

October 28, 2022

BOO!!! Contract Horror Stories (and How to Avoid Them)

Do you like scary stories? We at Lawyers Alliance LOVE scary stories and to celebrate Halloween, we compiled seven ghoulish contract stories. The scary stories describe circumstances that could happen to any organization that fails to review, understand, and negotiate a contract.¹ But don't be scared! Each story concludes with suggestions on how to avoid common pitfalls. Of course, the general suggestions provided are no substitute for legal advice. If you are considering walking alone in the graveyard at night...(oh, wait, we're talking about legal advice!) If your organization is entering into a contract that would benefit from legal counsel, contact us for legal advice. Above all, remember to read contracts your organization enters into. After all, the gaming company Gamestation once got 7,500 companies to agree by contract to sell their immortal souls!²

The Phantom Entity: When Non-existent Entities Execute Contracts

When our story begins, it is a dark and stormy night...Nonprofit signs a long-term contract with a government entity to fund one of its key programs. During the course of the contract period, Nonprofit merges with another entity and as a result, Nonprofit ceases to legally exist. Nonprofit signs an extension of the government contract under the former, non-existent entity name. Work continues as normal. Eventually, the government entity realizes the error and pauses payment.

This story illustrates potential problems when non-existent entities erroneously execute contracts. Such errors are generally not fatal to the contract, however. Technically speaking, minor mistakes relating to party names are generally considered "scrivener's errors," and a court will likely honor the contract and capture the correct party's name as understood by the parties.³ Moreover, it is a basic tenet of contract law that a party cannot accept the full benefit of an agreement, and then refuse to pay their side of the bargain by pleading invalidity of the contract.⁴ Still, in practice, errors in party name can prove costly for the parties involved.

For example, where the other party is a government entity, that party may severely delay their obligations under the agreement (say, making payments) because strict government auditing procedures require such minor technical errors be resolved before public dollars can be spent.

¹ While many of the stories described in this Legal Alert are based on real cases, details have been altered and anonymized to protect client confidentiality.

² https://www.huffpost.com/entry/gamestation-grabs-souls-o_n_541549

³ *313-315 West 125th Street L.L.C v. Arch Specialty Ins. Co.*, 30 N.Y.S.3d 74, 76 (N.Y. App. Div. 2016) ("...reformation is an appropriate remedy where the wrong party was named in the contract."); See Williston on Contracts § 70:93 (4th ed.)

⁴ *Washington Heights Federal Sav. & Loan Ass'n v. Brooklyn Fur Storage Corp.*, 161 N.Y.S.2d 674, 676 (Sup. Ct. 1957) ("... it is well settled in this state that where ... one party has received the full benefit of an ultra vires contract, it cannot plead invalidity of the contract to defeat an action upon it by the other party.")

Best Practices:

Double check that the correct entity is identified in the contract before signing. This may seem obvious, but such errors are easily made in the period after a legal name change. Moreover, promoters of an unincorporated entity may sign on behalf of the entity, but they will be solely, and personally, liable under the contract until the entity forms and formally adopts the contract.⁵

The Spooky Music: Clarifying Ownership Rights in Advance

As part of its charitable mission, Nonprofit provides studio time for musicians. During one of these studio sessions, Musician creates a ‘jingle’ that becomes popular. For-profit wants to buy the rights to the jingle, but there was no written agreement between Nonprofit and Musician to clarify who currently owns the rights to the jingle. With ownership unclear, Nonprofit and Musician must go to court to determine who can sell the ‘jingle’ to For-profit.

If certain other aspects of the contract are insufficiently clarified (for example, intellectual property rights) and relations between the parties break down, or other issues arise, there can be serious legal wrangling over ownership rights.

Best Practices:

Work with Intellectual Property counsel in advance to clarify and document in writing exactly who owns what, for how long and in what circumstances.

The Devil in the Details: Small Provisions with Big Impacts; Vague Provisions and Loss of Control

Nonprofit negotiated an HVAC maintenance contract for routine services with Contractor. The agreement included numerous terms that Nonprofit had not paid attention to, including that it had to hire Contractor to service any breakdowns or other malfunction/service needs. The payment for those service calls included travel time (from another borough) and the cost for any parts or labor. However, the labor costs were not specified in the contract, allowing Contractor to change rates that were never negotiated throughout the contract term and of course the entire contract was written in very small print.

As demonstrated above, seemingly minor provisions can have significant consequences. Contracts can be lengthy, making it difficult to parse out which terms require close attention. Here, for example, the contract may have had a single sentence that stated Contractor had the exclusive right to perform maintenance at Nonprofit’s expense. This example also shows the consequences of ill-defined provisions and omissions. Adding more specificity into the contract—excluding travel expenses, defining repair rates upfront, instituting a cap on maintenance fees—could have resolved the problem. Putting a contract in very small hard-to-read print purposely discourages you from reading it closely.

Best Practices:

Try to read every provision at least twice. Be sure to read all of the fine print. It can be beneficial to do a quick initial read of the contract to get a basic understanding of its structure, followed by a close read to drill down on details. Every contract is unique, so it is impossible to state unequivocally which sections are most important. That being said, when dealing with vendors or independent contractors, nonprofits should be sure that the deliverable/scope of work is as clearly defined as possible, and that control over

⁵ Munson v. Syracuse, G & C. Ry. Co., 103 N.Y. 58, 75-76 (N.Y. 1886)

variable costs is not ceded to the vendor/independent contractor (as with example above). Finally, assume the worst in the counterparty and picture worst case scenarios, just as a mental exercise while reading the contract. As applied to the scenario above, taking such a dim view of the counterparty may have revealed the problem of allowing Contractor to determine the costs of maintenance.

The Trickster: Prior Agreements and Merger/Entire Agreement Clauses

Nonprofit rented a storefront to operate programming. The landlord's agent knew and the Nonprofit had discussed with the agent that Nonprofit intended to make improvements to the space. However, there was no mention about the intended improvements in the lease. Nonprofit relied on the fact that the agent and landlord knew about their plans and hadn't said anything about a prohibition on doing such work, although the lease stated that improvements required landlord approval and there was an "Entire Agreement" clause stating that any understanding outside the words of the contract was not valid. Nonprofit spent a large sum of money making improvements to the space. After improvements were made, the landlord sought payment for building department fines and pursued the Nonprofit for payment of the fines and the breach of the lease provision requiring landlord approval for improvements.

A common issue arises, as illustrated above, where nonprofits might think they've reached oral agreements in the course of negotiations that are not written into the final contract. As a general matter, the language in the final contract controls over any prior understandings, even if those understandings were in writing. Both the parol evidence rule⁶ and "Entire Agreement" or "Merger" clause work to bar parties from introducing these prior understandings in court to contradict a final written agreement.

Best Practices:

Ensure the final written agreement contains all matters that were discussed and agreed upon prior to signing. Even if you have faith the counterparty will honor these prior agreements, it is safest to insist they be included in the final written agreement (indeed, if the counterparty is not willing to put it in the final contract then perhaps the faith is misplaced!). It is less important to negotiate over the language in the entire agreement clause, or to insist the contract not have one, than it is to ensure that everything that was agreed upon is covered in the final writing.

The Deal with the Devil: Unrealistic or Unacknowledged Representations and Warranties

A grant agreement had a warranty buried in the appendix, requiring Nonprofit to work with a certain percentage of minority and women business owners. No one thoroughly read the appendix, and as a result, the nonprofit did not comply with the requirements set forth by the reps and warranties. Now the organization is in trouble with the state, may have to return some funding, and also could face reputational harm.

The Representations and Warranties section of a contract is easy to ignore (particularly when it is in an appendix), however it is as legally binding as any other provision in a contract. Even if the Representations and Warranties are not ignored, they may be unrealistic or not work for the organization.

⁶ The parol evidence rule is a complex doctrine in contract law with many exceptions. For a brief explainer, *see*: https://www.law.cornell.edu/wex/parol_evidence_rule

Best Practices:

Read the Representations and Warranties section carefully and ensure that the nonprofit can and does comply with every provision contained therein. If the counterparty drafted this section, it is essential that each provision is understood by the nonprofit. If a representation or warranty is hard to understand, it can be beneficial to ask the opposing party to explain it in plain English, then propose to rewrite it as you understand it to ensure that you are making realistic representations and warranties.

The Haunting Contract: Ill-defined and Restrictive Termination Clauses

Nonprofit operates a transitional shelter and signed a contract with a food service provider that was required to deliver daily meals for 80 people at the shelter for one year. The contract had no provision allowing Nonprofit to terminate for the vendor's failure to deliver the meals or other poor performance. The vendor continually failed to meet Nonprofit's expectations, with frequent late deliveries, poor quality meals, and insufficient quantities.

The above story illustrates the problems that arise from contracts that inadequately define the basis for termination, fail to provide for self-help remedies and proper remuneration for additional costs incurred, or otherwise restrict the nonprofit's ability to terminate. Although the vendor in the above example was clearly performing poorly, without clearly defined self-help remedies or termination procedures it is not clear how or when Nonprofit could discontinue payments. For example, Nonprofit could have avoided this issue had the contract stated that it had a right to terminate after 5 late deliveries, or, even more broadly, could terminate for any reason if it provided adequate notice.

Best Practices:

Pay close attention to termination clauses to ensure you have the desired level of flexibility and protection against risk. As noted above, it is a good practice to, as a mental exercise, assume the worst in your counterparty and attempt to envision worst case scenarios. Do not forget that termination need not require that either party "does something wrong," but can be written to allow for termination for any reason upon requisite notice (e.g., 30 days). Finally, if the counterparty is producing a deliverable or service, consider using more concrete language to describe a cause for termination for poor performance. As in the example above, specifying the exact number of permissive late deliveries rather than using language like "prompt delivery."

The Invisible Man: When There's No Contract at All

Nonprofit signs a purchase order for an essential piece of equipment. The purchase order is a one-page agreement to pay an agreed price. The order is signed without first executing a more comprehensive sale and purchase agreement with the seller. The equipment is scheduled to arrive sooner than anticipated, and cannot be installed in the new office space until the following month. Nonprofit requests a cancellation of the order or a delay in shipment. The seller refuses, arguing that the purchase order—the only signed document—does not provide for flexibility. Nonprofit must pay to store the prematurely delivered and unused equipment.

In most situations, there is some form of contract, it just may be oral or a simple signed order form or receipt. The issue arises when these informal agreements legally bind parties in ways they would not have agreed to had everything been fleshed out in a final written agreement. Had the nonprofit in the above example taken the time to negotiate an underlying agreement, the above problem may have been avoided. For example, if the nonprofit required delivery on a particular date, it could have included that

in the agreement. Moreover, it could have sought termination provisions that provided more flexibility, including a right to terminate the agreement prior to receipt of the goods.

Best Practices:

Don't walk alone in the graveyard at night...and take the time to draft, negotiate and review contracts. It is tempting to treat this step in a transaction as a mere formality, but in our experience, it is anything but. You need not do this alone, contact us for legal advice or if you're not a client, consider [becoming a client](#) by submitting an application to receive pro bono assistance through Lawyers Alliance's extensive network of pro bono attorneys.

This alert is meant to provide general information only, not legal advice. If you have any questions about this alert please contact Rafi Stern at rstern@lawyersalliance.org or visit our website at www.lawyersalliance.org for further information. To become a client, visit www.lawyersalliance.org/becoming-a-client.

For his assistance in preparing this Legal Alert, Lawyers Alliance would like to thank Nick Aquino, a Legal Fellow working with Lawyers Alliance through NYU School of Law's National Center on Philanthropy and the Law. Lawyers Alliance would also like to thank former staff attorney Veronica Aksu for coming up with the idea for this scary stories legal alert.

Lawyers Alliance for New York is the leading provider of business and transactional legal services for nonprofit organizations and social enterprises that are improving the quality of life in New York City neighborhoods. Our network of pro bono lawyers from law firms and corporations and staff of experienced attorneys collaborate to deliver expert corporate, tax, real estate, employment, intellectual property, and other legal services to community organizations. By connecting lawyers, nonprofits, and communities, Lawyers Alliance for New York helps nonprofits to provide housing, stimulate economic opportunity, improve urban health and education, promote community arts, and operate and advocate for vital programs that benefit low-income New Yorkers of all ages.