condition to contract);**
  - **Guaranties – if your client is contracting with a new customer or a customer with suspect creditworthiness, then you should consider requesting a personal guaranty from the counter-party's principals or solvent affiliates**
- **Deposits – similar to a retainer in our line of work, if the contract does not require payment up front, you should nevertheless consider including a provision that requires a deposit, which can either be refundable, non-refundable, or applied as a credit in some way, depending on the circumstances to best align incentives and address client needs.**
- **Collateral / Liens – you can also mitigate the risk of nonpayment with lien rights in specific collateral**

Practical Ways to Address Risk of Nonpayment

1. **Credit Checks**
2. **Conditions Precedent (*e.g.*, payment triggers client obligation to perform)**
3. **Deposits**
4. **Guaranties**
5. **Collateral / Liens / ACH Transfer / Funding Agreements**
6. **Fee-shifting Provisions**
7. ***Termination Rights* – make sure your client has an exit if it is not getting paid**

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Liquidated Damages to Control and Allocate Risk

- **Pre-determined and expressly contemplated damages that a party is entitled to recover in the event of a later breach**
- **Contracts may state the damages amount to be awarded in the event of a breach if a precise damages amount is otherwise difficult to calculate – e.g., confidentiality or non-disparagement obligations.**
- **<u>General Rule</u>: Penalty clauses will not be enforced but true liquidated damages clauses intended for "fair compensation" will be upheld. *Gorco Constr. Co. v. Stein*, 99 N.W.2d 69, 74 (Minn. 1959).**
  - **In other words, don't get greedy when specifying a liquidated damages amount**

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Liquidated Damages: Requirements

***Gorco Constr. Co. v. Stein*, 99 N.W.2d 69, 74-75 (Minn. 1959):**

1. **The contract must fix the damages amount to be awarded in the event of a breach.**
2. **The fixed damages amount must constitute a reasonable forecast of just compensation for the contemplated breach.**
3. **The precise amount of harm to the non-breaching party must have been difficult or impossible to ascertain at the time the contract was formed.**

*** Consider including language in the contract reflecting the parties' express acknowledgment that these elements are satisfied.**

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Other Liability or Remedy Limitations

- **Contracting parties may include a limitation of liability provision that limits or disclaims the availability of specific types of damages (punitive, special, consequential, etc.) in the event of a breach.**

- **Such provisions need not apply to every type of breach, and can be limited accordingly (e.g., can carve-out indemnification obligations or caps on liability for certain types of technical breaches, but not others).**

Indemnification Provisions

Indemnification and "hold harmless" provisions are critically important, especially when the subject matter of the contract might foreseeably give rise to third-party liability and related litigation in the future.

Practical considerations:

- **What kind of legal relationship exists between the parties (agency, fiduciary, etc.) and could client be liable for counter-party's mistakes?**
- **What notice/procedural requirements should you include expressly?**
- **Should the indemnification and hold harmless provision be mutual?**
- **Attorneys' fees and costs?**
- **Scope – how broad or narrow?**
  - **"arising from," "relating to," etc. might create extremely broad indemnification rights and obligations.**

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Specific Example – *Pierringer* Releases

- **Arises where a settlement is reached with one joint tortfeasor, but that settling defendant is still subject to potential indemnification, contribution, or subrogation claims for the plaintiff's alleged injuries.**

- ***Pierringer v. Hoger*, 21 Wis. 2d 182, 124 N.W.2d 106 (1963)**

- **Approved by the Minnesota Supreme Court in *Frey v. Snelgrove*, 269 N.W.2d 918 (Minn. 1978)**

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Pierringer Releases, Continued

- **Essential elements of a *Pierringer*-type release:**
  - **The release of the settling defendants from the action and the discharge of a part of the claim equal to that part attributable to the settling defendants' causal negligence or fault;**
  - **The reservation of the remainder of the plaintiffs' causes of action against the non-settling defendants;**
  - **Plaintiff's agreement to indemnify the settling defendants from any claims of contribution/indemnification made by the non-settling parties and to satisfy any judgment obtained from the non-settling defendants to the extent the settling defendants have been released.**

Example of *Pierringer* Release Language

Nothing in this Release shall be interpreted to release any claim or cause of action by [plaintiff] against [non-settling parties], which are specifically preserved and excluded from the scope of this Release. Rather, this *Pierringer* Release releases the subject claims against the Released Parties only. Accordingly, in connection with this Release, plaintiff agrees to hold the Released Parties harmless for any claims, demands, or causes of action brought by any non-settling party against any of the Released Parties arising from the subject Incident, whether alleged or rendered final by reason of a judgment and adjudicated attribution of fault. The Released Parties are discharged from liability, if any, for contribution or indemnity, to the non-settling parties with respect to the plaintiff's claims for damages, and any portion of plaintiff's damages adjudicated at trial to have been caused by the relative fault of the Released Parties, whether for negligence or otherwise, shall be deemed and credited as having been satisfied and discharged, leaving the non-settling parties liable for that portion of plaintiff's damages attributable to their proportionate fault only.

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Escrow Agreements

In contractual arrangements that involve upfront investment/payment or that present risks of one party "defecting" after receiving something of value from the other party, an escrow or trusted third-party intermediary provision can help to control or otherwise mitigate risk.

Examples:

- **Real estate purchase / conveyance transactions**
- **Escrow provisions where certain intellectual property or trade secrets will revert to licensor following termination of the agreement**

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Be Creative and Thoughtful Lawyers

- **There are few legal or practical limitations to what can be accomplished by a written contract so long as the language is clear and unambiguous.**

- **Be open-minded when negotiating contracts, which means that you should also be mindful of your adversary's risk assessment in addition to your own.**

- **Do not allow your concerns about theoretical or remote risks get in the way of a positive deal for your client. The key is to educate your clients about the risks so they can make informed decisions about the contract's material terms.**

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Questions???



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