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A Study of the Risks of Contract Ambiguity

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A Study of the Risks of Contract Ambiguity

Preston M. Torbert

THE LAW SCHOOL
THE UNIVERSITY OF CHICAGO

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A Study of the Risks of Contract Ambiguity

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A Study of the Risks of Contract Ambiguity

Preston M. Torbert*

"Ambiguity is the greatest cause of litigation over drafted documents . . ."¹

I. INTRODUCTION

Ambiguity is more common, more unnoticed, and more important than we think. This article treats the risk² of ambiguity for the contract drafter. The principal goal of the contract drafter is setting forth precisely the rights and obligations that form the deal that the parties have agreed on. But a secondary and often neglected responsibility of the drafter is to avoid ambiguities in the text that can cause or promote disputes between the parties. My interest in the risk of ambiguity derives from the experience of drafting and negotiating bilingual English-Chinese contracts over several decades and in writing and teaching about the risk of ambiguity in these and other contracts.³ Of course, ambiguity is a narrow focus. Scholars

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¹ THOMAS R. HAGGARD & GEORGE W. KUNEY, *LEGAL DRAFTING IN A NUTSHELL* 242 (3d ed. 2007).

² See PETER L. BERNSTEIN, *AGAINST THE GODS: THE REMARKABLE STORY OF RISK* (1996).

³ Preston M. Torbert, *Globalizing Legal Drafting: What the Chinese Can Teach Us About Ejusdem Generis and All That*, 11 *SCRIBES J. LEG. WRITING* 41 (2007); Preston M. Torbert, *Contract Drafting: A Socratic Manifesto*, 14 *SCRIBES J. LEG. WRITING* 93 (2011–2012); Preston M. Torbert, *The Crisis Exposed by Pari Passu*, 40 *HOFSTRA L. REV.* 87 (2011); 陶博 (TAO BO), 法律英语: 中英双语法律文书制作 [LEGAL ENGLISH: THE PREPARATION OF BILINGUAL CHINESE-ENGLISH LEGAL DOCUMENTS] (2004); 陶博 (TAO BO), 法律英语: 中英双语法律文书中的句法歧义 [LEGAL ENGLISH: SYNTACTIC AMBIGUITY IN BILINGUAL CHINESE-ENGLISH LEGAL DOCUMENTS] (2008); 陶博 (TAO BO), 法律英语: 中英双语法律文书中的语义歧义 [LEGAL ENGLISH: SEMANTIC AMBIGUITY IN BILINGUAL CHINESE-ENGLISH LEGAL DOCUMENTS] (2010); 陶博 (TAO BO), 法律英语: 双语法

of incomplete contracts have emphasized gaps in contracts rather than ambiguity, but to this practitioner, the critical issue is ambiguity, not gaps.⁴ Of course, it is impossible to provide for every possible contingency in drafting a contract, but experience suggests that parties do not argue about what is not in the contract, they argue about what is in it—the ambiguities. Of course, ambiguity is but one perspective. A contract can be analyzed from many others, all valid and worthy of support. It is hoped that this article will encourage others to conduct similar analyses from these other perspectives.⁵

Three risks surround the question of ambiguity in contracts. The first is the risk of an event that the parties did not anticipate when they negotiated and signed the contract. In law practice, I was only surprised the first time when a client that had recently completed an acquisition called and said something like this: “Prior management made some mistakes. One of them was setting up a joint venture in China. We need to get out of it. I’ll send you the joint venture contract. Tell me what our options are.” When the unanticipated event brings significant economic benefit or detriment to a party, it has an incentive to review the contract, find ambiguities, and develop self-serving interpretations.

The second risk is of ambiguity itself. That risk is discussed in the contract review below. The third risk is *contra proferentem*—that the ambiguity will be construed in a manner adverse to the drafter. This risk is also discussed below. Eliminating the risk of unforeseeable events is impossible. But careful drafting can reduce the risks of both *contra proferentem* and ambiguity if we can perceive these risks. This article is a first step in that direction.

律文书的解释 [LEGAL ENGLISH: THE INTERPRETATION OF BILINGUAL LEGAL DOCUMENTS] (2013).

⁴ See, e.g., Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); Eric A. Posner, *There Are No Penalty Default Rules in Contract Law*, 33 FLA. ST. U. L. REV. 563 (2006); Ian Ayres, *Ya-huh. There Are and Should Be Penalty Default Rules*, 33 FLA. ST. U. L. REV. 589 (2006); Robert E. Scott, *Rethinking the Default Rules Project*, 6 VA. J. 84 (2003).

⁵ Examples of other perspectives are those of the comparison of the rights and obligations of the parties, contract doctrine, negotiation, and industry practice.

This article is directed primarily to students, but I hope it will also be of interest to practicing lawyers, judges, and law professors.

Its primary purpose is to help train students for the practice of law. While I believe it can benefit most law students, it is designed to serve as a template for students at the Peking University School of Transnational Law and at the University of Chicago Law School who have taken my course on ambiguity in contract drafting. The students can use this article as a template to write the 50-page thesis required for graduation at STL or to fulfill the writing requirement at Chicago. This article examines one "sanitized"⁶ contract taken from the SEC's EDGAR database and attached as Exhibit 1; a student can choose another contract from this or another database⁷ with a different governing law and perform a similar analysis. The process of researching and writing such a thesis would hone the analytical skills that the student learned in the course and train the student to apply legal doctrine to specific contract terms. It is hoped that a student's paper would be a writing sample that would help the student to obtain employment in a law firm or in-house legal department.

The contract examined is the License and Manufacturing Agreement between a Licensor, an American company, and a Licensee, a Hong Kong company dated June 24, 2011 and governed by California law.⁸ This contract was chosen because: it is a fairly recent and representative of a common type of contract that law school graduates will encounter in their legal careers (a technology transfer and product supply relationship between an American company and a company in China); it has a transnational element required for the student thesis at STL; and it is fairly complex, but not extremely lengthy. I did not contact the parties to the contract or their lawyers before or during the writing of this article and I have no understanding of the

⁶ Confidential pricing and some other information have been deleted from the contract as it appears in the SEC EDGAR database. In addition, as a courtesy to the parties, I have deleted specific information that would identify the parties or the individuals who signed the contract.

⁷ For example, that of the Contracting and Organizations Research Institute at the University of Missouri-Columbia, available at http://ronald.cori.missouri.edu/cori_search/engine_menu.php (last visited Feb. 1, 2014).

⁸ Neither of the parties to the contract nor a related company mentioned in the contract is a client of Baker & McKenzie where I serve as Senior Counsel.

relationship of the parties. Further, I have no understanding of whether future events might make the ambiguities discussed below relevant to their relationship. I hope not.

This article may also assist practicing lawyers in dealing with the risks of ambiguity by treating a typical commercial contract. Scholars and judges have discussed legal doctrine regarding ambiguity, particularly the presumption of *contra proferentem*, almost exclusively in the context of adhesion contracts,⁹ such as those for insurance. It has been said that in the United States “the bulk of contracts signed . . . are adhesion contracts.”¹⁰ The most typical contracts of adhesion are those between a company and an individual consumer or employee. The contract here is a commercial one, not a contract of adhesion. I have not done research to determine the relative size and bargaining power of the parties or to understand the details of the drafting and negotiation of the contract. My experience suggests that the Licensor is the stronger party and drafted the contract, that the contract is probably a form that the Licensor has used for other technologies and products, but it seems likely that parts of it were negotiated. Therefore, it does not seem to be a contract of adhesion. The contract, then, is not representative of the bulk of contracts, but it is very representative of the types of contracts corporate lawyers in practice deal with every day. Most corporate lawyers do not deal mainly with adhesive consumer or labor contracts; they generally draft and negotiate commercial contracts between two companies. But, if ambiguity is a key cause of disputes and litigation as suggested above, a detailed ambiguity study of a specific contract should be useful to practicing lawyers. But, to my knowledge, a detailed study of a specific contract from the perspective of ambiguity has not been done. It appears that the situation has not changed significantly¹¹ since Professor

⁹ See, e.g., David Horton, *Flipping the Script: Contra Proferentem and Standard Form Contracts*, 80 U. COLO. L. REV. 432 (2009); Michelle E. Boardman, *Contra Proferentem: The Allure of Ambiguous Boilerplate*, 104 MICH. L. REV. 1105 (2006); John T. Flynn, *The Rule Contra Proferentem in the Government Contract Interpretation Process*, 11 PUB. CONT. L.J. 379 (1979–1980).

¹⁰ ARTHUR L. CORBIN, CORBIN ON CONTRACTS, §24.27A (1999).

¹¹ Recent books on contract drafting have alleviated the “sins of omission . . . verging on the amazing and unpardonable” identified by Professor Llewellyn in 1951 (Karl Llewellyn, *Introduction*, in ROBERT N. COOK, LEGAL DRAFTING xi (1951)) but none seem to deal in detail with interpretation

Farnsworth stated in 1966, “although contract disputes often turn on the interpretation of contract language, this subject has received relatively little attention . . .”¹² This article can be seen as an attempt to fill that gap.

Further, it is hoped that judges who confront disputes in commercial contracts will also find this article useful. They may find, either *sua sponte* or at the suggestion of counsel, language-related arguments that can help them strengthen the reasoning that supports a just decision. Further, if ambiguity is a significant cause of disputes and litigation, the presumption *contra proferentem* becomes more important and deserves a reappraisal. This article suggests that this presumption could serve to improve contract drafting and reduce litigation.

Finally, this article may be seen as an attempt to begin to bridge the divide between the academy and the bar.¹³ In the academy, economic analysis of the law has become the prevailing current in contract theory over the last thirty years. The puzzle that a major branch of this current, the school of incomplete contracts, has posed is why are incomplete contracts the norm when economically complete contracts are optimal?¹⁴ Recent scholarship on the *pari passu* clause in sovereign debt instruments has posed a related question: why are these contracts so resistant to change?¹⁵ This article’s practical analysis of a specific contract is my attempt to answer the question of how contract drafting can reduce contract disputes and litigation. But, like these other inquiries, it wrestles with a single larger question: Why are contracts the way they are? Perhaps a kind reader can

and disputes. SCOTT J. BURNHAM, *DRAFTING CONTRACTS: A GUIDE TO THE PRACTICAL APPLICATION OF THE PRINCIPLES OF CONTRACT LAW* (1987); THOMAS R. HAGGARD, *LEGAL DRAFTING IN A NUTSHELL* (1996); KENNETH A. ADAMS, *A MANUAL OF STYLE FOR CONTRACT DRAFTING* (2004); TINA L. STARK, *DRAFTING CONTRACTS: HOW AND WHY LAWYERS DO WHAT THEY DO* (2007); DAVID ZARFES & MICHAEL L. BLOOM, *CONTRACTS: A TRANSACTIONAL APPROACH* (2011); SUE PAYNE, *BASIC CONTRACT DRAFTING ASSIGNMENTS: A NARRATIVE APPROACH* (2011).

¹² E. Allan Farnsworth, *Meaning in the Law of Contracts*, 76 YALE L.J. 939 (1966-1967).

¹³ Preston M. Torbert, *Contract Drafting: A Socratic Manifesto*, 14 Scribes J. Leg. Writing 93, 119 (2011-2012).

¹⁴ Scott, *supra* note 4, at 87.

¹⁵ MITU GULATI & ROBERT E. SCOTT, *THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN* (2013); Lee C. Buchheit & Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869 (2004).

help us blind men see the synergies among us as we grope different parts of the same elephant. And maybe bringing the specific problems of law practice to the law school will suggest paths for scholarly research that will benefit both the academy and the bar.

In short, this study of two ambiguity risks hopes to assist students and perhaps others by analyzing contract ambiguity in a specific, but representative, commercial contract.

II. THE RISK OF AMBIGUITY ITSELF

What is ambiguity? Linguists have described it as expressions “that can be interpreted in two or more different ways.”¹⁶ California courts have said that “[a]n ambiguity arises when language is reasonably susceptible of more than one application to material facts”¹⁷ and that a term is ambiguous if “it is reasonably susceptible to either of the meanings urged by the parties.”¹⁸ There are different types of ambiguity. California courts have sometimes distinguished between “patent” ambiguity that appears on the face of the contract, and “latent” ambiguity that is based on extrinsic evidence.¹⁹ Because the terms “patent” and “latent” bear strong procedural implications that may not always be appropriate,²⁰ they are not used here.

There are different forms of ambiguity, such as semantic, syntactic, and contextual.²¹ Commentators have proposed that syntactic ambiguity (ambiguity as to what modifies what) is the most common form of ambiguity in legal writing. William

¹⁶ JOHN LYONS, SEMANTICS II 396 (1977). For the distinction between vagueness and ambiguity, see Farnsworth, *supra* note 12, at 953. For a suggestion that the distinction is not relevant to contract interpretation, see Richard A. Posner, *Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1603 n.51 (2005).

¹⁷ *Dore v. Arnold Worldwide, Inc.*, 39 Cal. 4th 384, 391 (Cal. 2006).

¹⁸ *Curry v. Moody*, 40 Cal. App. 4th 1547, 1552 (1995).

¹⁹ *Solis v. Kirkwood Resort Co.*, 94 Cal. App. 4th 354, 360 (Ct. App. 2001); *Steller v. Sears, Roebuck & Co.*, 189 Cal. App. 4th 175, 183 (Ct. App. 2010).

²⁰ For example, in government contracting, the term “patent ambiguity” refers to an ambiguity that triggers a duty to inquire. *Chapman Law Firm LPA v. United States*, 103 Fed. Cl. 28, 41 (2012). For the history of the terms “latent” and “patent” ambiguity, see Farnsworth, *supra* note 12, at 960–61.

²¹ F. REED DICKERSON, THE FUNDAMENTALS OF LEGAL DRAFTING §6.1, 6.4 & 6.12 (2d ed. 1986); HAGGARD & KUNEY, *supra* note 1, at 243–92; G. C. THORNTON, LEGISLATIVE DRAFTING 11 (4th ed. 1996).

Cobbett, an early nineteenth century commentator, said that, "of all the faults in writing, the wrong placing of words is one of the most common, and perhaps it leads to the greatest number of misconceptions."²² Reed Dickerson, the dean of American drafting in the twentieth century, said, "Probably the biggest source of uncertainty of meaning in legal instruments . . . is the unclear use of modifiers or reference, technically known as 'syntactic ambiguity.'"²³ A contemporary UK specialist in statutory interpretation, Francis Bennion, has said, "The inefficient construction of the sentence is a prime cause of doubt. In particular, failure to make clear which words a modifier modifies and which it does not gives rise to ambiguous modification or syntactic ambiguity."²⁴ The other more familiar form of ambiguity is semantic ambiguity, an uncertainty of multiple meanings of a single word. Contextual ambiguity concerns consistency of language use throughout a document. The presumption of consistency²⁵ in contract drafting assumes that words are used consistently within a contract. Violation of this rule creates a presumption that the use of different words was intended to express a different meaning. Commentators, as noted above, have emphasized syntactic ambiguity as the major problem in contract drafting, but the analysis below seems to indicate that in this case contextual ambiguity creates more risks.

Ambiguity cannot only be semantic, syntactic, or contextual, it can also be intentional or unexpected.²⁶ The discussion here does not deal with intentional ambiguity because it is a lesser problem. Because of the ambiguity between normative and empirical expectations,²⁷ the discussion here also does not use the term "expected" or "unexpected." Further, the discussion does not use the terms "foreseeable" or "unforeseeable" because the

²² H. F. FOWLER, A DICTIONARY OF MODERN ENGLISH USAGE 21 (2d ed. 1983).

²³ DICKERSON, *supra* note 21, at §6.1.

²⁴ FRANCIS ALAN ROSCOE BENNION, STATUTE LAW 170 (2d ed. 1983).

²⁵ DRIEDGER ON THE CONSTRUCTION OF STATUTES 163 (R. Sullivan ed., 3d ed. 1994); NORMAN J. SINGER & J. D. SHAMBIE SINGER, SUTHERLAND STATUTORY CONSTRUCTION §46.06 (7th ed. 2009).

²⁶ See Farnsworth, *supra* note 12, at 956; R. Posner, *supra* note 16, at 1583; Gregory M. Duhl, *Conscious Ambiguity: Slaying Cerberus in the Interpretation of Contractual Inconsistencies*, 71 U. PITT. L. REV. 71 (2009).

²⁷ MARGARET JANE RADIN, BOILERPLATE: THE FINE PRINT, VANISHING RIGHTS, AND THE RULE OF LAW 85 (2013). "The ambiguity of 'expectations' makes for murky and unpredictable jurisprudence."

concept of foreseeability is not stable—we enjoy forethought and not foresight, but in retrospect everything is foreseeable. The key feature of ambiguity in contracts is that the ambiguity is not anticipated. The concern is not with the ability to predict the future as much as with the surprise of the unanticipated. Therefore, the ambiguities discussed below in the contract analysis are referred to as “unanticipated ambiguities.”²⁸

Unanticipated ambiguity is ubiquitous. As the linguist Th. R. Hoffman has said, “[i]t is astonishing how ambiguous most sentences are.”²⁹ Many expressions of language are ambiguous and in most contexts this does not cause a problem. But whatever form it takes, unanticipated ambiguity in a contract does pose a risk. The risk is of a dispute, including litigation or arbitration.³⁰ A legal education, especially the first-year Contracts course, tends to promote the belief that litigation or arbitration is caused by one party violating the contract. This may be true in some sense, but the more astute observations seem to be that of Thomas R. Haggard cited above that ambiguity is the greatest cause of litigation³¹ and the half-joking response of a senior litigation partner when I told him I was teaching a law school course on eliminating ambiguity in contract drafting: “Oh no! Don’t do that! You’ll put us all out of business!” I am not aware of any study that has documented the role of ambiguity in litigation or arbitration,³² but from experience it seems that two factors may account for the prominent, but underappreciated, role of ambiguity in litigation and arbitration.

²⁸ Of course, “anticipate” is polysemous. Here it is used in the sense of “realize beforehand” or “forestall,” and not “look forward to” or “accelerate.” I THE OXFORD ENGLISH DICTIONARY 522 (2d ed. 1991).

²⁹ THOMAS RONALD HOFFMANN, REALMS OF MEANING: AN INTRODUCTION TO SEMANTICS 254 (1993).

³⁰ Many examples of unanticipated ambiguity can be found in 陶博 (TAO BO) (2004), (2008), (2010), (2013), *supra* note 3.

³¹ The comment, “[m]any contract disputes turn on questions of interpretation” would seem to support this point. Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 YALE L.J. 829, 839 (2003).

³² One study of 500 reported cases found that in categorizing contract disputes on the basis of traditional contract doctrine, cases either arising from the ill-considered use of language or inherent in the use of language itself were the most common. Harold Sheperd, *Contracts in a Prosperity Year*, 6 STAN. L. REV. 208, 226 (1953).

First, ambiguity is very difficult to recognize. Because one characteristic of effortful mental activity is laziness,³³ we are not naturally adept at finding ambiguity in texts. As Steven Pinker has commented about reading, “many sensible ambiguities are simply never recognized.”³⁴ As Daniel Kahneman has said, when we think, the brain’s “associative system tends to settle on a coherent pattern of activation and suppresses doubt and ambiguity” and further that this system “is not prone to doubt. It suppresses ambiguity and spontaneously constructs stories that are as coherent as possible.”³⁵ Other scholars have demonstrated that in our observations we often are subject to “inattentional blindness” (failure to see things we were not expecting to see).³⁶ An unanticipated ambiguity is a good example of inattentional blindness.

Second, because ambiguity is not the focus of attention in the drafting or negotiation of a contract, it is often not noticed. Later, however, after a contract has been in effect for some time, an unanticipated event, a small Black Swan,³⁷ may occur that challenges an underlying assumption of the contract. If this change in circumstances substantially benefits one party and harms the other party, each party will search the contract language carefully to find an interpretation of the contract that is favorable to it under the changed circumstances. Generally, the

³³ DANIEL KAHNEMAN, *THINKING, FAST AND SLOW* 31 (2011).

³⁴ STEVEN PINKER, *THE LANGUAGE INSTINCT: HOW THE MIND CREATES LANGUAGE* 211 (1995).

³⁵ KAHNEMAN, *supra* note 33, at 88, 114.

³⁶ CHRISTOPHER CHABRIS & DANIEL SIMONS, *THE INVISIBLE GORILLA: HOW OUR INTUITIONS DECEIVE US* 6–7 (2010). Reading on computer screens can exacerbate the problem if the reading consists of “skimming” rather than “reading deeply.”; NICHOLAS G. CARR, *THE SHALLOWS: WHAT THE INTERNET IS DOING TO OUR BRAINS* 138 (2010). For the propensity towards errors, see JOSEPH T. HALLINAN, *WHY WE MAKE MISTAKES: HOW WE LOOK WITHOUT SEEING, FORGET THINGS IN SECONDS, AND ARE ALL PRETTY SURE WE ARE WAY ABOVE AVERAGE* (2009); MICHAEL KAPLAN & ELLEN KAPLAN, *BOZO SAPIENS: WHY TO ERR IS HUMAN* (2009). Unanticipated ambiguities do not generally qualify as “mistakes” under contract law. RESTATEMENT (SECOND) OF CONTRACTS §151 (1981) defines a “mistake” as “a belief that is not accord with the facts,” not as an improvident act. Further, the erroneous belief must relate to the facts as they exist as the time of the making of the contract, not later.

³⁷ Nassim Nicholas Taleb has said of events such as strikes, electricity shortages, accidents, bad weather, etc. that “[t]hese small Black Swans that threaten to hamper our projects do not seem to be taken into account.” NASSIM NICHOLAS TALEB, *THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE* 157 (2010).

party benefited will adopt a new, self-serving interpretation of the language, while the harmed party will insist on what it believes was the original understanding. In many cases, the original understanding was never fully expressed and the words that the harmed party insists express it are ambiguous.³⁸ And each party will have a good recollection of the gist of the contract negotiations, but not for the details, will fill in the gaps in its memory with sincere, but created self-serving facts, and honestly believe its created memory.³⁹

Three examples illustrate the important, but underappreciated, role of unanticipated ambiguity in contract interpretation. The first is a good example of the clear presentation of an unanticipated ambiguity that was acknowledged as such. The second and third show that unanticipated ambiguity has often not been characterized as ambiguity and therefore has been underappreciated.

The first example concerns a partnership dissolution agreement between a law firm and a partner described in *Dunne & Gaston v. Keltner*.⁴⁰ When the parties drafted the agreement they included a provision concerning a pending case that the withdrawing partner was handling and provided that he would receive 1/6 of the legal fees that would be eventually “recovered,” that is, paid. At the time the agreement was negotiated, neither party considered that the firm might refer the case to another law firm for settlement. In fact, the case was referred to another law firm that settled the case for 60% of the fees recovered. The word “recovered” in the dissolution agreement then became ambiguous. Did the 1/6 mean 1/6 of 100%, i.e., the entirety of all legal fees or only 1/6 of 40%, i.e., the fees received by the law firm that was party to the agreement after deducting the 60% share to the other firm? Since no evidence was introduced to show the parties’ intentions at the time of entering into the agreement, the court focused on the common connotation of “recovered” among attorneys. This common connotation was the entirety of fees

³⁸ This phenomenon of finding new meanings in an effective contract raises interesting questions of the intention of the parties and of good faith and fair dealing as set forth in the Restatement (Second) of Contracts (1981) and the California Civil Code.

³⁹ LEONARD MLODINOW, *SUBLIMINAL: HOW YOUR UNCONSCIOUS MIND RULES YOUR BEHAVIOR* 62 (2012).

⁴⁰ *Dune & Gaston v. Keltner*, 50 Cal.App.3d 560, 561(1975).

recovered. The court applied the whole statute presumption to decide in favor of the withdrawing partner.⁴¹

The second example concerns the *pari passu*, equal rank, provision in sovereign debt instruments. Lee Buchheit, Jeremiah S. Pam, Mitu Gulati, and Robert E. Scott have described the expression “*pari passu*” as “opaque,”⁴² “vague,”⁴³ “oracular,”⁴⁴ and “unconfiding.”⁴⁵ It has been said that the expression “is a chameleon, able to take on whatever meaning is advanced by the prevailing party in litigation.”⁴⁶ Although the word “ambiguous” has not been used, the *pari passu* problem can be characterized as one of unanticipated ambiguity. This provision has been a standard provision in sovereign debt instruments to indicate that the debt ranked in equal step with other creditors who form a queue during liquidation. It was thought to have little significance except, since the 1970s, in countries that permitted existing creditors to be subordinated, without their consent, to future lenders. In 2000, however, a Belgian court interpreted it to mean that one debtor who refused to enter into a restructuring agreement for sovereign bonds could obtain an injunction barring the payments to the other holders of the restructured debt because payments to them did not include proportional payments to the holdout debtor. This was the first interpretation of *pari passu* that was unanticipated. More recently, in 2012, the U.S. Second Circuit Court of Appeals’ decision in *NML v. Republic of Argentina* has adopted a similar interpretation, holding that the sovereign’s covenant to maintain the equal ranking of the defaulted bonds was an adequate basis for the District Court to grant an injunction ordering the sovereign to pay the defaulted bonds “ratably” if it wished to pay certain new bonds issued as part of the sovereign’s debt restructuring.⁴⁷ The ambiguity problem with *pari passu* was due to a future event, but it was not an extraneous event; it was simply the adoption of a creative,

⁴¹ *Id.* at 563–66.

⁴² GULATI & SCOTT, *supra* note 15, at 74.

⁴³ *Id.* at 178.

⁴⁴ Buchheit & Pam, *supra* note 15, at 871.

⁴⁵ *Id.* at 918.

⁴⁶ GULATI & SCOTT, *supra* note 15, at 178.

⁴⁷ Lee C. Buchheit, *What to Do about Pari Passu*, draft of unpublished manuscript dated Aug. 12, 2013, provided by the author; *NML Capital Ltd. v. Republic of Argentina*, 699 F. 3d 246 (2d Cir. 2012); *NML Capital Ltd. v. Republic of Argentina*, 727 F. 3d 230 (2d Cir. 2013).

unanticipated, and self-serving interpretation of an ambiguous phrase by one party.

The third example, concerning the insurance coverage for the twin World Trade Towers in New York, is a more common, but less clear, instance of unanticipated ambiguity. In this, as in many cases, for tactical or other reasons, the issue was not perceived as one of unanticipated ambiguity. The property manager of the twin Towers, the Silverstein companies, had demanded and agreed to a "single-occurrence" insurance policy to cover the twin Towers prior to September 11, 2001. They demanded "single-occurrence" policies because they anticipated that any claims would in total be less than the coverage amount and therefore multiple events could be covered as one event and they would pay only one deductible.⁴⁸ The specific language was: "'Occurrence' shall mean all losses or damages that are attributable directly or indirectly to one cause or to one series of similar causes." After September 11, however, it was clear that the damages far exceeded the coverage amount, so the Silverstein companies suddenly rejected the interpretation of the policy as "single-occurrence" and claimed that it should be interpreted as a "multiple occurrence" policy.⁴⁹ The "single-occurrence" interpretation in this and the other policies would result in insurance proceeds of \$3.6 billion for the Silverstein companies, the "multiple-occurrence" interpretation, \$7.2 billion.⁵⁰ This change of heart was characterized by an insurance executive as a "self-motivated hoax."⁵¹ The judge disposed of the issue by determining that the ambiguity in the language was a question of fact for the jury and the jury did not accept the Silverstein companies' interpretation. From the court's decision it is not clear whether the Silverstein parties ever mentioned the word "ambiguity." But the interpretation by the Silverstein companies necessarily implied that ambiguity in the policy language allowed them to interpret it differently after the attack.

⁴⁸ SR Int'l Bus. Ins. Co. v. World Trade Ctr. Properties LLC, 2003 U.S. Dist. LEXIS 1103, at *14 (S.D.N.Y. 2003).

⁴⁹ SR Int'l Bus. Ins. Co. v. World Trade Ctr. Properties LLC, 222 F. Supp. 2d 385, 388-89 (S.D.N.Y. 2002).

⁵⁰ David Wessel, *Who Will Provide Terrorism Insurance?*, THE WALL ST. J. (Oct. 11, 2001) at A1.

⁵¹ Charles V. Bagli, *In Dispute on Trade Center's Insurance, Billions at Stake*, N.Y. TIMES (Feb. 9, 2004), at A24.

The failure to recognize unanticipated ambiguity may explain in part why contract doctrine on ambiguity does not seem to directly address the issue. But another reason is probably because contract doctrine focuses on the intentions of the parties at the time they enter into the contract and when the ambiguity is not perceived by the parties at that time, inquiring into intentions is not informative. Consider the most relevant provisions of the California Civil Code, Section 1649, and the Restatement (Second) of Contracts, Section 201.⁵²

A. Section 1649 of the California Civil Code

Section 1649 of the California Civil Code states that “[I]f the terms of a promise are in any respect ambiguous or uncertain, it must be interpreted in the sense in which the promisor believed, at the time of making it, that the promisee understood it. [emphasis added]”⁵³ This rule would appear to make the subjective belief of the promisor the focus of inquiry. But proving subjective belief is difficult. Thus, California courts have chosen a way to interpret Section 1649 that makes it much easier to fulfill its requirements, but protect the promisee at the same time: in California, the subjective intent of the promisor does not control the interpretation. A California Court of Appeal has stated that, “[Section 1649] is . . . designed to override the promisor’s subjective intent whenever necessary to protect the promisee’s objectively reasonable expectations.”⁵⁴ This and other decisions seem to have imported the concept of “objectively reasonable expectations” developed from insurance contracts.⁵⁵ In *Wolf v. Superior Court*, the Court ruled that the promisor’s subjective understanding of the term “gross receipts” was not determinative because extrinsic evidence of industry custom and usage which reflected the promisee’s “objectively reasonable expectations” showed that the term had more than one meaning. Other cases seem to support the idea that the promisee’s understanding can

⁵² CAL. CIV. CODE §1649 (2013); RESTATEMENT (SECOND) OF CONTRACTS §206 (1981).

⁵³ CAL. CIV. CODE, §1649 (2013).

⁵⁴ *Wolf v. Superior Court*, 114 Cal. App. 4th 1343, 1357 n.18 (Ct. App. 2004).

⁵⁵ *Montrose Chem. Corp. v. Admiral Ins. Co.*, 10 Cal 4th 645, 667 (Cal. 1995); *Helfand v. National Union Fire Ins. Co.*, 10 Cal. App. 4th 869, 880 (Ct. App. 1992).

either be an understanding that it would be reasonable for the promisee to have or be subjectively true.⁵⁶

Section 1649 describes the beliefs and understandings—the intentions—of the parties at the time of entering into the contract, not during performance of the contract. It thus does not address the problem of unanticipated ambiguity that arises during performance when circumstances change. However, when an ambiguity arises due to an unforeseen event, the use of the “objectively reasonable expectations” of the promisee may help to discourage both the promisor and the promisee from constructing a self-serving rationalization after the fact.

B. Section 201 of the Restatement (Second) of Contracts

Section 201 of the Restatement first sets out the general rule that where the parties have attached the same meaning to a promise, it is interpreted in accordance with that meaning and neither party is bound by the interpretation that the other party gives to ambiguous language even if this results in a failure of mutual assent. Then, in the following section, it addresses the question of ambiguity—which meaning prevails when the parties have attached different meanings to a promise. It states that:

(2) where the parties have attached different meanings to a promise or agreement or a term thereof, it is interpreted in accordance with the meaning attached by one of them if at the time the agreement was made

(a) that party did not know of any different meaning attached by the other, and the other knew the meaning attached by the first party; or

(b) that party had no reason to know of any different meaning attached by the other, and the other had reason to know the meaning attached by the first party. [emphasis added]⁵⁷

This provision, like Section 1649 of the California Civil Code, addresses the question of ambiguity and looks to the

⁵⁶ *Med. Operations Mgmt, Inc. v. Nat'l Health Lab., Inc.*, 176 Ca. App. 3d 886 (Ct. App. 1986); *Bank of the West v. Superior Court*, 2 Cal. 4th 1254 (1992).

⁵⁷ RESTATEMENT (SECOND) OF CONTRACTS §201 (1981).

knowledge of, or reason to know, the intentions of both parties, but, like Section 1649, it only concerns the intentions of the parties at the time of entering into the contract. Like Section 1649, it does not address the problem of unanticipated ambiguity that arises during performance when circumstances change.

III. THE RISK OF CONTRA PROFERENTEM

A. History

California has codified the common law rule of *contra proferentem* in Section 1654 of the California Civil Code. The concept that ambiguities in contract language should be interpreted against the drafter originated in Roman law, but the term “*contra proferentem*” is an invention of the glossators of the Middle Ages. Roman law did not use this general term; it had more specific expressions (such as, *contra stipulatorem* (“against the stipulator”)) that Roman jurists used to interpret ambiguous terms to the disadvantage of the party that had introduced them into the transaction.⁵⁸ For example, doubt as to whether a condition had been satisfied in a sales transaction was held against the seller.⁵⁹ The rule was a subsidiary rule of interpretation and only used as a last resort,⁶⁰ but it was based on a concern to protect the weaker party to a contract. The Roman and later medieval rule of *contra proferentem*, then, was developed to deal with commercial contracts that in essence were similar to those signed today between corporations and dealt with by most corporate lawyers—not mass consumer contracts of adhesion. Since the 15th century, English common law has applied this presumption to commercial contracts where an imbalance of power allowed one party to determine the terms of the contract. But in addition to the imbalance of power justification, Roger Bacon suggested that a primary reason for the presumption was that “it is a schoolmaster of wisdom and

⁵⁸ REINHARD ZIMMERMAN, *THE LAW OF OBLIGATIONS: ROMAN FOUNDATIONS OF THE CIVILIAN TRADITION* 634 (1990); PÉTER CSERNE, *POLICY CONSIDERATIONS IN CONTRACT INTERPRETATION: THE CONTRA PROFERENTEM RULE FROM A COMPARATIVE LAW AND ECONOMICS PERSPECTIVE* 8 n.39, available at http://works.bepress.com/peter_cserne/28 (last visited Feb. 1, 2014). Cserne’s work is the best historical and comparative description of *contra proferentem*.

⁵⁹ ZIMMERMAN, *supra* note 58, at 736.

⁶⁰ *Id.* at 640.

diligence in making men watchful in their own business.”⁶¹ The presumption has also been included in the principles of European contract law and Unidroit.⁶² Over the centuries *contra proferentem* has been applied to commercial contracts although the policy reasons for employing it in the interpretation of ambiguity in these contracts have changed somewhat.

However, with industrialization, the rise of the insurance industry, and the invention of “contracts of adhesion” in the twentieth century,⁶³ the presumption became closely associated with “take-it-or-leave-it” contracts between a corporation and an individual.⁶⁴ California law on this presumption derives from its Civil Code.

B. Section 1654 of the California Civil Code

Section 1654, which codifies the common law presumption of *contra proferentem*,⁶⁵ states:

“In case of uncertainty not removed by the preceding rules [of interpretation], the language of a contract should be interpreted most strongly against the party who caused the uncertainty to exist. [emphasis added]”⁶⁶

This Section does not refer to “ambiguity;” instead it employs the term “uncertainty,” but the California Supreme Court, in discussing Section 1654, has used the term “ambiguity” to describe the term “uncertainty.”⁶⁷ The language of this Section

⁶¹ FRANCIS BACON, THE WORKS OF FRANCIS BACON III 225 (1852).

⁶² Article 5:107: *Linguistic Discrepancies*, in THE COMMISSION ON EUROPEAN CONTRACT LAW, PRINCIPLES OF EUROPEAN CONTRACT LAW, PARTS I AND II 298 (Ole Lando & Hugh Beale eds., 2000); THE UNIDROIT PRINCIPLES IN PRACTICE 242 (Michael Joachim Bonell ed. 2006).

⁶³ Horton, *supra* note 9, at 444.

⁶⁴ As a result, California courts sometimes have taken the position that the presumption only applies if the contract possesses one or more of the characteristics of a contract of adhesion. *Garcia v. Truck Ins. Exch.*, 36 Cal. 3d 426, 441 (1984) (where contract was not one of adhesion, *contra proferentem* was not applied); *Mitchell v. Exhibition Foods*, 184 Cal. App. 3d 1033, 1042 (Ct. App. 1986) (refusal to apply *contra proferentem* because the contract was the product of joint drafting).

⁶⁵ It appears from the case reports that California judges often rely on precedents and the general sense of the common law presumptions, such as *contra proferentem*, rather than the specific wording of the code section.

⁶⁶ RESTATEMENT (SECOND) OF CONTRACTS §206 (1981).

⁶⁷ *AIU Ins. Co. v. Superior Court*, 51 Cal. 3d 807, 822 (1990). The application of *contra proferentem* generally requires ambiguity, but that is not

does not mention an imbalance of power. It seems to emphasize fault and imply that the party responsible for the problem should bear the adverse consequences of it. This seems similar to, but stronger than, the rationale behind the Roman practice and Section 206 of the Restatement (Second) of Contracts⁶⁸ that the drafter is more likely to provide more carefully for the protection of its own interests than those of the other party and is more likely than the other party to have reason to know of ambiguities. But in the Code, the reference to “cause” seems to imply a desire to incentivize the drafter to reduce the risk of ambiguity by improving contract drafting.

In this Code Section, the reference to the “preceding rules” is to the other presumptions of contract interpretation and indicates that *contra proferentem*, as it was under Roman law, is a last resort—it applies when the other presumptions have not resolved the ambiguity.

C. Applying Contra Proferentem: A Checklist of Risk Factors⁶⁹

1. Introduction

A review of relevant California case law involving *contra proferentem* shows that many factors affect the risk that the presumption may apply. The risk factors are set forth below in the form of an initial checklist of questions that may be useful for practitioners.⁷⁰ This checklist covers only California; changes would need to be made for other states.

always the case. The question of whether it can apply when there is no ambiguity is rarely raised. However, the decision by the United States Supreme Court in *United States v. Seckinger*, 397 U.S. 203 seems to leave open that possibility.

⁶⁸ Section 206 states: “In choosing among the reasonable meanings of a promise or agreement or a term thereof, that meaning is generally preferred which operates against the party who supplies the words or from whom a writing otherwise proceeds.” The United States Supreme Court has cited this section of the Restatement in ruling that a securities firm “drafted an ambiguous document, and they cannot now claim the benefit of the doubt.” *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 63 (1995).

⁶⁹ This checklist is a first step towards a systematic analysis of *contra proferentem* suggested in Torbert (2011), *supra* note 3, at 91.

⁷⁰ The usefulness of checklists has been noted by ATUL GAWANDE, *THE CHECKLIST MANIFESTO* (2010). The checklist here can assist drafters and negotiators of contracts to assess the risks presented by the text of a specific contract. It would appear that knowledge of these factors and how they together

The list of factors below requires one caveat. As noted above, the contract analyzed here is a business-to-business, that is, “commercial” contract typical of those handled by many practicing lawyers. It is not a contract of adhesion.⁷¹ Therefore, in the discussion below I have tried to construct from the case law and scholarly commentary a California *contra proferentem* doctrine for commercial contracts that excludes, to the extent possible, adhesion contract precedents, especially insurance contract precedents. It seems proper, and likely, that a judge or arbitrator examining the ambiguity of language in a commercial contract would look for precedents concerning commercial contracts rather than adhesion contracts.

(a) Contract Term Precluding the Application of *Contra Proferentem*

In a contract governed by California law, can a drafter preclude the application of *contra proferentem* by including a clause to that effect?

Yes, subject to possible concerns of public policy and unconscionability. Contract law in the United States generally allows the parties substantial freedom of contract, subject to certain exceptions such as public policy and unconscionability. In theory, it should be possible for the drafting party to include a clause in the contract that precludes the application of *contra proferentem*. In fact, a number of commentators on contract drafting have suggested that the drafting party include such a provision in contracts.⁷² In my experience such a clause is rare, but it seems to be common in some contracts.⁷³

Two provisions of California’s Civil Code are potentially applicable to such a clause. The first, Section 1667, concerns public policy. It states that a contract is not lawful if it is “[c]ontrary to the policy of express law, though not expressly

constitute the risk of the application of *contra proferentem* would be helpful in evaluating the economic value of the contract and in negotiation.

⁷¹ The term “commercial contract” is used below to describe a contract between two companies that would not be characterized by a court in the jurisdiction of the governing law as a contract of adhesion.

⁷² HAGGARD & KUNEY, *supra* note 1, at 117; C. MARVIN GARFINKEL, REAL WORLD DOCUMENT DRAFTING: A DISPUTE-AVOIDANCE APPROACH 87 (2008).

⁷³ Duhl, *supra* note 26, at 112; R. Posner, *supra* note 16, at 1600, n.48.

prohibited.” It seems unlikely, however, that a clause precluding *contra proferentem* would qualify as contrary to the policy of express law.

The second provision, which concerns unconscionability, is California Civil Code Section 1670.5. It was copied from the Uniform Commercial Code and states that:

(a) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made, the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.⁷⁴

A search of California cases has not revealed any cases in which a California court opined on whether a clause precluding *contra proferentem* would be unconscionable or not. But Section 206 of the Restatement notes that at times it is difficult to distinguish between the application of *contra proferentem* and a denial of effect to an unconscionable contract clause.⁷⁵ Thus, it is arguable that a contract provision eliminating a presumption that has been used to deny effect to unconscionable clauses could be found to be unconscionable.

California Court decisions have indicated that the concept of unconscionability has both a procedural and substantive element. The procedural element focuses on oppression or surprise. “Oppression” arises from an inequality of bargaining power that results in no real negotiation and an absence of meaningful choice. “Surprise” involves the extent to which the supposedly agreed-upon terms are hidden in a prolix printed form drafted by the party seeking to enforce them. Substantive unconscionability consists of an allocation of risk or cost which is overly harsh or one-sided and is not justified by the circumstances in which the contract was made. Presumably both procedural and substantive unconscionability must be present

⁷⁴ CAL. CIVIL CODE, §1670.5.

⁷⁵ RESTATEMENT (SECOND) OF CONTRACTS §206 (1981).

before a contract will be held unenforceable.⁷⁶ It seems that there would be a greater probability of a contract of adhesion, as opposed to a commercial contract, being found unenforceable.

It seems unlikely that most commercial contracts between companies would meet these criteria, except perhaps insurance contracts, for which the application of *contra proferentem* against the insurer is a matter of course.⁷⁷ In one Delaware case, the Superior Court noted the presence of a clause excluding *contra proferentem* in a settlement agreement and refused to accept an insurance company's argument that, because it was in an unequal bargaining position in negotiating the agreement, *contra proferentem* should be applied to its benefit.⁷⁸ This decision seems to indicate that a clause precluding the application of *contra proferentem* may not be considered unconscionable. Therefore, if the contract discussed below were to include a clause precluding *contra proferentem*, it seems unlikely that the clause would be found unconscionable and unenforceable under California law.

This fact, however, does not guarantee that a clause precluding *contra proferentem* in a commercial contract would still effectively preclude the presumption. If the provision precluding *contra proferentem* justified the preclusion by stating that both parties had participated in the drafting and the court allowed the admission of extrinsic evidence⁷⁹ showing that only one party had drafted the contract, the application of *contra proferentem* to the preclusion clause itself could result in the application of the presumption to the contract as a whole.

Deciding whether to include a clause precluding *contra proferentem*, then, will depend on the drafter's balancing the benefits of a carefully drafted clause with the costs of negotiating it.

⁷⁶ *Samura v. Kaiser Found. Health Plan, Inc.*, 17 Cal. App. 4th 1284 (Ct. App. 1993). See also *Vance v. Villa Park Mobilehome Estates* 36 Cal. App. 4th 698 (Ct. App. 1995); *Ilkhchooyi v. Best*, 37 Cal. App. 4th 395 (Ct. App. 1995); *Flores v. Transamerica Homefirst Inc.*, 93 Cal. App. 4th 846 (Ct. App. 2001).

⁷⁷ This probably explains why insurance contracts generally do not seem to contain such a clause.

⁷⁸ *I. U. North America, Inc. v. A.I.U. Ins. Co.*, 896 A. 2d 880 (Del. Super. 2006).

⁷⁹ The admission of extrinsic evidence under California law is discussed *infra* p. 22.

(b) Contract of Adhesion

If the contract is not an “adhesion contract,” can *contra proferentem* still apply?

Yes. The seminal California case on adhesion contracts, *Steven v. Fidelity & Casualty Co.*, concerned an insurance contract that was issued from a vending machine. The Court described the contract as a “contract of adhesion” and applied the presumption of *contra proferentem*. It characterized an adhesion contract as one that met some of the following criteria: “a standardized contract prepared entirely by one party” that exhibited a “disparity in bargaining power” between the parties and that had to be accepted or rejected on a “take it or leave it basis” without opportunity for bargaining.⁸⁰ The application of *contra proferentem* to contracts possessing all or some of these characteristics would not be—and has not been—unusual.⁸¹ In fact, the U.S. Supreme Court’s decision in *C & L Enterprises, Inc. v. Citizen Bank Potawatomi Indian Tribe*⁸² could be interpreted to require an adhesion contract before *contra proferentem* applies. In explaining why the presumption did not apply in that case, the Court said that the contract was not ambiguous and that the Tribe did not find itself holding “the short end of an adhesion contract stick [emphasis added].” However, it is also true under California law that a contract does not have to be one of adhesion for the presumption to apply. In *Cathay Bank v. Lee*, the court found that the guaranty contract at issue was not a contract of adhesion, but still applied the presumption.⁸³

Considering the nature of contracts of adhesion there is good reason to apply the presumption of *contra proferentem* to them, but considering that the presumption has existed for about two thousand years before the invention of “contracts of adhesion,” there is clearly no reason to limit its application to these contracts, particularly where the ambiguity was unanticipated.

⁸⁰ *Steven v. Fidelity & Cas. Co.*, 58 Cal. 2d 862, 882 (Cal. 1962).

⁸¹ See *Tahoe Nat’l Bank v. Phillips*, 4 Cal. 3d 11 (1971) discussed *infra* p. 28.

⁸² *C & L Enters., Inc. v. Indian Tribe*, 532 U.S. 411, 423 (2001).

⁸³ *Cathay Bank v. Lee*, 14 Cal. App. 4th 1533, 1541 (Ct. App. 1993) where the court stated “It is true that guaranty contracts are not contracts of adhesion But that cannot reverse the usual rule that ambiguities are construed against the drafter.”

(c) The Admission of Extrinsic Evidence

Do California case law and California's Code of Civil Procedure allow the admission of extrinsic evidence only to clarify contract language that is ambiguous on its face?

Generally not, but the case law is inconsistent. Until 1968, California followed the traditional "plain meaning rule" for determining ambiguity. This rule required a judge to find that contract terms were ambiguous on their face before extrinsic evidence could be admitted to explain them. Under this rule, an ambiguity on the face of an adhesion contract was fatal for the drafter because the application of *contra proferentem* resulted in a decision against the drafter without consideration of extrinsic evidence.⁸⁴ In this situation, *contra proferentem* was generally the first, last, and only resort for dealing with ambiguity. Chief Justice Traynor's decision in *Pacific Gas & Electric Co. v. Thomas Drayage & Rigging Co.*, 69 Cal. 2d 33 (1968) abolished the "plain meaning rule" in California and substituted another test for the admissibility of extrinsic evidence: that the offered evidence was relevant to prove a meaning to which the language of the contract is "reasonably susceptible."⁸⁵ The effect of this decision was that ambiguities could not only exist in the language on the face of the contract, but could also be found in the seemingly plain language of the contract through the aid of extrinsic evidence. It seems likely that, as a result, recognized ambiguities have increased. Previously, ambiguities in the language on the face of the contract had been resolved by *contra proferentem*; those found through interpreting the language with the aid of extrinsic evidence could be resolved by other canons of interpretation or, as a last resort, by *contra proferentem*.

Justice Traynor's decision was not unanimous. Justice Mosk issued a thoughtful dissent in *Pacific Gas* and in another case the same year, *Delta Dynamics, Inc. v. Arioto*.⁸⁶ And *Pacific Gas* was followed three years later by another Supreme Court decision, *Tahoe National Bank v. Phillips*,⁸⁷ in which Justice Tobriner created a significant exception to Chief Justice

⁸⁴ Horton, *supra* note 9, at 448.

⁸⁵ *Pacific Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co., Inc.*, 69 Cal. 2d 33, 37 (1968).

⁸⁶ *Delta Dynamics, Inc. v. Edwin Arioto*, 69 Cal. 2d 525 (1968).

⁸⁷ *Tahoe Nat'l Bank v. Phillips*, 4 Cal. 3d 11 (1971).

Traynor's rule of allowing the admission of extrinsic evidence to clarify ambiguity. He said that in determining whether an adhesion contract is "reasonably susceptible" to the interpretation suggested by the extrinsic evidence, one factor for consideration is whether that interpretation would do violence to the "fundamental considerations of policy" that underlay *contra proferentem*.⁸⁸ In effect, the import of the decision is that equitable considerations inherent in *contra proferentem* can prevail over the rule announced in *Pacific Gas*, particularly for an adhesion contract.

Since 1971 California courts have failed to establish consistent rules on the admissibility of extrinsic evidence.⁸⁹ The decisions of trial and appellate courts often differ.⁹⁰ Appellate, but not trial, courts interpreting contracts have often followed *Pacific Gas*, but in *Nedlloyd Lines B. V. v. Superior Court*, the Supreme Court ruled that the plain meaning of contract language can bar extrinsic evidence.⁹¹ The combined effect of the case law seems to be that California law will often prevent the application of *contra proferentem*, but not if either of the following conditions exists: (1) extrinsic evidence is absent; or (2) the extrinsic evidence does not resolve the ambiguity.

To implement the *Pacific Gas* decision, Article 1856 of the California Civil Code was amended in 1978. It allows the parties to provide extrinsic evidence to "interpret the terms of the agreement . . ." ⁹² Thus, the interpretation of ambiguity in a contract consists of two steps. In the first step, the court provisionally receives (without actually admitting) all credible

⁸⁸ *Id.* at 20.

⁸⁹ Eric A. Posner has suggested that no jurisdiction has a bright-line absolutely allowing or preventing extrinsic oral evidence because all sorts of subsidiary doctrines provide exceptions to any general rule established by the courts. Eric A. Posner, *The Parol Evidence Rule, the Plain Meaning Rule, and the Principles of Contractual Interpretation*, 146 U. Pa. L. Rev. 533, 553 (1998). Others have noted that "[i]ndeed, the continuing vitality of the traditional parol evidence and plain-meaning rules cannot be underestimated." Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions between Express and Implied Contract Terms*, 73 Cal. L. Rev. 261, 307 (1985).

⁹⁰ Susan J. Martin-Davidson, *Yes, Judge Kozinski, There Is a Parol Evidence Rule in California—The Lessons of A Pyrrhic Victory*, 25 SW. U. L. Rev. 1, 4 (1995-1996).

⁹¹ *Nedlloyd Lines B. V. v. Superior Court*, 834 P. 2d 1148, 1155 (Cal. 1992).

⁹² CAL. CIV. CODE, §1856.

evidence to determine whether the language is reasonably susceptible to the interpretation urged by a party. If it is, then, in the second step, the court proceeds to interpret the ambiguity. In this second step, *contra proferentem* may be applied to resolve the ambiguity.⁹³ Limiting the application of *contra proferentem* to the second step, together with the decision in *Pacific Gas*, seems to have diminished the frequency of resort to *contra proferentem* in California in the first step, but probably not in the second. Overall, considering both steps, resort to *contra proferentem* may actually be more frequent after *Pacific Gas*.

(d) The Sense of “Drafter”

What is the sense of the word “drafter”⁹⁴ in the presumption *contra proferentem*?

The sense depends on the context. The word is ambiguous in at least two ways and existing law does not seem to provide clear guidance.

First, the translation of the Latin term “*contra proferentem*” as “against the drafter” is not strictly correct. The term really means “against the [party] proffering” or “against the [party] making” the ambiguous language.⁹⁵ This raises the question of whether the presumption should be applied when the party proffering the document uses a form that has been prepared by others. In such case, the party will often use the form, altering it slightly by filling in the blanks and by making a few adjustments, but then “proffer” it to the other party. For most purposes, the party preparing the document is not the “drafter” but only the “profferor.” Should *contra proferentem* be applied to the disadvantage of this party? Further, in some cases, the form contract offered by the “profferor” will be one prepared by an industry group, as in the construction industry.⁹⁶ Should the party

⁹³ *Wolf v. Superior Court*, 114 Cal. App. 4th 1343, 1351 (Ct. App. 2004).

⁹⁴ CAL. CIV. CODE §1654, of course, does not mention the “drafter” but only the “party that caused the ambiguity to exist.” California courts, however, generally used the term “drafter” in discussing the application of *contra proferentem*.

⁹⁵ See the definition of *profero* in CHARLTON T. LEWIS, A LATIN DICTIONARY 1457 (1993).

⁹⁶ A. M. Netto, Alice Christudason & Gabriel Kor, *The Contra Proferentem Rule and Standard Forms of Construction Contracts*, 19 INT’L CONSTR. L. REV. 387, 388–89 (Jan.–Oct., 2002). The role of the Insurance Service Office in the

using such a form be considered the drafter? Should it depend on whether the form was prepared without input from outside parties with different interests? If the form represents the efforts of a group representing both parties, such as employers and contractors, then should the presumption not apply, even though the party that prepares the contract is the “profferor”? California law has not addressed these questions.

Second, as noted above, most contracts are prepared by one party that is generally referred to as the “drafter.” But in negotiations, the other party often may make changes that will be incorporated into the final document. Should the other non-drafting party then be referred to as the “drafter” of these provisions and be subject to the application of *contra proferentem*? There would appear to be two plausible answers. One is that, if in fact the new provisions have been discussed and negotiated, they should be seen as a type of joint drafting that can prevent the application of the presumption.⁹⁷ The other is that the party adding the provisions caused any ambiguity in those provisions and therefore should suffer the application of *contra proferentem*. Perhaps further research can provide some guidance on this and the questions raised above.

For present purposes, it seems that the contract discussed below is probably not an industry form, but was prepared by the American party Licensor from its precedents. In reviewing the document without the benefit of extrinsic evidence, it seems safe to presume that the Licensor is probably the “drafter,” or at least the “profferor,” of every word in the contract subject to rebuttal that specific words were added by the Licensee.

(e) Reliance on Interpretation of the Ambiguous Language

Under California law, must the party asserting *contra proferentem* have relied on its interpretation of the ambiguous language at the time of entering into the contract?

No. But in contracts with the U.S. government, the application of the presumption of *contra proferentem* often depends on whether the non-governmental party has relied, at the

insurance industry is well known. See <http://www.iso.com> (last visited Feb. 1, 2014).

⁹⁷ See the discussion *infra* p. 27.

time of entering into the contract, on its interpretation of the ambiguous language in order to sign the contract. Absent such reliance, courts often refuse to apply the presumption.⁹⁸ A U.S. District Court for the Northern District of California, however, has ruled that this requirement does not exist under California law. It limited the application of this rule to contracts to which the United States was a party and found that this rule was not applicable to a contract to which the United States was not a party.⁹⁹ Therefore, a non-drafting party wishing to assert the presumption of *contra proferentem* under California law should not have to prove that it relied at the time of entering into the contract on its interpretation of the ambiguous language.

(f) Reasonableness of Interpretation

Must each interpretation of the ambiguous language be “reasonable” in order for ambiguity to exist?

Yes. The Restatement requires that the interpretation by the non-drafting party must be reasonable before ambiguity can exist. In discussing *contra proferentem*, it refers to “choosing among the reasonable meanings of a promise or agreement or a term thereof [emphasis added].” The California Civil Code does not include this requirement, but case law has prescribed it. As noted above, *Thomas Drayage* and *Tahoe National Bank* both refer to language that is “reasonably susceptible” to the interpretation by the party proposing the application of *contra proferentem*. Other cases have confirmed the requirement of “reasonableness”¹⁰⁰ but have also suggested that the standard is whether an interpretation is “semantically reasonable”¹⁰¹ or “semantically permissible.”¹⁰² Therefore, under California law, a party’s interpretation must be one to which the language of the contract is “reasonably susceptible,” “semantically reasonable,” or “semantically permissible” before *contra proferentem* can be applied.

⁹⁸ See, e.g., *Cray Research, Inc. v. United States*, 44 Fed. Cl. 327 (1999).

⁹⁹ *World S & L Ass’n v. Fed. Home Loan Bank of San Francisco*, 2002 U.S. Dist. LEXIS 15875 citing *Patterson v. Hughes Aircraft Co.*, 11 F. 3d 948 (9th Cir. 1993).

¹⁰⁰ *Curry v. Moody*, 409 Cal. App. 4th 1547 (Ct. App. 1995).

¹⁰¹ *California Nat. Bank v. Woodbridge Plaza LLC*, 78 Cal. Rptr. 3d 561 (Ct. App. 2008).

¹⁰² *Schaffter v. Creative Capital Leasing Group, LLC*, 83 Cal. Rptr. 3d 19 (Ct. App. 2008).

(g) Negotiation of the Contract

Does *contra proferentem* apply to a contract that has been negotiated?

Other things being equal, not if the contract has been “actively negotiated.” In 1962, a California court ruled that where the terms of a contract are “arrived at by negotiations between two parties,” the contract will not be construed against the drafter.¹⁰³ Later, U.S. Federal courts in California applying California law have set forth a standard of “active negotiations” that limits the application of the presumption. In *Miller v. United States*, a bankruptcy court said that California cases do recognize that where contract terms are “actively negotiated,” “neither party should be considered the drafter.”¹⁰⁴ Subsequent cases have applied this standard. The United States District Court for the Southern District of California in *Herring v. Teradyne, Inc.* found that “no meaningful discussions” meant that the contract was not “actively negotiated.”¹⁰⁵ In *Healy v. MCI WorldCom Network Serv.*, the U.S. Federal Court for the Eastern District of California decided that “negotiations on the periphery” did not meet the test of being “actively negotiated.”¹⁰⁶ This standard of “actively negotiated” does not explain how “active” the negotiations have to be or whether they have to address the issue involved in the ambiguity.

These cases demonstrate the difficulties in interpreting the term “actively negotiated.” Does “negotiate” mean not only discussion of the issues, but a resulting substantive change in the text of the contract? Or can it refer to a form contract with blanks for the price and a couple of other items where the only item negotiated was the price? The term “negotiate” therefore is ambiguous by itself and does not provide much guidance. Further, the combination “actively negotiate” does not provide any information on the whether the parties enjoy equal bargaining

¹⁰³ *Indenco, Inc. v. Evans*, 201 Cal. App. 2d 369, 375 (Ct. App. 1962).

¹⁰⁴ *Miller v. United States*, 253 B.R. 455, 459 (Bankr. N. D. Cal. 2000). The court cited as support *Dunne & Gaston v. Keltner*, 50 Cal. App. 3d 560 (Ct. App. 1975), but that decision does not say anything about who the drafter of the document was in that case, so it seems to be weak support.

¹⁰⁵ *Herring v. Teradyne, Inc.* 256 F. Supp. 2d 1118, 1126 (S. D. Cal. 2002).

¹⁰⁶ *Healy v. MCI WorldCom Network Serv.*, 2006 U.S. Dist. LEXIS 446, 18–19 (E. D. Cal. 2006).

power, or whether the parties are equally sophisticated, but it probably implies that both parties had input into the drafting of the contract as discussed below.

(h) Joint Drafting

Does *contra proferentem* apply if the contract was jointly drafted by the parties?

It depends. The question of negotiation of the contract is closely related to that of joint drafting. Generally, as noted above, one party will prepare the initial draft of a contract, but unless the contract is an adhesion contract, the parties will negotiate the initial draft of a commercial contract and change parts of it. The case law calls this “joint drafting” and it would seem generally to be the result of “active negotiations.” In a 1984 case, the California Supreme Court ruled that an insurance contract that was negotiated between an insurance carrier and the California Hospital Association, which enjoyed substantial bargaining power, was the product of “joint drafting” and refused to apply *contra proferentem*.¹⁰⁷ In another case two years later, *Mitchell v. Exhibition Foods*, a trial court determined that the right-of-first-refusal provision was the product of a “joint drafting” and therefore refused to apply *contra proferentem*.¹⁰⁸ In *Herring v. Teradyne*, the only changes made during the negotiations to the first sentence of the section of the agreement that was the subject of the ambiguity analysis involved certain “carve out” subsections that were not relevant to the ambiguity question.¹⁰⁹ Therefore, the court decided that *contra proferentem* could be applied.

These cases leave open the questions of how much change in the contract constitutes “joint drafting,” but together with the cases concerning active negotiations, they suggest that the changes will probably result from the negotiations and may prevent the application of *contra proferentem* if they relate to the specific ambiguity issue.

(i) Unequal Bargaining Power

¹⁰⁷ *Garcia v. Truck Insurance Exchange*, 36 Cal. 3d 426, 441 (1984).

¹⁰⁸ *Mitchell v. Exhibition Foods*, 184 Cal. App. 3d 1033, 1042 (1986).

¹⁰⁹ *Herring v. Teradyne, Inc.*, 256 F. Supp. 2d 1118, 1134 (S. D. Cal. 2002).

Is unequal bargaining power a precondition for the application of the presumption?

Other things being equal, it seems to be. This is because unequal bargaining power is the primary policy issue that *contra proferentem* addresses. California courts have looked to the bargaining power of both parties to a contract in deciding whether *contra proferentem* should be applied. In *Neal v. State Farm Ins. Cos.* the court applied *contra proferentem* to a contract of adhesion that was drafted and imposed by “the party of superior bargaining strength.”¹¹⁰ In *Tahoe*, mentioned above, the California Supreme Court identified the bank as occupying “the superior bargaining position” and therefore applied *contra proferentem* against a standardized contract.¹¹¹ In *Mitchell v. Exhibition Foods*, one of the reasons the court refused to apply *contra proferentem* was because the parties stood on “an equal footing.”¹¹² But, as noted above, the presumption can be applied even if the contract between the parties is not a contract of adhesion.¹¹³

(j) Sophistication of the Parties

Is a lack of sophistication in the non-drafter a precondition for the application of *contra proferentem*?

It depends. The sophistication of the non-drafter is a factor that California courts have cited in deciding whether to apply the presumption. For example, in a 1976 case of alleged ambiguity in a real estate loan agreement, the court found that the non-drafting parties were “sophisticated borrowers in the field of real estate development” and refused to apply the presumption.¹¹⁴ In a 1995 case, the court refused to apply the presumption because *contra proferentem* was inapplicable where “sophisticated parties” negotiated and jointly drafted the language in question.¹¹⁵ The California Supreme Court in a 1990 decision acknowledged that where an insurance policyholder does not suffer from lack of

¹¹⁰ *Neal v. State Farm Ins. Cos.*, 188 Cal. App. 2d 690 (Ct. App. 1961).

¹¹¹ *Tahoe Nat'l Bank v. Phillips*, 480 P. 2d 320 (1971).

¹¹² *Mitchell v. Exhibition Foods*, 184 Cal. App. 3d 1033 (Ct. App. 1986).

¹¹³ *Cathay Bank v. Lee*, 14 Cal. App. 4th 1533 (Ct. App. 1993).

¹¹⁴ *Powell v. Central Cal. Fed. Sav. & Loan Assn.*, 59 Cal. App. 3d 540 (Ct. App. 1976).

¹¹⁵ *Cooper Co. v. Transcon. Ins. Co.*, 312 Cal. App. 4th 1094 (Ct. App. 1995).

sophistication or a relative lack of bargaining power and where the insurance policy is actually negotiated and jointly drafted, a court need not go so far in protecting the insured from ambiguous or highly technical drafting. However, where the drafter does not present any evidence that the provisions were actually negotiated or jointly drafted, the court saw little reason to depart from the ordinary principles of interpretation that would apply the presumption.¹¹⁶ In a 2002 case involving a loan agreement, the U.S. District Court for the Northern District of California found that even though the non-drafter was a “sophisticated borrower,” the presumption should be applied because the agreements were not subject to negotiation.¹¹⁷ It seems that California courts will not apply the presumption if the non-drafter is sophisticated, does not lack bargaining power and participated in the negotiation and drafting of the contract. It appears, however, that sophistication alone, or a lack of it, is not sufficient to preclude the presumption or to apply it.

(k) Duty to Seek Clarification

Does the non-drafter have a duty to ask for clarification of a patent ambiguity before the presumption will be applied?

In government contracting, courts have developed a doctrine that where the ambiguity is patent, the private, non-drafting party has an obligation to seek clarification of the ambiguity and, if it has not, a court will not apply *contra proferentem* against the government as the drafter.¹¹⁸ State courts, including those in California, however, do not seem to have adopted this doctrine, but it is possible that they may in the future. Two commentators have proposed that Tennessee do so.¹¹⁹ Clearly, the adoption of such a rule would reduce the frequency of application of *contra proferentem* and could prevent its application in a specific instance.

¹¹⁶ *AIU Ins. Co. v. Superior Court*, 51 Cal. 3d 807 (1990).

¹¹⁷ *World S&L Ass'n v. Fed. Home Loan Bank of San Francisco*, 2002 U. S. Dist. LEXIS 15875.

¹¹⁸ Flynn, *supra* note 9, at 379; Steven W. Feldman & James A. DeLanis, *Resolving Contractual Ambiguity in Tennessee: A Systematic Approach*, 68 TENN. L. REV. 73 (Fall, 2000). See *Merando, Inc. v. United States*, 201 Ct. Cl. 23 (1973) and *Fort Vancouver Plywood Co. v. United States*, 860 F. 2d 409 (9th Cir. 1988).

¹¹⁹ Feldman & DeLanis, *supra* note 118, at 98–99.

(I) Effect of Arbitration

Does a provision for arbitration in the contract affect the application of the governing law to the contract and possibly the application of *contra proferentem*?

Yes. California law will certainly be applied in resolving ambiguities under this contract, but it will be applied by an arbitrator rather than a judge. The contract here provides for arbitration by a single arbitrator¹²⁰ under the Arbitration Rules of the International Chamber of Commerce (ICC) rather than resort to California courts.¹²¹ Under international arbitration practice, the arbitrator will conduct the proceedings in accordance with the choice-of-law clause, which is California law, specifically California arbitration law.¹²²

California arbitration law, contained in the Code of Civil Procedure, provides that the parties may agree on the procedure to be followed by the arbitrator in conducting the proceedings, but if they fail to do so (as they have in this case), the arbitrator may, subject to certain restrictions in the arbitration law, conduct the arbitration “in the manner [he or she] considers appropriate.”¹²³ In conducting the arbitration, the arbitrator has the power under California’s arbitration act to determine the admissibility, relevance, materiality, and weight of any evidence,¹²⁴ but the arbitrator would also consider the ICC Rules on evidence (requiring the arbitrator to study the written submissions of the parties and all documents relied upon; to hear the parties together in person; and to decide whether to hear witnesses). The Rules also require the arbitrator to take account of the provisions of the contract regarding the admissibility of evidence, but the contract in this case does not contain any provisions on this.

¹²⁰ In this case, the contract calls not for an arbitral tribunal, but for a single independent arbitrator who has significant experience in arbitrating matters related to the biopharmaceutical industry and who was either mutually agreed on by the Parties or selected by a senior executive of the ICC in Paris. See Clause 18.2 of the contract *infra*.

¹²¹ See Clause 18.2 of the contract *infra*.

¹²² “..the procedural law of the arbitration is almost always the arbitration legislation of the arbitral seat...” GARY B. BORN, INTERNATIONAL COMMERCIAL ARBITRATION 1310 (2009)

¹²³ CAL. CODE CIV. PROC., §1297.191, 192 (1988).

¹²⁴ CAL. CODE CIV. PROC., §1297.193 (1988).

The California arbitration law, the ICC Rules, and the terms of the contract here together give the arbitrator some latitude. Thus, the specific procedures on the admissibility of evidence, specifically extrinsic evidence to resolve ambiguity, will depend on the arbitrator. In most cases, international arbitral tribunals take a pragmatic approach to the admissibility of evidence and are reluctant to be limited by the technical rules of evidence, particularly those rules designed for use in jury trials.¹²⁵ If the arbitrator follows general practice, he or she will take practical steps to admit evidence in order to establish the facts without restriction by the procedural rules of California's Code of Civil Procedure.

California law will be applied, but the application of California law by an arbitrator will be different from its implementation by a judge.¹²⁶ An arbitrator is required to interpret the law in a reasonable manner, but, within the scope of reasonable interpretation, an arbitrator will often be more flexible in applying the law and soften the impact of a law that appears to work too harshly against one of the parties.¹²⁷ In some cases, the parties have the arbitrator assume the powers of an *amiable compositeur* or decide *ex aequo et bono*. If the parties do this, the arbitrator will be less bound by technical legal rules. The parties in this case, however, have not so provided in the arbitration clause.¹²⁸

In sum, it seems likely that the single arbitrator, in interpreting ambiguities, may be inclined to apply *contra proferentem*, particularly if he or she finds persuasive equitable considerations. More specifically, in the context of California law,

¹²⁵ NIGEL BLACKABY, CONSTANTINE PARTASIDES, ALAN REDFERN & MARTIN HUNTER, REDFERN AND HUNTER ON INTERNATIONAL ARBITRATION 386 (2009).

¹²⁶ In jurisdictions that still follow the plain meaning rule, it is unclear whether an arbitral panel would disallow extrinsic evidence to show ambiguity if the contract language was clear on its face. But it could be impossible for the arbitration panel to follow the applicable law where that law provided for the deciding of fact issues but a jury, rather than a judge.

¹²⁷ MARGARET L. MOSES, THE PRINCIPLES AND PRACTICE OF INTERNATIONAL COMMERCIAL ARBITRATION 82 (2012).

¹²⁸ The ICC Rules state that if the contract contains any agreement that the arbitrator should assume the powers of an *amiable compositeur* or decide *ex aequo et bono*, the arbitrator should assume such role. The contract here contains no such agreement, so under the Rules the arbitrator should not assume such powers.

it would appear likely that the arbitrator would adopt an approach on the application of *contra proferentem* in the interpretation of ambiguities similar to that in *Tahoe*, one that emphasized equitable concerns. How likely this possibility is will depend on the experience and disposition of the single arbitrator and on other facts which he or she discovers through the proceedings.

(m) Varied Application of *Contra Proferentem* to the Contract

Does the probability of the application of *contra proferentem* vary with the particular provision of the contract?

Yes, it may where other policy considerations rebut the presumption. Ambiguity in an arbitration clause is one example. In the United States and in California, the courts have stated a preference for arbitration in resolving disputes. Therefore, when a contract clause requires the settlement of disputes by arbitration, the preference for arbitration would normally be given effect. However, the *contra proferentem* presumption may contradict this preference for arbitration. When the preference and the presumption conflict, which prevails? In California, the Supreme Court's decision in *Victoria v. Superior Court*¹²⁹ decided that *contra proferentem* applied where the contract was not adhesive (although it contained some adhesive provisions) and the parties had equal bargaining power.¹³⁰ A later decision by a Court of Appeal, however, has suggested that because *contra proferentem* is a "subordinate canon applied when other canons fail to dispel uncertainty," it should not be applied to construe ambiguity in an arbitration clause against the drafter.¹³¹ One factor that influenced the court's decision not to apply *contra proferentem* was that compulsory arbitration was not a term that inherently favored the interests of the drafter.¹³² These decisions suggest that under California law an ambiguous arbitration clause in a contract that is not an adhesion contract will be interpreted

¹²⁹ *Victoria v. Superior Court*, 40 Cal. 3d 734 (1985).

¹³⁰ The U.S. Supreme Court decision *Mastrobuono v. Shearson Lehman Hutton*, 514 U.S. 52, 63 (1995) also favored *contra proferentem* over the preference for arbitration.

¹³¹ *Pacific Gas & Electric Co. v. Superior Court*, 6 Cal. App. 4th 207 (Ct. App. 1991).

¹³² *Id.* at 242.

against the drafter, but if the arbitration clause does not inherently favor the interests of the drafter, this result may be less likely.

In the contract analyzed below, there does not appear to be any significant ambiguity in the arbitration clause, so the issue is moot here.

(n) *Contra Proferentem* as Last Resort Tie Breaker

Is *contra proferentem* a last resort tie-breaker?

Yes. As noted above, it was seen as a last resort in Roman law. The Restatement (Second) of Contracts states that, “so long as other factors are not decisive, there is substantial reason for preferring the meaning of the [non-drafting] party.” And as noted above, the California Civil Code requires that “[i]n the case of uncertainty not removed by the preceding rules [of interpretation],” *contra proferentem* will apply. This rule, together with Article 1856 of the Code of Civil Procedure noted above, means that *contra proferentem* can be seen as a presumption of last resort.¹³³

California cases also refer to *contra proferentem* as a “tie-breaker.”¹³⁴ This case law assumes an interpretive process in which ambiguity is resolved first by the application of various linguistic presumptions (such as the presumption of consistent drafting and the whole statute interpretation), but if presumptions rebut each other, that is, the number of presumptions supporting the drafter’s interpretation and the number of those supporting the non-drafter’s interpretation are equal, then the language should be interpreted according to *contra proferentem*, that is, against the drafter.

California courts, when mentioning the role of *contra proferentem* as a tie-breaker, have often emphasized that the presumption is more than a tie-breaker. In the 1962 case *Steven v. Fidelity & Casualty Co.* noted above, the Supreme Court of California applied *contra proferentem* to an egregious standard form travel insurance contract, stating that *contra proferentem*

¹³³ *Carella v. eBay Inc.*, 2006 Cal. App. Unpub. LEXIS 3247 (2006); *Laub v. Dudley*, 2008 Cal. App. Unpub. LEXIS 8359 (2008).

¹³⁴ *Tahoe Nat’l Bank v. Phillips*, 480 P. 2d 320 (1971); *Powers v. Dickinson*, 54 Cal. App. 4th 1102 (Ct. App. 1997); and *Pacific Gas & Electric Co. v. Superior Court*, 15 Cal. App. 4th 576 (Ct. App. 1993).

“does not serve as a mere tie-breaker; it rests upon fundamental considerations of policy.” Later decisions, such as *Tahoe* have echoed this sentiment, but applied it to other contracts that are less adhesive. The Restatement’s Reporters Notes say that “one may doubt that the rule [of *contra proferentem*] is ‘the last one to be resorted to, and never to be applied except when other rules of interpretation fail’”¹³⁵ seems to reflect this view that the policy considerations behind the presumption allow it to be applied in certain situations to serve equity.

2. Summary

It appears that no California court has described precisely all the possible factors affecting the application of this presumption. But it is clear from the above discussion that courts have often focused on only one factor affecting the application of *contra proferentem* in analyzing whether to apply the presumption. It seems that the absence of any of the following factors can increase the likelihood that the presumption will apply: equal bargaining power, negotiations, joint drafting, or equal sophistication. A drafter will want to keep in mind all of these factors and consider which ones may deserve further thought in the context of a particular contract. The overall conclusion, however, is this: *Ceteris paribus, contra proferentem*.

IV. REVIEW OF CONTRACT FOR AMBIGUITY

A. Introduction

The contract review below is an attempt to identify those provisions that could be interpreted as ambiguous if an unanticipated event resulting in material consequences for one of the parties occurred and prompted that party to examine the contract again. The purpose of this review is not to criticize the drafter. How much time and effort the drafter was able to spend preparing the contract, what precedent the drafter used, the value of the contract, and many other factors are unknown and make it impossible to pass judgment. The primary purpose of the review is to give students a scaffolding that they can use to learn and to

¹³⁵ RESTATEMENT (SECOND) OF CONTRACTS §206 (1981).

practice a very narrow, but important, skill—examining a contract to identify potential ambiguities.

But this purpose imposes a number of limitations on the review. It was done without any knowledge of the parties or their relationship. It is narrow in that it only addresses language issues and does not cover other key aspects of the contract. Further, the review is superficial—it emphasizes those ambiguities that can be seen on the surface of the contract and does not involve a deep analysis of the structure of the document, the interaction of the various provisions, or the commercial background. Finally, the review does not propose solutions to the ambiguity issues it identifies. The reason for this limitation is because I wanted to leave this challenge for the students writing their theses.¹³⁶ Proposing solutions is a task the students should work out from the materials cited in the footnotes to this article and in class. But this task should not be unduly difficult. Identifying the ambiguities is the greater challenge.

The review also has a secondary purpose—to serve practicing lawyers as an initial checklist of issues in reviewing contracts for ambiguity. The checklist reflects my experience, case law, commentators on legal drafting, and some contributions from students.¹³⁷ It is not exhaustive and includes a few issues that do not happen to be relevant to this particular contract.

B. Checklist of Contract Ambiguity Issues

1. Absence of Provision Precluding *Contra Proferentem*

In reviewing a contract for purposes of ambiguity, we are concerned about two risks, the risk of ambiguity and the risk of *contra proferentem* applying. The review of the contract will reveal how much ambiguity there is in the document. That is, what the general risk of ambiguity is. But we will learn this only after the review is complete. We can determine the risk of *contra*

¹³⁶ Readers can see one strategy for reducing the ambiguity associated with the class presumption in Torbert (2007), *supra* note 3, at 11.

¹³⁷ The final three-hour exam for my course “Drafting Contracts: The Problem of Ambiguity” at the University of Chicago Law School, Winter Quarter, 2013, asked each student to identify and explain the ambiguities in this contract and then, assuming the student represented the drafter, decide whether to eliminate the ambiguity and, if so, how.

proferentem applying, however, before performing a full review of the contract. The above description of the risk factors under California law for the application of *contra proferentem* gives us a sense of the risk in general, but does not tell us whether the parties have intended *contra proferentem* to apply to the contract or not. But we can discover this rather simply by quickly scanning the contract to see whether it contains a provision precluding the application of *contra proferentem*. Given that clauses precluding *contra proferentem* are common in some contexts and drafters should be aware of them, the presumption of *expressio unius* (the negative implication presumption) should apply. That is, if the contract does not contain such a provision, the parties will be found to have intended for *contra proferentem* as interpreted by California courts to apply. If the contract does contain such a provision, it will be interpreted as signifying that the parties intended that *contra proferentem* would not apply to the contract. In this case, the contract contains no such provision. Therefore, the risk of the application of *contra proferentem* is greater than it might have been. The risk factors examined above give a sense of how great that risk is.

2. Ambiguity of “Agreement” in the Title of the Contract

The word “agreement” in the title exhibits semantic ambiguity. It can refer to either a document that is legally binding or to one that is not. Even though there is no formal recitation of consideration in the contract, the mutual obligations set forth in the text seem to express the intention to create a legally binding document. Of course, the title of the document is generally not considered to be decisive in determining whether the document is legally binding or not.¹³⁸ The use of “agreement,” however, has in some circumstances caused a problem. Consider *Pennzoil v. Texaco*.¹³⁹ There a jury found that a “Memorandum of Agreement”¹⁴⁰ between Pennzoil and Getty Oil shareholders for the purchase of the shares in Getty Oil was a legally enforceable

¹³⁸ KENNETH A. ADAMS, A MANUAL OF STYLE FOR CONTRACT DRAFTING 1-2 (2d ed. 2008); CHARLES M. FOX, WORKING WITH CONTRACTS 161 (2008); HOWARD DAMSTADTER, HEREOF, THEREOF AND EVERYWHEREOF: A CONTRARIAN GUIDE TO LEGAL DRAFTING 80 (2002); CALLAGHAN’S ILLINOIS LEGAL FORMS, §1.12 (2003).

¹³⁹ *Texaco, Inc. v. Pennzoil, Co.*, 729 S.W.2d 768 (Tex. St. App. 1987).

¹⁴⁰ For the text of this document see JAMES SHANNON, *TEXACO AND THE \$10 BILLION JURY* 167-75 (1988).

contract. The court ruled that Texaco's later purchase of the Getty Oil shares tortiously interfered in the contractual relations between Pennzoil and the Getty Oil shareholders. Texaco was ordered to pay \$10.53 billion in damages to Pennzoil. It seems likely that if the document had been titled "Initial Contract" instead of "Memorandum of Agreement," Texaco would have been on notice that the document was legally binding and that making a bid for the Getty Oil shares would constitute tortious interference in contractual relations. Under such circumstances, it seems likely that it would not have made its bid for Pennzoil.¹⁴¹

In the contract here, the use of "agreement" in the title should not cause a problem.

3. Ambiguity of "Agree" in the Text of the Contract

The use of the word "agree," in addition to exhibiting semantic ambiguity, poses problems of tautology, inconsistency, and contextual ambiguity. These arise from the use of "agree" in the agreement formula. In a contract, the agreement formula serves the same purpose as the enactment clause in a statute: everything that follows is the direct object of the verb "agree" and is the text of what was agreed.¹⁴² The repetition of the enacting formula "it is hereby enacted," frequently repeated in the purview of English statutes, was abolished in England in 1850,¹⁴³ but the analogous practice seems to continue on in contract drafting. This repetition of the word "agree" in the past or present tense is tautologous. In effect, it means that the parties agree that they agree. (See for example, the use of "agree" in the agreement formula on page 1 "NOW IT IS HEREBY AGREED" and in Clauses 2.2; 2.4; 2.5, etc.¹⁴⁴) This tautologous usage is not ambiguous in itself, but in context it causes contextual ambiguity because of inconsistency. According to the presumption of

¹⁴¹ This conclusion is based on conversations with several litigators in which I posed the question of whether, *ceteris paribus*, they thought they could win a suit in which they had to persuade a jury that a document signed by two sophisticated parties and titled "Initial Contract" was not legally binding.

¹⁴² The illocutionary force of the purview of a statute (everything that follows the enacting clause) is declarative. The same is true of everything that follows the agreement formula in a contract.

¹⁴³ THORNTON, *supra* note 21, at 199; and FREDERICK BOWERS, *LINGUISTIC ASPECTS OF LEGISLATIVE EXPRESSION* 37 (1989).

¹⁴⁴ See Clauses 3.4, 3.5, 4.1, 4.4, 4.5, 5.2, 5.3, 13.2, 13.3, 15.1, and 20.6.

consistent drafting, the interpreter of a contract assumes that the drafter is careful and uses the same words to express the same meaning and different words to express different meanings. From this perspective, it would appear that the drafter repeats “agree” in order to express something different from those clauses that do not have a repeat “agree.” The different language would seem to be an effort to emphasize the importance of that particular provision. However, that does not seem to be the case here. Why would the clause that set the amount of the royalty not contain the extra “agree” (Clause 3.1), but the clause that requires the payment into the Licensor’s bank account contain an extra “agree” (Clause 3.4)? If the extra “agree” is used out of an excess of caution for the avoidance of doubt, then that poses another consistency issue, because it is not consistent with other provisions which specifically use the phrase “for the avoidance of doubt” (Clauses 3.1, 4.4, and 17.1(iii)). Should an interpreter understand that the obligations preceded by an extra “agree” are somehow more important than other obligations? That seems improbable, but could become an issue if an arbitrator was confronted with a situation where one of the parties presented extrinsic evidence to suggest this interpretation as a way to deal with an unanticipated circumstance.

4. Ambiguity of *Ejusdem Generis* (the Class Presumption)¹⁴⁵

The class presumption assumes that in an enumeration a general word following specific words will be interpreted to include only things similar in nature to those enumerated by the preceding specific words. Semantic ambiguity arises because the application of the class presumption is not consistent, so it is not clear whether a court will give the general word a broad or a narrow sense. Although courts often apply the class presumption when the general word is preceded by “other,” that is not always the case. In the contract, there do not appear any occurrences of enumerations ending in general words that are not preceded by

¹⁴⁵ SINGER & SINGER, *supra* note 25, at §47.17; ANTONIN SCALIA & BRYAN A. GARNER, *READING LAW: THE INTERPRETATION OF LEGAL TEXTS* 199–213 (2012); 陶博 (TAO BO) (2004), *supra* note 3, at 92–93; 陶博 (TAO BO) (2010), *supra* note 3, at 72–79, 109–216.

“other.” And the enumerations ending in a general word preceded by “other” are not very numerous.

Ordinarily, under the class presumption, “other” is interpreted to mean “other similar.” In the contract, however, the presumption of consistent drafting and the negative implication presumption (*expressio unius*) seem to combine to rebut this presumption and create contextual ambiguity. In Clause 1.1 “Prosecution and Maintenance,” line 7, the phrase “the defense of oppositions and other similar proceedings with respect to the particular patent or patent application . . .” appears. This usage shows that when the drafter intended for the word “other” before a general word to narrow the sense of the general word, the drafter added the word “similar.” The negative implication presumption would then have the reader presume that for all other uses of “other” in the contract the drafter intended for “other” to have a broad, not narrow, sense.

For example, in Clause 6.2, concerning representations and warranties, do the words in line 22 “any other documents” in the phrase “all representations, warranties and any other documents” refer only to documents that are in the nature of representations and warranties or to any other documents of any nature? In Clause 8.4, do the “other factors . . . excluding an event of Force Majeure” in the phrase “changes in market conditions, regulatory conditions or other factors but excluding an event of force Majeure” include any factors at all or only factors that are similar to market conditions and regulatory conditions? In Clause 20.6 concerning the relationship of the parties, do the words “or any other relationship” in the phrase “an employment, agency or any other relationship” refer only to a relationship that is of the same nature as “employment” and “agency” or to a wider range of relationships? In all these Clauses, the argument from the viewpoint of consistency and the negative implication presumption would be, *ceteris paribus*, that the sense is not narrow, but broad.

A similar analysis applies to an enumeration of verbs ending with the adverb “otherwise” before the last verb. In Clause 2.1 (b) concerning the license grant, do the words “otherwise exploit” in the phrase “practice any method, process or procedure or otherwise exploit the Licensor Technology” refer only to actions similar to the practice of a method, process or

procedure? In Clause 20.1 concerning assignment, do the words “or otherwise” in the phrase “(whether by merger, reorganization, acquisition, sale, or otherwise)” refer only to assignment by actions similar to a merger, reorganization, acquisition, or sale or to do they refer to any other possible means of assignment? In Clause 20.6 concerning the relationship of the parties, do the words “or otherwise” in the phrase “to assume, create or incur any expense, liability or obligation . . . on behalf of the other Party, or otherwise act as an agent for the other Party for any purpose . . .” refer only to acts similar to assuming, creating, or incurring any expense, liability or obligation or do they include acts that are dissimilar to those acts? Here again, the argument set forth above would lead to an interpretation that, other things being equal, the broad sense was intended. Whether this was, in fact, the intention of the drafter or of both parties is unknown. Whether extrinsic evidence might clarify the intention is also unknown. If the presumptions in favor and against such an interpretation were equal in number, the application of *contra proferentem* could result in an interpretation unfavorable to the drafter.

5. Ambiguity of Reverse *Ejusdem Generis*

The risk of semantic ambiguity can arise not only from the class presumption (*ejusdem generis*), but also from a new variant of it, the presumption called “reverse *ejusdem generis*.” The presumption is called “reverse *ejusdem generis*” because, when the presumption applies to an enumeration, it is not the preceding narrower words that restrict the sense of the broader word at the end, but the broader word at the end that restricts the senses of the preceding narrower words. The origin of this presumption lies in the interpretation of a criminal statute stating that to commit the crime a person must have occupied “a position of organizer, a supervisory position, or any other position of management.” The question posed in the first case, *U.S. v. Apodaca*,¹⁴⁶ was whether each of the positions of “organizer” and “supervisor” was a “position of management.” The court answered affirmatively.

¹⁴⁶ United States v. Apodaca, 843 F. 2d 421 (10th Cir. 1988).

Later cases ¹⁴⁷posed the question in the form of the phrase “bass, trout, or any other freshwater fish,” stating that the phrase did not include sea bass because the phrase “or any other freshwater fish” limits the scope to freshwater fish. This presumption is not widely recognized and therefore not widely applied, so it creates ambiguity as to the scope of the enumeration.

Reverse *ejusdem generis* does not appear applicable to the contract because the contract contains no enumerations where the last noun is preceded by “or” and modified by “any.”

6. Ambiguity of *Noscitur A Sociis* (the Associated Words Presumption)¹⁴⁸

The associated words presumption is similar to the class presumption and overlaps with it to a certain extent. Typically, it is applied when there is not an enumeration, but only a pair of nouns or of verbs and the pair is joined by the conjunction “or.” Semantic ambiguity is created by the doubt as to whether the presumption will be applied or not. For example, in Clause 6.2 (h) concerning representations and warranties do the words “other intellectual property rights” in the phrase “infringe . . . patents or other intellectual property rights” refer to all intellectual property rights that are not patent rights or only intellectual property rights that share common features with patents? In Clause 6.2(i) (i), do the words “invalidate or otherwise challenge” in the phrase “claims or litigation or investigations seeking to invalidate or otherwise challenge the Licensor Technology . . .” refer to challenges that are similar to invalidation or to any possible challenge? In Clause 18.1 regarding disputes, do the words “or other matter” in the phrase “unable to resolve any dispute or other matter arising out of or in connection with this Agreement . . .” refer only to matters that are similar to disputes or to any other matter? The analysis above of the class presumption would also apply to these Clauses.

¹⁴⁷ *United States v. Delgado*, 4 F. 3d 780 (9th Cir. 1991); *United States v. Williams-Davis*, 90 F. 3d 490 (D.C. Cir. 1996); *Dong v. Smithsonian Institution*, 125 F. 3d 877 (D.C. Cir. 1997).

¹⁴⁸ SINGER & SINGER, *supra* note 25, at §47.16; SULLIVAN & DRIEDGER, *supra* note 25, at 200-02; 陶博 (TAO BO) (2004), *supra* note 3, at 91-92; 陶博 (TAO BO) (2010), *supra* note 3, at 65-72.

7. Ambiguity of *Expressio Unius* (the Negative Implication Presumption)¹⁴⁹

The negative implication presumption assumes that the expression of one thing is the exclusion of another. It is often applied to lengthy enumerations with the result that it is presumed that the drafter intentionally omitted an item not included in the enumeration. The likelihood of the presumption applying varies with the length of the enumeration. Generally, an enumeration of three items, the most common number,¹⁵⁰ does not pose a problem. More lengthy enumerations can cause ambiguity.

The contract does not seem to contain many lengthy enumerations. Some of the longest appear in Clauses 3.8 royalty and payment (“make, manufacture, use, commercialize, market, distribute or sell”), Clause 6.28 on representations and warranties (“research, development, manufacture, use, sale, offer for sale or importation of the Products”), 16.2 regarding post termination (“research, develop, make, have made, manufacture, use, sell, offer for sale, import and export”), and Clause 20.7 on force majeure (“earthquake, riot, civil commotion, war, terrorist acts, strike, flood, or governmental acts or restriction . . .”). The enumeration in Clause 7.1 (and 7.2) concerning indemnities can serve as an example of the possible ambiguity caused by the application of this presumption. The enumeration is “suits, investigations, claims, costs, demands, liabilities, losses, damages, and expenses, including reasonable attorneys’ fees (collectively, “Losses”).” As discussed below¹⁵¹, one issue with this enumeration is whether it is intended to cover undischarged liabilities. Most of the surrounding nouns (“costs,” “demands,” “losses,” “damages,” “expenses”) imply discharged liabilities. Only one of the words, “liabilities,” clearly implies undischarged liabilities. Might the omission of the word “debts” strengthen the implication that undischarged liabilities were not meant to be included? Might the use of the word “including” only at the end emphasize that other items not the object of this preposition were

¹⁴⁹ SULLIVAN & DRIEDGER, *supra* note 25, at 163; COURTNEY ILBERT, LEGISLATIVE METHODS AND FORMS 247 (1901); 陶博 (TAO BO) (2004), *supra* note 3, at 93-94.

¹⁵⁰ WILSON FOLLETT, MODERN AMERICAN USAGE: A GUIDE 67 (Erik Wenberg ed. 1999).

¹⁵¹ See *infra* pp. 45-47.

not intended to be included? Does the use of the term “Losses” to describe all these items support the interpretation that the enumeration is intended to include only discharged liabilities? An unanticipated event and extrinsic evidence could make these questions significant.

8. Ambiguity of “Including”¹⁵²

The word “including” is used to counter the negative implication presumption, but it is semantically ambiguous. Depending on the context, courts have found four different senses: illustrative (“B is an example of A” or “B is a kind of A”); componential (“B is a component of A”); expansive (“B is deemed to be a kind of, or part of, A”); and limiting sense (“B constitutes A”). In the contract, Clause 20.09 attempts to specify that throughout the entire document the words “include” and “including” have the expansive sense equivalent to “but not limited to” or “without limitation.” This is a seemingly efficient way to avoid ambiguity and assure that these words in the contract always have the expansive sense. However, although it eliminates some ambiguities, it creates others.

First is the presumption of consistent expression.¹⁵³ If all uses of “including” mean “including but not limited to,” then it is not necessary to use the words “but not limited to” in the text after “including.” However, Clause 1.1 in the definition of Licensor Know-How states that the proprietary information, trade secrets, documented techniques, materials and data “including but not limited to discoveries . . . test data (including pharmacological, toxicological, clinical and manufacturing information and test data) . . .” The inconsistent use of “including” in the Clause causes the careful reader, other things being equal, to presume that there is a good reason for it. Might the insertion of “but not limited to” be an effort by the drafter, for the avoidance of doubt, to emphasize this expansive sense in this Clause more than in other clauses?

The other issues with the wholesale application of the expansive sense of “include” concern its collocation. For example,

¹⁵² 陶博 (TAO BO) (2010), *supra* note 3, at 114–28.

¹⁵³ SULLIVAN & DRIEDGER, *supra* note 25, at 163–68; 陶博 (TAO BO) (2004), *supra* note 3, at 88–90.

in Clause 1.1 in the definition of “Licensor Patents” when it states that ““Licensor Patents means the patents which includes.” does it mean that the definition of Licensor Patents is not limited to those described in the following subclauses (i), (ii), and (iii)? In Clause 15.1 regarding confidentiality, it is not clear what the implications of Clause 20.09’s prescriptive definition of “including” are when “including” is within the scope of negation. Clause 15.1 states that ““Confidential Information’ shall not be deemed to include information or materials . . .” It seems that the scope of the negation should be expanded here to conform with the expansive sense of “including,” but it seems questionable whether this interpretation was intended by the drafter.

9. Postmodification Ambiguity (the Last Antecedent Presumption)¹⁵⁴

A modifying word or phrase that follows what it modifies often causes syntactic ambiguity because more than one possible object of the modifying word or phrase precedes it. Although the context often disambiguates, sometimes ambiguity results. The contract employs postmodification less than many other contracts and the risk of ambiguity is reduced. In fact, the issue is more miscue (described below) than ambiguity. In almost all of the Clauses the context allows the reader to discern the scope of modification. For example, in Clause 1.1 the definition of “Affiliate” (“ . . . the stock or shares having the right to vote”) it is clear that the postmodifying phrase “having the right to vote” modifies both “shares” and “stock;” in Clause 2.1 (“Licensor hereby grants . . . a . . . license . . . , with the right to grant, sublicenses, subject to the conditions described in this Agreement, under the Licensor Technology . . .”) it is clear that the phrase “under the Licensor Technology” modifies “license” and not “conditions”; and in Clause 13.4 (“The Licensee shall be responsible for the maintenance and repair of all equipment used in the manufacture of the Products in accordance with applicable laws . . .”) it is clear that the phrase “in accordance with applicable laws” modifies “maintenance and repair” and not “manufacture.”

¹⁵⁴ THORNTON, *supra* note 21, at 26–28; SCALIA & GARNER, *supra* note 145, at 144–46; 陶博 (TAO BO) (2008), *supra* note 3, at 70–130.

But in two Clauses the scope of the postmodification is not clear. In Clause 1.1 the definition of “EMA Costs” (“ . . . costs resulting in a specific fee charged and a deliverable documented output for EMA meetings, animal test, and human tests, resulting in a competent authority submission . . .”) it is not clear whether the underlined phrase modifies “costs,” “output,” or “meetings, animal test, and tests.” This ambiguity might be significant. In Clause 20.7 (“ . . . earthquake, riot, civil commotion, war, terrorist acts, strike, flood, or governmental acts or restriction, or other cause that is beyond the reasonable control of the respective Party . . .”) it is not clear whether the underlined phrase modifies only “other cause” or all the preceding nouns. Perhaps the sense of “other” is “other similar” and the similarity is that the entire group consists of acts beyond the reasonable control so whether the phrase grammatically modifies all the preceding nouns is irrelevant. This ambiguity does not seem to be significant.

10. Ambiguity of the Proviso¹⁵⁵

A proviso, a construction using the word “provided” or “provided however,” often exhibits semantic ambiguity as between four different senses.¹⁵⁶ These are the exceptional sense (often equivalent to “except that”), the limiting sense (often equivalent to “but”), the conditional sense (often equivalent to “but only if”), and the additional sense (often equivalent to “and”). It may be difficult to distinguish between these different senses.

The most common problem seems to be ambiguity between the conditional sense and the other senses. The reason is that whether a phrase is a condition or not has a greater impact on the legal effect of the provision. It appears that in the eight instances of provisos in the contract, the senses are fairly clear. Four provisos seem to be conditional (Clause 3.2: “provided that the aforesaid products [are] manufactured according to the New Patents . . .”); Clause 5.4 (b) (“ . . . provided, however, that nothing shall be deemed an agreement to transfer . . . to Licensee

¹⁵⁵ ELMER A. DRIEDGER, *THE COMPOSITION OF LEGISLATION: LEGISLATIVE FORMS AND PRECEDENTS* 93–103 (2d ed. 1976); ROBERT C. DICK, *LEGAL DRAFTING* 90 (1972); SCALIA & GARNER, *supra* note 145, at 154–55.

¹⁵⁶ BRYAN A. GARNER, *A DICTIONARY OF MODERN LEGAL USAGE* 710 (2d ed. 1995); ADAMS, *supra* note 11, at 282–84.

ownership of any Licensor Technology”); Clause 18.2 (“provided that any written evidence originally in a language other than English shall, insofar as practicable, is [*sic*] submitted in English translation”); and Clause 20.7 (“provided that such Force Majeure event has not ended during such sixty (60) day period”). Two provisos seem to express the limiting sense (Clause 1.1 “Licensor Know-How”: “provided however, that Licensor Know-How that is the subject of the licenses . . . shall extend only to those applications of any of the foregoing items that are associated with specifically defined carbohydrate chemistry formulation” and Clause 1.1 “Licensor Patents”: “provided, however, that Licensor Patents that are the subject of the licenses and other rights granted Licensee hereunder shall extend only to those applications of any of the foregoing items that are associated with NDS or its drug candidate equivalent.”) One proviso seems to express the additional sense (Clause 15.2: “provided, however, that if a Party is required by law . . . to make any such disclosure of the other Party’s Confidential Information it will . . . give reasonable advance notice to the other Party”). And one proviso seems to express the exceptional sense (Clause 18.2: “provided that if the Parties are unable to agree on a single arbitrator . . . , the arbitrator shall be selected by the senior executive of the ICC in Paris.”).

The risk of ambiguity appears greatest in Clauses 5.4 and 18.2, which seem to express the limiting sense, but could also be interpreted as expressing the conditional sense. In Clause 5.4, for example, might the proviso indicate that the failure to deem the agreement as involving a transfer or assignment of ownership was a condition to Licensor’s providing all reasonable assistance? In Clause 18.2 might the proviso indicate that a condition for the conduct of the arbitration proceedings in English was that English translations be provided? In either case, the conditional sense does not seem to collocate perfectly with the preceding phrase, but an unanticipated event and extrinsic evidence might make such an interpretation acceptable.

11. Ambiguity in the Expression of Time and Numbers

The expression of time and numbers in contracts often creates the risk of ambiguity. The two principal problems are

semantic ambiguity as to what period the time-related words express and the scope of time-related prepositions.

Clause 20.09 of the contract provides some clarification as to two time-related words, “day” and “year.” It says that these words both refer to a calendar year unless otherwise specified. This short statement, however, raises two questions. First, the word “month” is not mentioned in this Clause but appears twenty one times in the contract. Because “month” is not referred to in Clause 20.09, the negative implication presumption would lead us to think that the word “month” is not used in the calendar sense, but probably in the sense of 30 continuous days. The reference in Clause 17.1(a) to “twelve (12) months prior written notice” rather than one year’s prior written notice seems to reinforce this presumption. Therefore, in the absence of countervailing contextual or extrinsic evidence, the twelve months prior written notice, then, should be 360 days prior written notice, not 365 days prior written notice. Further, the other provisions calling for time periods measured in “months” would be calculated in multiples of 30 days rather than according to the calendar. In Clause 8.5, the “three (3) months” would be 90 days; in Clause 18.2 the “six (6) months” would be 180 days.

The use of the calendar year leads to ambiguity. It is not clear how to calculate the 1.5 years referred to in Clause 4.7. Does it mean 182 or 183 days in any year or 183 days only if the calculation includes February in a leap year?

Time-related prepositions are notorious for ambiguity.¹⁵⁷ As David Mellinkoff wrote, “The riddle of the preposition of time is this: Do I lead you just up to the point, into it, or past it?”¹⁵⁸ In the contract, the preposition “prior to,” which appears fifteen times, poses no problem. The date referred to is not included in the calculation. The question in the contract is whether the five prepositions “upon,” “of,” “from,” “following,” and “after” all express the sense that the number of days or months begins on the date of reference or the day after. Clearly, in the case of “after” the calculation begins on the day after the day referred to.¹⁵⁹ Thus,

¹⁵⁷ For example, even the phrase “prior to December 31” was considered ambiguous by Justice Stevens in *United States v. Locke*, 471 U.S. 84, 118 (1985).

¹⁵⁸ DAVID MELLINKOFF, *LEGAL WRITING: SENSE & NONSENSE* 41 (1982).

¹⁵⁹ Note, however, the different interpretations of the phrase “from and after” by the Eighth Circuit (including the date) Board of Comm’rs of Kearney

the calculation of the time periods in Clauses 3.9, 3.4(i)(iii), 4.6, 4.8, 4.9, 4.10, 16.1, 17.1 (b), and 18.1 is clear: the starting date referred to is not included in the calculation. The other words are ambiguous as to the intention. The presumption of consistent expression would lead us to think that these words should be interpreted as having different meanings. The context, however, seems to provide some hint that they are intended to be synonyms. For example, Clause 3.3 states that the Licensee shall pay the royalty Payment “within 30 days upon the expiry of a quarter in a year,” and then includes a detailed breakout of the payment stating that the first payment will be “on or before” April 30. Clearly, the word “upon” is used in the sense of “after” and does not include the date referred to. The context does not provide much assistance as to the other words, but it seems more natural that they would be interpreted to be synonyms with “after.” Thus, the calculation of the time periods in the Clauses employing “of” (12.1, 18.2, 20.5), those employing “from” (2.2, 3.3, 8.4, 17.1 (b), and 18.1) and that employing “following” (18.2) in the absence of other contrary extrinsic or contextual evidence, should be interpreted as not including the date referred to.

12. Ambiguity of “Indemnity”¹⁶⁰

The word “indemnity” and its verb form “indemnify” are semantically ambiguous as to whether they mean to compensate for a past loss or for a future loss, that is, for a loss or a liability. Generally, the term “hold harmless” is used to refer to compensating for liability, but there is no noun form for “hold harmless,” so “indemnity” is used as a superordinate to cover compensation for both loss and for liability. This is why the title of Clause 7 is “Indemnification” and the titles to Clauses 7.1 and 7.2 are “Indemnities” and do not use the expression “Hold Harmless.” However, “indemnify” and “hold harmless” are also interpreted as synonyms.¹⁶¹ Thus, “indemnity” or “indemnify”

County v. Vandriss, 115 F. 866, 871 (8th Cir. 1902) and the Seventh Circuit (excluding the date) Zimmerman v. United States, 277 F. 965, 965 (7th Cir. 1921).

¹⁶⁰ DAVID MELLINKOFF, MELLINKOFF'S DICTIONARY OF AMERICAN LEGAL USAGE 286 (1992); 陶博 (TAO BO) (2010), *supra* note 3, at 297–319.

¹⁶¹ GARNER, *supra* note 156, at 436. Garner seems to rely on *Brentnall v. Holmes*, 1 Root (Conn.) 291, 1 Am. Dec. 44 (1791). But other cases over the last two hundred years show that when one looks at not just the verb, but both the

without an object does not clarify whether the obligation is to compensate for just loss or also for liability. The difference can be significant as when an indemnitee with both past losses and unpaid liabilities goes bankrupt.¹⁶² Does the indemnitor have the obligation to compensate only the past losses or also the unpaid liabilities? Often, the indemnity clause is arguably ambiguous.

In the contract, the indemnity provisions in Clause 7.1 and 7.2 provide that, “Licensee [or Licensor] shall . . . indemnify, hold harmless and defend Licensor . . . from and against any and all suits, investigations, claims, costs, demands, liabilities, losses, damages, and expenses, including reasonable attorneys’ fees (collectively, “Losses”).” This sentence contains both the verbs “indemnify” and “hold harmless” and the words “losses” and “liabilities” so at first glance one assumes that compensation for both losses and liabilities is intended. However, the placement of the verbs together at the beginning and the objects together following the verbs confuses the relationship between the verbs and the nouns and makes unlikely the application of the presumption “rendering each to each.”¹⁶³ Is “liabilities” the object of “indemnify”? Since the term “liabilities” can refer to both discharged and undischarged liabilities, does making it an object of “indemnify” imply that the compensation here is only for losses? If the term “hold harmless” is synonymous with “indemnify,” then is the sense of “hold harmless” here compensate for loss rather than liability? In the list of verb objects would the associated words presumption apply so that the words “suits,” “investigations,” “claims,” “demands,” and “liabilities” would be interpreted as applying to discharged liabilities because that is what the other words “costs,” “losses,” “damages,” and “expenses” refer to? Finally, if the clause is intended to cover undischarged liabilities, why is the list of verb objects defined as “Losses,” which only refers to discharged liabilities? This line of interpretation, although implausible in the abstract, could become attractive in the case of an unanticipated event with significant financial consequences.

verb and its object, the meaning as to compensation of loss or liability becomes clear. See cases cited in 陶博 (Tao Bo) (2010), *supra* note 3, at 303–05.

¹⁶² *Cunningham v. Nashville*, 476 S.W. 2d 641 (Tenn. 1972).

¹⁶³ Reed Dickerson gave the classic example of this presumption: “Men and women may become members of fraternities and sororities.” REED DICKERSON, *THE INTERPRETATION AND APPLICATION OF STATUTES* 233 (1975).

13. Ambiguity of “And”¹⁶⁴

The conjunction “and” exhibits semantic ambiguity. It has three senses that often occur in contracts. The classic example of these senses is the phrase “charitable and educational institutions.” The several sense of “and” is “institutions that are either charitable or educational,” the joint sense is “institutions that are both charitable and educational,” and the combined joint and several sense is “institutions that are charitable, educational, or both.”¹⁶⁵ In most cases, the context clarifies which sense is intended or the ambiguity does not pose a problem (often between the several sense and the combined joint and several sense). This is generally true of the contract.

“And” is often used in the several sense, but the context in some Clauses makes clear that the sense is joint. Examples are in Clause 3.1 concerning the royalty payment, in the phrase “excluding those manufactured and supplied to Licensor;” in Clause 17.1 concerning termination (“... fails to pay ... and the payment is not settled;” and in Clause 20.5 concerning modification (“reduced to writing and signed”). The one situation in which the context could suggest either a several or joint sense is Clause 2.3 where the intent of the clause is to restrict sale and distribution of the products. In this Clause might the “and” in the phrase “Products for human and veterinary use” be used in the joint sense? After the verb “restrict” wouldn’t it be more natural to write “Products for either human or veterinary use”? Would the negative implication presumption (*expressio unius*) suggest that the intent here was joint conjunction? Further, the use of the phrase “human or veterinary use” in Clause 1.1 “Additional Territory Licensed Products” would seem to suggest that the use of “and” in Clause 2.3 was intended to express something different than disjunction. In the future if an unanticipated event caused Licensor to wish to restrict the sale and distribution of the products, it could argue that any such products would have to be

¹⁶⁴ DICKERSON, *supra* note 21, at 104–14; 陶博 (TAO BO) (2004), *supra* note 3, at 258–80.

¹⁶⁵ DICKERSON, *supra* note 21, at 110. Dickerson uses the term “several” to refer to the situation where “and” is used in the sense of “A and B, severally or jointly,” but I have not followed that use. Instead, I use “several” for “A and B, severally but not jointly” and “joint and several combined sense” for “A and B, jointly or severally.”

for both human and veterinary uses. But the presumption of *contra proferentem*, if applied, would suggest an interpretation unfavorable to Licensor as the drafter.

In two Clauses the use of “and” exhibits semantic ambiguity. In Clause 5.4(a), line 20, concerning assistance by either party, the context does not make it clear whether the “and” in the phrase “if it involves new technology and requires travel to other country” is joint or several. In Clause 6.2(b) concerning the representation and warranty of non-infringement by “any . . . employee or consultant of Licensor or consultant of Licensor and its Affiliates” it is not clear whether the sense is several, joint, or combined joint and several.

14. Ambiguity of “Or”¹⁶⁶

In contracts, the coordinating conjunction “or” exhibits semantic ambiguity as to exclusivity or inclusivity. That is, does “or” express “A or B, but not both” or “A or B, or both”? Clause 20.09 of the contract attempts to clarify the use of “or” in the document. It states that “the word ‘or’ shall be construed as the inclusive meaning identified with the phrase ‘and/or.’” Because the phrase “and/or” has been subject to criticism,¹⁶⁷ it is unusual that Clause 20.09 uses it to stipulate the sense of “or.” The reference to “inclusive meaning,” however, seems to clarify the intention—that in all instances in which the word “or” is used in the contract, it will be interpreted to be used in the inclusive sense, that is, “A or B, or both.” Such a rule attempts to achieve clarity and simplicity, but it runs the risk of being inappropriate in some provisions. That seems to be the case in the contract.

The word “or” is used extensively throughout the document and in almost all cases it seems proper to interpret it as having the inclusive sense. However, there are two provisions in which the context suggests that the sense is exclusive, not inclusive. Clause 13.2 concerning the Licensee’s right to manufacture the Products for third parties states, “This right must be exercised within five (5) years or it becomes non-exclusive [*sic*, “exclusive”?] as to the manufacture.” This sentence seems to be attempting to express the thought that if the exclusive right is not exercised within five

¹⁶⁶ *Id.* at 104–14; 陶博 (TAO BO) (2004), *supra* note 3, at 258–80.

¹⁶⁷ See the discussion *infra* pp. 49–50.

years, the right becomes non-exclusive as to manufacture. However, if “or” has the inclusive sense as prescribed by Clause 20.09, then it would seem that the meaning of the sentence is that even if the right is exercised within five years it becomes non-exclusive after five years. This interpretation could be prejudicial to the Licensee. If *contra proferentem* were applied to this interpretation, however, this interpretation might fail because Licensor appears to be the drafter.

The other instance in which the context argues against an inclusive interpretation of “or” is Clause 17.1(a). This Clause states, “This Agreement can be terminated by a Party (“Non-Defaulting Party”) if and only if: (a) the other Party (“Defaulting Party”) fails and/or refuses to pay to the Non-Defaulting Party pursuant to this Agreement and the payment is not settled after serving a twelve (12) months prior written notice to the Defaulting Party; or (b) . . .” This provision seems to contemplate that either one of two actions, either (a) or (b), can lead to termination and both actions are not required. However, if only one of the actions was performed and “or” was interpreted in the inclusive sense, then the Non-Defaulting could deny that termination was possible and argue that both conditions were required for termination. This is a potential ambiguity that does not seem to favor either party because it is impossible to predict which of the parties might wish to make such an argument in the future.

In addition to these potential ambiguities, Clause 20.09 also causes problems of inconsistency with the ten occurrences of the combination “and/or” as discussed below.

15. The Ambiguity of “And/Or”¹⁶⁸

The expression “and/or” has often been criticized for semantic ambiguity,¹⁶⁹ but apparently no empirical study has been done of its use. Almost all legal commentators condemn the

¹⁶⁸ DICKERSON, *supra* note 21, at 104; 陶博 (TAO BO) (2004), *supra* note 3, at 280–88.

¹⁶⁹ DRIEDGER, *supra* note 155, at 130; MELLINKOFF, *supra* note 158, at 56; LOUIS PHILIPPE PIGEON, DRAFTING AND INTERPRETING LEGISLATION 43–44 (1988); EDMUND LEOLIN PIESSE & J. K. AITKEN, THE ELEMENTS OF DRAFTING 90–91 (J. K. Aitken ed., 9th ed. 1995); SINGER & SINGER, *supra* note 25, at §21.14; HAGGARD & KUNEY, *supra* note 1, at 253–256; GARNER, *supra* note 156, at 56.

expression for its “ambiguity” but do not explain how it is ambiguous. It seems that it expresses inclusive disjunction,¹⁷⁰ that is, the same meaning as the inclusive sense of “or” (“A or B, or both”).

In the contract, as we saw above, the word “or” is defined as having the same meaning as “and/or.” But in the contract both “or” and “and/or” are used. “Or” is used very frequently, but “and/or” only ten times. This use of synonyms is a violation of the rule of consistent use of words in contract drafting and is potentially confusing. It raises the issue of whether “and/or” is used infrequently to capture some nuance that “or” itself does not express. This seems unlikely. For example, it is difficult to understand how the conditions of termination would be different if Clause 17.1(a) line 3, instead of providing that a condition of termination was “the other Party . . . fails and/or refuses to pay” was changed to “the other Party . . . fails or refuses to pay.” In either case, termination would be allowed if a party either failed or refused to pay or both failed and refused to pay.

“And/or” is only one example of ambiguity associated with the slash. In fixed expressions where two nouns or verbs are joined by the slash, the question is not only whether the slash plays the role of “and” or of “or” with their various senses, but also whether the expression has created a new term that refers to something that is somehow a combination of the two words.¹⁷¹

The slash is a good example of a trifle that can cause significant damage. The misreading of a slash in the expression “Prices Ex Plant: No Packing/Protection/Transport Included” cost one of my clients hundreds of thousands of dollars. In the contract, however, the slash does not pose significant risks of semantic ambiguity. It appears not only in the expression “and/or,” but several other times. For example, in Clause 14.1 (a) line 3 the Licensee is permitted to continue to use the Licensors Know-How for “any Products which the Licensee obtains/procures or intends to obtain MAA for . . .” It is not clear why the slash was used here rather than simply using the conjunction “or.” Might it be used to create a new word that combines the characteristics of the two nouns but is somewhat

¹⁷⁰ BOWERS, *supra* note 143, at 323–24.

¹⁷¹ FOLLETT, *supra* note 150, at 279; PAUL W. LOVINGER, *THE PENGUIN DICTIONARY OF AMERICAN ENGLISH USAGE AND STYLE* 347–48 (2000).

different? It is not clear whether that is the intention here. In other Clauses, the slash seems to have the sense of either exclusive disjunction (Clause 20.1 stating that no assignment or transfer is valid “until the assignee/transferee agrees . . .”) or several conjunctions (Clause 26.5, “Entire Agreement/Modification”). The use of the slash instead of a conjunction would appear to be another violation of the rule of consistent drafting that again poses the question of the intention of the parties and the possibility of extrinsic evidence to explain it.

16. Ambiguity of the Modal Auxiliary Verb “Shall”¹⁷²

In English, the modal auxiliary verbs “shall” and “may,” which are commonly used in contracts, exhibit semantic ambiguity. “Shall” can express futurity, obligation, or rhetorical emphasis. The most common problem seems to be the use of “shall” to express obligation, which Frederick Bowers has called “a spurious expression parasitic on the biblical rhetoric of command,”¹⁷³ (such as, “Thou shalt not . . .”) and “a kind of totem, to conjure up some flavour of the law.”¹⁷⁴ In contracts, this creates ambiguity between the senses of obligation and of rhetoric. For example, in the contract, “shall” is clearly used in the obligational sense in Clauses 3.1 and 3.4 regarding the Licensee’s duty to make payments, but in other sections its use is not obligational. It does not seem to make sense to make an obligation doubly obligatory as in “shall be required” in Clauses 11.2 and “shall be responsible” in Clause 13.4. And surely, it is not an obligation for the Licensee to “be entitled” to do something as in Clauses 3.8 and 5.1, nor to “have the right” in Clauses 12.1, 14.1 and 20.7, nor to “retain the right” in Clause 8.1 or to “be permitted” under Clause 8.2. It seems reasonable for the parties to impose obligations on each other by the terms of the contract, but does the contract language also impose obligations on third parties, such as the arbitrator in Clause 18.2 who “shall select” an independent technical expert? Where the sense of “shall” does not seem to be obligational, it might be seen as

¹⁷² RANDOLPH QUIRK, SIDNEY GREENBAUM, GEOFFREY LEECH & JAN SVARTVIK, *A COMPREHENSIVE GRAMMAR OF THE ENGLISH LANGUAGE* 221 (1985); 陶博 (TAO BO) (2004), *supra* note 3, at 110–27.

¹⁷³ BOWERS, *supra* note 143, at 223.

¹⁷⁴ *Id.* at 80.

expressing futurity. In Clause 16.1, the phrase “the term shall commence” seems to be talking about the future, not imposing an obligation on the parties.

In sum, it appears that “shall” is used in a strict obligational sense only rarely in the contract and mostly it is simply being used for rhetorical purposes—to lend some of the authority of the biblical rhetoric of command to the document. But this use of “shall” for rhetorical effect violates the presumption of consistent expression and creates ambiguity. Does making an obligation doubly obligatory mean that that obligation is more important than other obligations? Does the use of “shall” for rhetorical purposes weaken the obligational sense of its legal force? Does the ambiguity between the rhetorical and future senses mean that the rhetorical effect is weakened because the sense can also be interpreted as referring to the future? These questions tell us that ambiguity among the obligational, future and rhetorical senses of “shall” poses risks.

There is, however, another risk of ambiguity with “shall” that is often overlooked. This ambiguity is whether “shall” is expressing an obligation or a condition.¹⁷⁵ When “shall” expresses a condition for obtaining a benefit, the failure to fulfill the condition leads only to the failure to obtain the benefit. When “shall” expresses an obligation, the failure to perform the obligation leads to a violation of the contract and poses the risk of a suit for damages. In the contract, one Clause appears to exhibit this type of ambiguity. Clause 1.1 defines Licensor Know-how, but ends the definition with a clause stating “provided that . . . Licensor Know-how . . . shall extend only to those applications . . . associated with specifically defined carbohydrate chemistry formulation.” Is the sense of “shall” here one of obligation combined with a condition, so that the Licensor Know-How must extend only to these applications associated with carbohydrate chemistry formulations to be included in Licensor Know-How? If some know-how does not extend only to those applications, would it be considered not to be Licensor Know-How and not subject to the contract? Only the contracting parties know whether this ambiguity does, in these circumstances, pose a

¹⁷⁵ See ADAMS, *supra* note 11, at 70. For a discussion of this distinction, see BURNHAM, *supra* note 11, at §11.2-11.6.

problem. But this is a risk in contract drafting that drafters can learn to avoid.

17. Ambiguity of the Modal Auxiliary Verb “May”

Like “shall,” the modal auxiliary verb “may” also exhibits semantic ambiguity. It can express permission, authority, possibility, or even—in statutes—obligation. In the contract, the word “may” appears twenty five times, most often in the sense of permission or authorization, but sometimes in the sense of possibility. For example, clear uses of the sense of permission or authorization are in Clauses 2.4(b) (“ . . . Licensee may request [***] in Product . . .”); Clause 9.1 (“ . . . Licensee may use its own brand name . . .”), Clause 13.2 (“ . . . the manufacturing facilities may be used to manufacture products other than the Products . . .”), and Clause 20.2 (“either Party may assign this Agreement . . .”). In one provision, “may” is used with negation to express the withdrawal of permission or authorization (Clause 20.3, “Neither party may waive or release . . .”).¹⁷⁶ Clear uses of the sense of possibility are Clause 1.1 (“ . . . patent applications that may hereafter be filed . . .”) and (“ . . . patents which may be granted . . .”), and Clause 20.6 (“Except as may be specifically provided herein . . .”). And in one sentence both senses occur (Clause 12.1, “ . . . Licensee may take such action . . . as the Licensee may request . . .”). In one Clause, the ambiguity between these senses seems not to pose any risk (“This Agreement may be executed in two or more counterparts . . .”).

But in other cases, the ambiguity does pose a risk. Consider the provisions regarding adding Products to the list of those to be manufactured and to the adjustment of prices. In Clause 1.1, the definition of “Products” mentions Additional Territory Licensed Product(s) “ . . . as the same may be added to this Agreement . . . details of which are set out in Exhibit 7.” Is the “may” here used in the sense of possibility or authorization? If in the sense of authorization, does it authorize the addition of further products to the list in Exhibit 7 without a writing signed by the Parties as

¹⁷⁶ This raises the question of whether the expressions “Neither party may...” and “neither party shall have any right, power or authority...” (see *infra* Clause 20.6) mean the same or different things.

required by Clause 20.5?¹⁷⁷ In Clause 3.6 (d) regarding audit, does the phrase “adjustments that may impact royalties payable to Licensor” imply that the Licensee has permission to make adjustments based on records of sub-licensees? In Clause 6.2(a), which concerns the Licensor Technology, does the phrase “a list of which is set out in Exhibit 6, but which may change from time to time as new patents and know-how are obtained” authorize Licensor to change the list without the writing signed by the Parties as required by Clause 20.5? In Clause 8.7 regarding purchase orders does the last sentence “Pricing of sales may be adjusted due to raw material increases supplied by Licensor” authorize Licensor to lower the prices because volume purchases of raw materials reduce the production cost or authorize the Licensee to raise prices because raw material prices increase or does it merely point to the possibility of such adjustment?¹⁷⁸ The ambiguity in the senses of “may” creates a risk of different self-interested interpretations of these provisions.

18. Ambiguity of the Modal Auxiliary Verb “Must”

In contract drafting, semantic ambiguity in the verb “must” arises from confusion of conditions (imposed by “must”) with obligations (imposed by “shall”). If the verb “shall” is used to impose obligations on legal or human persons, then the verb “must” should be reserved for objective conditions that must be met before some benefit or detriment results. In many contracts, this distinction is not observed and results in ambiguity. The contract here clearly distinguishes between an obligation imposed on a party and a condition that needs to be met to qualify for certain treatment. There should be no ambiguity problems in the use of “must.”

For example, Clause 2.5 requires that for any change in price, both Parties “must sign a written agreement for such change.” This provision does not impose an obligation on the parties to sign a written agreement; it merely means that no

¹⁷⁷ Clause 20.5 also raises separate questions regarding changes to the Agreement. Does this section cover all changes, so that in effect no changes may be made after 60 days after the Effective Date? Or is it that a writing signed by both parties will be required only for changes made within 60 days after the Effective Date of the Agreement?

¹⁷⁸ It appears from *infra* Clause 2.5 that such an adjustment would have to be agreed upon in writing by both parties.

change in price will be effective unless it is reflected in a writing signed by the parties. Also, in Clause 3.1 the phrase “. . . Territory Licensed Products must be manufactured based on the existing Licensor Patents” means that a product not based on the existing Licensor Patents does not qualify as a Territory Licensed Product. Clause 4.7 has a requirement that the Reference Materials that a requesting party wishes to obtain “must be” Reference Materials which obtain marketing authorization approval not more than 1.5 years before such request. Here again “must” refers to a requirement that must be met to fulfill a condition. In Clause 13.2, the provision that a right “must be” exercised within five (5) years or it becomes non-exclusive as to the manufacture prescribes the fulfillment of a certain condition and the consequences of its non-fulfillment.

19. Ambiguity of the Modal Auxiliary Verb “Will”

The modal auxiliary verb “will” is generally considered to exhibit semantic ambiguity as to the senses of prediction and volition.¹⁷⁹ However, in a contract it can be ambiguous between the senses of prediction¹⁸⁰ and obligation.

In the contract, “will” clearly has a predictive sense in some Clauses. For example, in the representations and warranties in Clause 6.2 (d) (“Licensor has not granted and will not . . . grant any right to any Third Party . . . and will not enter any agreement . . .”); Clause 6.2 (h) (“ . . . Licensee’s practice, use and exploitation of the Licensor Technology will not infringe . . .”); Clause 11.1 (“The Licensee will own all new intellectual property related to the Products . . .”), and Clause 20.2 (“ . . . address . . . as such Party will have last given . . .”). But the use of “will” in other provisions raises the risk of ambiguity because it is inconsistent with the above uses of “will” in the sense of prediction and the use of “shall” to indicate obligation. If “will” is used to express prediction, as noted in the above sections, and the verb “shall” is used to express obligation,

¹⁷⁹ QUIRK, *supra* note 172, at 228–29.

¹⁸⁰ In statutory drafting it is assumed that because a statute is “constantly speaking” the future tense is inappropriate. This same concern does not appear in contracts. See BOWERS, *supra* note 143, at 241–43; DRIEDGER, *supra* note 155, at 335.

then what does the use of “will” in the other sections of the contract express?

From the context it seems that this use may express obligation. See, for example, Clause 3.6(d) (“Licensee will assemble relevant records . . .”); Clause 5.4(a) (“Each Party will use its best reasonable efforts to provide assistance . . .”); Clause 5.4 (c) (“ . . . the filing will be made . . .”); Clause 9.1 (“Each Party will be responsible for filing . . .”); Clause 11.1 (“ . . . the Licensee will grant a royalty-free exclusive license . . . to Licensor . . .”); Clause 13.2 (“Such manufacturing facility will be in compliance with internationally accepted standards . . .”); Clause 15.2 (b) (“ . . . if a Party is required by law . . . to make any disclosure . . . it will . . . give reasonable advance notice . . . and will use its reasonable efforts to secure confidential treatment . . .”); Clause 18.1 (“ . . . a memorandum will be prepared . . .”); Clause 18.2 (“Attorney’s fees will be paid to prevailing party.”); and Clause 20.7 (“The Party affected by such Force Majeure event will provide . . . full particulars . . . and will use diligent efforts to overcome the difficulties . . .”). But if these provisions impose an obligation, then why wasn’t the verb “shall” used as it is in so many other provisions? This violation of the rule of consistency supports a presumption that the meaning of “will” is different from that of “shall” and that it expresses merely prediction, not obligation. Taken to the extreme, this distinction would imply that the failure of a party to perform an obligation expressed by “shall” constitutes a violation of the contract allowing termination or damages, but the failure of a party to perform an act expressed by “will” is merely a failure of prediction and does not constitute a violation of the contract. Further, if the Licensee is the party to perform the act, the presumption of *contra proferentem* could be applied to the prejudice of Licensor as the drafter. Of course, such a possibility seems remote, but the risk could be eliminated by careful drafting.

20. Ambiguity of the Auxiliary Modal Verb “Should”

The risk of semantic ambiguity in the modal verb “should” is similar to that in “will.” The modal auxiliary verb “should” is generally used in formal language in the United States to indicate

obligation or hypothetical meaning.¹⁸¹ Like “must,” the verb “should” generally implies the speaker’s authority, but unlike “must,” “should” does not express the writer’s confidence that the act will be carried out and has the sense that the proposition within its scope is desirable. The hypothetical meaning often occurs in a sentence with the word “if.”

In the contract the word “should” appears eight times, sometimes in the sense of obligation, sometimes with the hypothetical meaning. The sense of obligation occurs in Clause 4.1 (“A Party has absolute discretion to choose whether to reference such MAA and which part of a MAA should it references [*sic*] to.”); Clause 4.5 (“ . . . the costs to be shared by both Parties . . . should be the costs arising from or in connection with that particular D & I”); Clause 13.3 (“both parties agree . . . They should agree on the price of the Products . . .”); and Clause 17.1 (b) (“ . . . the written notice issued by Licensor should enclose the aforesaid evidence . . .”). The sense of hypothetical meaning occurs in Clause 2.5 (“Should there be any proposed change in prices . . .”); Clause 14.2 (“ . . . using a brand name other than Licensor should Licensor so request . . .”); Clause 18.1 (“If the Parties should resolve such dispute or claim . . .”); and Clause 20.4 (“If any provision hereof should be held invalid . . .”). In these Clauses, “should” seems to be used in the two different senses. But the reader of the above passages would not be confused as to the sense because the context clarifies which sense is intended.

The semantic ambiguity of “should,” like that of “will,” is also contextual; it arises from the violation of the rule of consistent drafting. If the verb “shall” is used to impose binding obligations under the contract that carry the force of law, then the use of another verb such as “should” to impose an obligation raises the presumption that the obligation expressed by “should” is different from that expressed by “shall.” It seems likely that most readers of English would assume that “should” expresses a weaker sense of obligation than “shall.” The inference is that therefore the obligations imposed by “should” have lesser force than those expressed by “shall.” Whether and how extrinsic

¹⁸¹ QUIRK, *supra* note 172, at 227, 234–35.

evidence might present an arbitrator the chance to give effect to this distinction is unclear.

21. Ambiguity of “Law”¹⁸²

Broadly speaking, the word “law” in most contracts, as in this one, exhibits semantic ambiguity between two senses. One is the general “mass-noun” sense referring to the whole legal system and all three branches of government at three levels, the national, state, and local. The other is the “count-noun” sense referring to a specific statute and only the legislative branch of government. In contract provisions concerning compliance or authorization, the distinction between these two senses can be significant.¹⁸³ Does the provision require compliance with the rules issued by all three branches of government at all levels or only with those issued by the legislative branch in the form of a statute? Is the authorization based on support in any of the three branches of government or only in a specific statute passed by the legislative branch? Because of the ambiguity of “law” the answer is often not clear.

This ambiguity is exacerbated by several factors. These are whether “law” is used with the definite or indefinite article, whether its use is in the singular or the plural, and whether it is the object of a preposition. As to the use of an article, when “law” is used as a singular noun with the indefinite article “a,” it has the count-noun sense. This is true regardless of whether it is otherwise premodified or postmodified, or is the object of a preposition. When “law” is used in the singular with the definite article “the,” is not otherwise premodified, and the preceding text does not refer to a specific statute, it will generally have the mass-noun sense.¹⁸⁴ But if a specific statute is referred to in the preceding text, then it generally has the count-noun sense.¹⁸⁵ Further, the intensifiers “all” and “any” can be used with either a count noun or a mass noun, so they do not help disambiguate.

¹⁸² 陶博 (TAO BO) (2010), *supra* note 3, at 217–245.

¹⁸³ Generally, in provisions regarding authorization a higher level of authority is desired, but in those regarding compliance a lower, broader level of authority is desired.

¹⁸⁴ For example, “The life of the law has not been logic: it has been experience.” FRED R. SHAPIRO, *THE OXFORD DICTIONARY AMERICAN LEGAL QUOTATIONS*, 242 (1993).

¹⁸⁵ For example, “the Chinese contract law.”

Thus, the use of an article, particularly the indefinite article, helps to disambiguate “law” in the singular when it is not the object of a preposition. But there is no plural form of the indefinite article. This poses the question of disambiguating the plural. A partial answer is that the mass-noun sense, referring only to a mass, logically should not have a plural. Therefore, it would seem that the plural “laws” should always have the count-noun sense and should always refer only to statutes.¹⁸⁶ However, case law from *Yick Wo v. Hopkins*,¹⁸⁷ and continuing through *Erie Railroad Co. v. Tompkins*,¹⁸⁸ have interpreted the plural “laws” in some instances to have a meaning very close to that of the mass-noun sense.

The frequent use of “law” as the object of a preposition further complicates the picture. In expressing compliance or authorization, “law” is often the object of a preposition, such as “in accordance with” or “by.” Due to an historical quirk, in English usage the article is often omitted after a preposition. Therefore, the “law” in the phrase “by law” is ambiguous as to the mass-noun sense or the count-noun sense.

The ambiguities caused by this combination of factors appear clearly in the contract. The word “law” in the singular or plural appears fourteen times.¹⁸⁹ Of these 11 occur as the object of a preposition, 7 relating to compliance, 3 to authorization, and one is unclear. Of the 14 instances, 6 have no article or intensifier, 4 have the article “the,” 3 have the intensifier “any,” and one has the intensifier “all.” Eight of the instances use the plural “laws,” while six use the singular. Eleven instances concern the use of “law” as the object of a preposition, three do not.

¹⁸⁶ For an early example, see *Swift v. Tyson*, 41 U.S. 1, 18; 10 L. Ed. 865 (1842). As Justice Story said, “In the ordinary use of language it will hardly be contended that the decisions of Courts constitute laws. They are, at most, only evidence of what the laws are; and are not of themselves laws.”

¹⁸⁷ *Yick Wo v. Hopkins*, 118 U.S. 356, 370 (1886); OXFORD ENGLISH DICTIONARY, *supra* note 28, at 712; *Ralston v. Dep’t. of Licenses*, 374 P. 2d 571, 575 (Wash. 1962).

¹⁸⁸ *Erie R.R. Co. v. Tompkins*, 304 U. S. 64, 91 (1938). Justice Reed said, “To decide the case now before us and to ‘disapprove’ the doctrine of *Swift v. Tyson* requires only that we say that the words ‘the laws’ include in their meaning the decisions of the local tribunals.”

¹⁸⁹ See *infra* pp. 74, lines 4 and 8; Clauses 1.1, 6.1, 13.4, 5.2, 19, 19.1, 20.8, and 20.09.

Ambiguity arises as the result of the use of the plural “laws.” In the first sentence of the contract, does the mention of the incorporation of the parties “under the laws” of a particular jurisdiction refer to authority or compliance? If it refers to compliance, does it refer only to compliance with statutes or does it also include compliance with administrative regulations and judicial orders and decisions? Similar questions are posed in Clause 6.1 by the phrase “organized, validly existing and in good standing under the laws of the jurisdiction of its incorporation;” in Clause 13.4 concerning the obligation of maintenance and repair of the equipment “in accordance with applicable laws” and in Clause 20.8 as to the obligation to “comply with all laws.”¹⁹⁰

Ambiguity also arises in the use of the singular. Does the reference to “material applicable law” in Clause 6.1.3 refer to a statute passed by the legislative branch or to any binding document issued by any branch of government at any level?

Finally, it is not clear whether the count-noun sense of “law” includes regulations or not. It would seem reasonable to assume that regulations issued pursuant to a specific statute should be covered, but the reference to “law, rule or regulation” in Clause 20.09 could allow the application of the rule of consistent drafting and the negative implication presumption (*expressio unius*) to make the assumption that the count-noun sense of “law” must express something different than “law, rule, or regulation” and therefore does not include regulations.

22. Ambiguity between the Singular and the Plural¹⁹¹

A common semantic ambiguity is whether the singular includes the plural and the plural the singular. Where the contract has a provision stating that the singular includes the plural and *vice versa*, unexpected interpretations can occur. In a long-term-care insurance policy that has such a provision and states that the

¹⁹⁰ Another complication appears in *infra* Clause 19.1 in which the word “laws” is capitalized. It is unclear whether this is an effort to emphasize that only things called “Laws,” that is, statutes, are referred to or not. The term “laws” is not defined in the definition section Clause 1.1, so the initial capitalization does not indicate that it is a defined term.

¹⁹¹ DICKERSON, *supra* note 21, at 124; DONALD HIRSCH, DRAFTING FEDERAL LAW 43–44 (2d ed. 1989); LAWRENCE E. FILSON, THE LEGISLATIVE DRAFTER’S DESK REFERENCE 230 (1992); ROBERT J. MARTINEAU, DRAFTING LEGISLATION IN PLAIN ENGLISH 67 (1991).

insurance company cannot cancel the policy “unless you do not make the required premium payments on a timely basis,” will the plural be interpreted to include the singular so the company can cancel after the failure to make timely payment only once?

More generally problems occur, as here, due to the lack of consistent usage. It appears that in Clause 1.1, the definition section, the drafter has chosen to use the convention of appending “(s)” to singular words to indicate that they can also express the plural. See “Definition(s),” “Additional . . . Product(s),” etc.¹⁹² But the use of the “s” in parentheses is unnecessary and repetitive of Clause 20.9 (viii) which provides that “words using the singular or plural number also include the plural or singular number, respectively.” It could be argued that the inconsistent use of the “s” in parentheses creates a presumption that certain nouns only have the plural sense and the plural in such cases does not include the singular. The possible consequences of such an interpretation are difficult to predict.

23. Ambiguity in Use of the Comma¹⁹³

A comma can be critical. Roger Casement was said to have been “hanged by the comma” in the Treason Statute of 1351.¹⁹⁴ In contracts, the comma, especially the serial comma, can eliminate syntactic ambiguity, but inattention to the serial comma can cause ambiguity, especially post-modification ambiguity.¹⁹⁵ For example, the sentence “Tenant shall not allow to remain on the premises overnight any persons not related by blood or marriage, minor children or pets weighing more than 25 pounds,” is ambiguous as to whether the postmodifier “weighing more than

¹⁹² “Business Day(s),” “Products(s),” “Reference Material(s),” and “Territory Licensed Product(s).” But even within this Clause there are plural nouns with no parentheses, such as “BTI Patents,” and “EMA Costs.”

¹⁹³ THE CHICAGO MANUAL OF STYLE, §5.57 (14th ed. 1993); SINGER & SINGER, *supra* note 25, at §21.15; RICHARD C. WYDICH, *PLAIN ENGLISH FOR LAWYERS* 84 (3rd ed. 1994).

¹⁹⁴ DAVID MELLINKOFF, *THE LANGUAGE OF THE LAW* 167–70 (1963).

¹⁹⁵ For an example of premodification ambiguity caused by the absence of the serial comma, see HAGGARD & KUNEY, *supra* note 1, at 290. See also *Anderson v. State Farm*, 270 Cal. App. 2d 346 (Ct. App. 1969); *McCormack Trucking Co. v. United States*, 298 F. Supp. 39 (N.J. 1969). For the effect of the serial comma in limiting the scope of postmodification see *Ludwig v. State of Texas*, 931 S. W. 2d 239 (Tex. Crim. App. 1996); and *Elliot Coal Min. Co. v. Dir., Office of Workers’ Comp. Programs*, 17 F. 3d 616 (3rd. Cir 1994).

25 pounds modifies not only “pets” but also “children.” A serial comma after “children” would restrict the scope of the postmodification to the last antecedent “pets” and make clear that it did not modify “children.” The contract here, however, does not seem to contain any example of ambiguous postmodification that could be clarified by a serial comma.

Two examples of postmodification after a series show that the absence of a serial comma allows the inference that the postmodification applies to all the preceding conjoins. In Clause 2.4(i) in the phrase “. . . the results, documents and other information related to the chemical trials . . .,” it seems clear that the drafter intended the underlined postmodifying phrase to modify “results” and “documents.” In Clause 6.1, in the phrase “. . . duly organized, validly existing and in good standing under the laws of its jurisdiction of incorporation . . .,” it seems clear that the drafter also intended the underlined postmodifying phrase to modify all of “organized,” “validly existing” and “in good standing.”

24. Ambiguity of “As of”¹⁹⁶

The expression “as of” is used to assign an event to one time and the recognition of it to another,¹⁹⁷ that is, to express the meaning of the phrase “as if it were.”¹⁹⁸ This American jargon for expressing a date has become so popular that many people, including the drafter of the contract, seem to think it is the only way to express a date.¹⁹⁹ In Clause 6.1 concerning representations and warranties and Clause 6.2 concerning representations and warranties, the use of “as of” seems to express simply the same concept as “on” a specific date. There seems to be no need to use “as of” instead of “on.”²⁰⁰

¹⁹⁶ 陶博 (TAO BO) (2004), *supra* note 3, at 178–80.

¹⁹⁷ FOLLETT, *supra* note 150, at 41–42.

¹⁹⁸ Horwitz v. New York Life Ins. Co., 80 F. 2d 295, 299 (9th Cir. 1935).

¹⁹⁹ FOLLETT, *supra* note 150, at 41–42; MERRIAM-WEBSTER'S DICTIONARY OF ENGLISH USAGE 132 (Merriam-Webster, Inc., 1974).

²⁰⁰ In fact, the drafter in §16.1 did use the phrase “on the Effective Date” supporting a presumption that the drafter intended a distinction between “as of” and “on” the Effective Date.

But in legal documents, “as of” can be used to disclose the fact that a document has been backdated.²⁰¹ In this contract, the usage is semantically ambiguous because it is not clear whether the document has been backdated. In determining whether a contract has been backdated, it is necessary to know two facts: when the contract was signed and when it became effective. If the two are the same, there is no backdating issue. If they are not and the effective date is prior to the signing date, then the expression “as of” to modify the effective date discloses the backdating. In this case, however, the contract does not make clear what the signing date is. The first line of the Agreement tells us the effective date (“as of June 24, 2011”), but the description of the execution of the document in Clause 20.10 tells us merely that it was executed “as of the Effective Date.” Thus, both the effective date and the execution date of the contract are expressed as “as of” June 24, 2011. Therefore, it is not clear whether the document was backdated or not. If it was backdated and the failure to disclose this fact would compromise the rights of a third party or violate a law, then it would pose a problem.

25. Ambiguity of “Termination”

Contracts sometimes confuse the related concepts of “termination” and “expiration,” apparently because “termination” exhibits semantic ambiguity as to whether the ending of the legal effect of the contract is due to the action of a party or occurs automatically by operation of the set duration of the contract. For example, an agreement may contain provisions that allow either party to “terminate” the agreement upon advance notice, that the agreement will “expire” at the end of the term if not renewed, but that prohibitions on the use of one party’s proprietary information continue after the “termination” [but not the “expiration”?] of the agreement.

The contract does not appear to exhibit substantial ambiguities of this nature, the term “termination” being used only for the active ending of the contract, and “expiration” only for the automatic ending of the contract. However, the reference to “termination” in provision in Clause 14.1.2 may include the sense

²⁰¹ Jeffrey L. Kwall & Stuart Duhl, *Backdating*, 63 BUS. LAW. 1153, 1177–78 (Aug. 2008). In this contract, it is also used simply in the sense of “as if it were” in Clauses 10, 6.1, and 6.2.

of automatic ending. That Clause states that the Licensee has the right to continue the use of the Licensor Intellectual Property for the research and the manufacturing of “[a]ny other new products until termination date.” It seems unreasonable to assume that the Licensee will have the right to use Licensor Intellectual Property in perpetuity, so the reference to “termination” probably does not exclude, but includes, expiration. That is, the Licensee has the right to use the Licensor Intellectual Property until the earlier of either termination or the expiration of the last patent.

There is also a postmodification issue in Clause 14.1.2. The preceding subclause 14.1.1 does not have any termination or expiration provision. It seems that perhaps the postmodifying phrase “until termination date” in Clause 14.1.2 may be intended to modify Clause 14.1.1 as well, but the division of the two subclauses into two separate paragraphs prevents the scope of this postmodifying clause from including the preceding subclause. Is the Licensee’s right to continue to use the Licensor Intellectual Property to research and manufacture the products for which the Licensee obtains or intends to obtain MAA perpetual? From the language this would seem to be so.

26. Ambiguity of “Execution”²⁰²

The word “execution” presents the risk of semantic ambiguity because it can have three different meanings when used in contracts. First, it can refer to the completion of all acts necessary to render an instrument complete with nothing remaining to be done to make it legally effective. Second, in common usage it also is used as a synonym for “sign.” Third, it can have the sense of “perform” or “carry out” a contract or, especially, a will. This third sense is the one that civil law lawyers often assume that “execute” has in a contract written in English.

In the contract, it seems “execution” is used mainly in the second and third senses. Clause 6.1.2 concerning representations and warranties refers to authorization “to execute and deliver this Agreement” and Clause 6.1.3 states that the “execution, delivery

²⁰² OXFORD DICTIONARY, *supra* note 28, at 521–2; BLACK’S LAW DICTIONARY 467 (7th ed. Bryan A. Garner ed. 2000); FREDERICK STROUD & JOHN S. JAMES, STROUD’S JUDICIAL DICTIONARY OF WORDS AND PHRASES 905 (5th ed. 1986).

and performance of this Agreement”²⁰³ does not conflict with any agreement or violate any law. Clause 20.10 states that the Agreement “may be executed in two or more counterparts” and the signature block records the fact that the parties have “executed” the Agreement “as of the Effective Date.” Taken together, the use of “execute” in these Clauses could be interpreted to be that of “sign,” because completion of all acts to bring the document into legal effect would not make sense in Clauses 6.1.2 and 6.1.3. However, as to the amendment of the contract, Clause 20.5 provides that a change to the contract is binding “if and only if reduced to writing and signed” by the representatives of the Parties. This would seem to indicate that “signing” is the act that makes the change legally binding. The senses of “execute” and “sign” are further confused by Clause 18.1 regarding dispute resolution, which refers to a memorandum by the Chief Executive Officers being “signed” by the parties. The presumption of consistency and the negative implication presumption would lead us to assume, *ceteris paribus*, that “sign” and “execute” have different meanings, “sign” meaning simply to write one’s name and “execute” meaning to bring into legal effect. If the memorandum described in Clause 18.1 is not intended to have legally binding effect, then the use of “sign” does not pose any problem with that Clause, but it and the use of “sign” in Clause 20.5 leave some doubt about whether the sense of “execute” in the other Clauses has the sense of “sign” or the sense of “bring into legal effect.”

“Execute” in the third sense appears in the context of implementation of the contract. Clause 12.1 concerning enforcement refers to the discovery of “an executed or potential patent infringement” and Clause 14.1 concerning events of default refers to the fact that “no execution to cure [a gross default] has been taken.” These instances do not seem to pose a significant risk of ambiguity.

²⁰³ It is not clear why one clause refers to “execute” and “deliver” while the other refers to “execution,” “delivery” and “performance.” The negative implication presumption would seem to raise the question of whether the parties are authorized only to execute and deliver the Agreement, but not to perform it. Further, the use of “deliver” seems tautologous or a mere courtesy if “execute” means to bring into legal effect.

27. Ambiguity of “Due” and “Payable”²⁰⁴

The adjectives “due” and “payable” exhibit semantic ambiguity as to matured or unmatured debt. Generally, when “due” is used together with an expression indicating a specific time, it expresses the sense of matured debt. Otherwise, it is ambiguous. “Payable” can also express matured or unmatured debt as well as possibility of payment.

The contract uses both “due” and “payable.” It appears that “due” is used in the sense of matured debt. For example, Clause 3.8 regarding Licensee’s right to make deductions from the Royalty, states that the Licensee may “deduct from the Royalty payment due to Licensor” royalty payments made to a third party. Clause 3.9 regarding the calculation of the Royalty states that the Licensee is to “provide a calculation of the Royalty Payment amount due . . . within ninety (90) days.” The payment due and the amount due seem to refer to amounts that should be paid immediately. The use of “payable” is more ambiguous. Clause 3.6(d) obligates Licensee to assemble records for determining the aggregate price of Products sold “that may impact royalties payable to Licensor.” Clause 4.6 regarding reimbursement states that “[w]here reimbursement and repayment is payable pursuant to Clause 4.4 . . .” In both these Clauses “payable” could refer to amounts that should be paid immediately or later. It is not clear whether the drafter was trying to distinguish between “due,” using it only to express matured debt, and “payable,” using it only to express unmatured debt. While the use of these two adjectives leaves open a risk of ambiguity, it seems unlikely to result in any negative consequences.

28. Bijuridical Ambiguity²⁰⁵

“Bijuridical” is a term used in Canada to refer to federal legislation that applies to the two legal systems that exist in Canada, the common law and the civil law. The term “bijuridical ambiguity” can be used to refer to a semantic ambiguity that

²⁰⁴ GARNER, *supra* note 156, at 298–99; 陶博 (TAO BO) (2010), *supra* note 3, at 320–26.

²⁰⁵ DRIEDGER, *supra* note 155, at 235–43; MICHEL BASTARACHE, NAIOMI METALLIC, REGAN MORRIS, & CHRISTOPHER ESSERT, *THE LAW OF BILINGUAL INTERPRETATION* 114–35 (2008); 陶博 (TAO BO) (2013), *supra* note 3.

occurs in the use of a legal term from one legal system in the context of another legal system. Examples are the concepts “notarize,” “power of attorney,” and “bankruptcy” in English which differ between the common law and civil law. As one would expect, bijuridical ambiguity occurs in international contracts. The contract is often written in one language and has a governing law provision that applies the law of a jurisdiction that uses that language. When one of the parties is based in another jurisdiction that uses another language, the question arises of how the terminology of the language of the governing law jurisdiction applies in the other jurisdiction. Often, this discrepancy in the terminology and the two legal systems results in ambiguity.

A representation and warranty of “good standing” is an example of semantic and possibly bijuridical ambiguity. In the contract Clause 6.1 concerning representations and warranties by each party, the Licensee represents and warrants that it is “in good standing” under the laws of the jurisdiction of its incorporation (the Hong Kong Special Administrative Region). The term “standing” is ambiguous. Black’s Law Dictionary²⁰⁶ defines “standing” as “One’s place in the community in the estimation of others; his relative position in social, commercial, or moral relations; his repute, grade, or rank . . .” For corporations, however, the meaning is more specialized. In the United States, it refers to a Certificate of Good Standing issued by the Secretary of State of a company’s state of incorporation certifying the corporation has complied with all the provisions of the business corporation act relating to the filing of annual reports and payment of franchise taxes. Some states, such as New Hampshire, the state of incorporation of Licensor, while using similar language, do not use the words “good standing.”²⁰⁷ In any case, however, these certificates do not certify the corporation’s standing in the community or financial resources, merely the fact that the corporation has been established, has not been dissolved, and has filed any required annual reports and paid any required annual fees. In Hong Kong, which is a common law jurisdiction using the English language, the Registrar of Companies issues a

²⁰⁶ BLACK’S LAW DICTIONARY 1405 (6th ed. 1990).

²⁰⁷ For samples of certificates of incorporation, see the Certificate of Existence Good Standing/Status Samples on the Indiana Secretary of State’s website, available at [http://www.in.gov/sos/business/files/COEsamples2011_\(2\).pdf](http://www.in.gov/sos/business/files/COEsamples2011_(2).pdf) (last visited Feb. 1, 2014).

Certificate of Continuing Existence which is similar in nature to a certificate of good standing. Therefore, the use of the term “good standing” would be understood to mean that Licensee could obtain a certificate of continuing existence to evidence its “good standing” under Hong Kong law. If Licensee had been established in mainland China, however, there would be a bijuridical issue because the Chinese authorities do not issue certificates of good standing regularly during the year, but documents evidencing yearly compliance with required annual inspections.²⁰⁸

29. Miscues²⁰⁹

A miscue is a temporary, often syntactic, ambiguity, a temporary misreading of a document. Fowler called it “false scent” after the practice in a fox hunt when the dogs go off in one direction only to find that they have made a mistake, retreat and then pick up the scent again.²¹⁰ But for non-native speakers of English a miscue is often a permanent ambiguity.

The contract contains a number of examples of miscues. In Clause 1.1 the definition of “Licensor Technology” is “Licensor Patents and Licensor Know-How relating to NDS or its drug candidate equivalent only.” It appears at first reading that the word “only” modifies only “drug candidate equivalent” but in fact it modifies both “NDS” and “drug candidate equivalent.” A similar issue occurs in the definitions of EMA Costs and FDA Costs. Clause 3.1 setting forth the obligation to pay royalties, states that the royalty is based on “the sales and distribution of the Territory Licensed Products (excluding those manufactured and supplied to Licensor) . . .” Because the verb “manufactured” does not collocate with the preposition “to,” the reader’s first impression is that the products manufactured are not necessarily supplied to Licensor, that is, that the “and” is several, not joint. A moment’s reflection, however, informs the reader that the sense is joint, that is, that the products excepted are those that are both

²⁰⁸ 企业年度检验办法 (2006 年修改) [Enterprise Annual Inspection Regulations (2006 revised)] (promulgated by the General Administration for Industry and Commerce, Feb. 24, 2006, effective Mar. 1, 2006), CLI.4.75065 CHINALAWINFO.

²⁰⁹ GARNER, *supra* note 156, at 564.

²¹⁰ H. W. FOWLER & F. G. FOWLER, *THE KING’S ENGLISH* 356 (3d ed. 1931).

manufactured for Licensors and provided to Licensors. In Clause 13.4 which states that the Licensee is responsible “for the maintenance and repair of all equipment used in the manufacture of the products in accordance with applicable laws . . . ,” the reader at first assumes that the postmodifier “in accordance with applicable laws” modifies “manufacture,” but then realizes that it modifies “maintenance and repair.”

30. Oversights

Oversights in contracts are mostly typographical, not common, and not consequential. This is true for the contract for the most part. For example, the phrase “damage receivables” for “damaged receivables” in Clause 12.2 is probably just a miscue. The words “Paid-Up, Non-Exclusive License on Expiration” at the end of Clause 16.1(ii) are confusing until one realizes that they are the title of the following Clause 6.2. The misnumbering of subclauses in Clause 3 does not cause problems because there are no cross references to these subclauses elsewhere in the document. In Clause 4.6 concerning the payment of joint expenses, the verb “pay” or “transfer” is missing in the sentence “Where reimbursement and repayment is payable pursuant to Clause 4.4, the Party owing such reimbursement or repayment shall via telegraphic transfer to the account details set forth in Exhibit 4”

C. Summary

The vast majority of the ambiguities noted in the contract are semantic. Often this is combined with contextual ambiguity caused by inconsistent drafting. It is difficult to say which form of ambiguity or which combination is most dangerous, but the combination of semantic and contextual ambiguity is a good candidate because the ambiguity often only emerges from a reading of the whole contract. The ambiguity issues are similar to those in other commercial contracts of this type, but the modal verbs seem to be more prominent here. In other commercial contracts, ambiguities relating to the application of the class presumption, the last antecedent presumption, and the calculation of time periods seem to occur more often. Our ignorance about the commercial background, the relationship between the parties, and the impossibility of knowing in advance what unanticipated

event might occur and what extrinsic evidence would be available make it impossible to judge which ambiguities are most important. (For example, if this contract were a “relational contract”²¹¹ evidencing solidarity and reciprocity through a stable, long-term relationship between the parties, these issues could be irrelevant.) Still, the following ambiguities would seem to be potentially significant: those regarding the definition of Licensor Patents, Licensor Know-How, and Licensor Technology; those concerning changes in the Products and audit; those concerning the Licensee’s right to manufacture Products for third parties, the scope of Products sold by Licensee in the Additional Territory, and the condition to Licensor’s providing assistance; those concerning indemnity and termination; those concerning EMA costs and the pricing of sales; those concerning the imposition of obligations; and those concerning the calculation of time periods.

V. CONCLUSION

The primary purpose of this article is to help train students for the practice of law by helping them, through the analysis of one commercial contract, to identify the risks associated with ambiguity in contracts and to reduce those risks. This exercise can in this way assist them in improving their contract drafting. But it will also teach them to see things in a contract which others cannot and that ability will allow them to distinguish themselves from others in drafting, negotiating, implementing, and litigating contracts.

A secondary purpose has been to propose a working hypothesis that the most important problem for commercial contracts is disputes; that ambiguity is a major, if not the major, cause of commercial contract disputes; and that reducing ambiguity in contracts can benefit both parties to the contract and the legal system as a whole. More specifically, it suggests that the contract drafter faces three risks associated with contract disputes: that of an unanticipated event, that of ambiguity in the contract, and that of the application of *contra proferentem*. It suggests specific measures for identifying and eliminating ambiguity in commercial contracts in order to reduce these risks.

²¹¹ IAN R. MACNEIL, THE RELATIONAL THEORY OF CONTRACT: SELECTED WORKS OF IAN MACNEIL 298–310 (David Campbell ed. 2001).

This working hypothesis is not without fault. Common sense tells us that it is not just ambiguity that causes disputes. The ultimate cause of disputes is probably the divergent interests of the parties. But the written document that largely expresses the parties' intent is the medium in which the struggle of these divergent interests plays out. If we want to understand why and how disputes and contracts interact, it seems practical to focus intensely on this medium and on its specific wording. After all, humans communicate through language, not pheromones.²¹² This working hypothesis, with its heightened focus on the language, is only a preliminary tool, but it seems to this practitioner that it offers us a useful approach that, with others, can bring us closer to the question of why contract disputes occur.

This working hypothesis poses some other challenges and questions.

For drafters, the first of the three risks, that of an unanticipated event, is something they will find difficult to quantify. Although sophisticated probability methods to assess risks have developed in the natural sciences, it seems that their application to the real world of human conduct is still premature.²¹³ But even in an imperfect world where drafters suffer from heuristic biases and bounded rationality, they may be able to make sufficing decisions on the risks of at least the known unknowns, if not the unknown unknowns.²¹⁴ Even if a risk cannot be completely eliminated, chance still favors the prepared.²¹⁵

Drafters can estimate the second risk by studying the application of *contra proferentem* under the governing law of the contract, preparing a checklist of factors like that above, and then they can consider this risk in drafting and negotiating the contract.

²¹² See 陶博 (TAO BO) (2011–2012), *supra* note 3, at 93–94.

²¹³ NASSIM NICHOLAS TALEB, *FOOLED BY RANDOMNESS: THE HIDDEN ROLE OF CHANCE IN THE MARKETS AND IN LIFE* 188 (Texere, 2001); MICHAEL KAPLAN & ELLEN KAPLAN, *CHANCES ARE...: ADVENTURES IN PROBABILITY* 223–27 (Viking, 2006).

²¹⁴ For the terms “known unknowns” and “unknown unknowns”, see remarks by Secretary of Defense Donald H. Rumsfeld, News Transcript, Feb. 12, 2002. “...there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don’t know we don’t know . . .” *available at* <http://www.defense.gov/transcripts/transcript.aspx?transcriptid=2636> (last visited February 1, 2014).

²¹⁵ TALEB, *supra* note 37, at 208.

Drafters can reduce the third risk by taking care in drafting to identify ambiguities and to eliminate them to the extent practicable. They can use the above checklist of ambiguity issues and revise it to suit the particular contract. The draft contract could then be reviewed and changed after a careful weighing of the different factors and making the appropriate tradeoffs. Reducing two of these three risks should reduce the likelihood of a dispute or litigation.

Practitioners, including some drafters, may question the costs to the individual party of improving drafting, saying that perfect foresight is infinitely costly and providing for every possible contingency in a contract is prohibitive.²¹⁶ They may say that it is useless to expend greater resources on careful contract drafting. As the analysis above suggests, to reduce disputes it is more important to reduce the ambiguity of the provisions in the contract, than speculate about including additional provisions the contract does not contain. And the costs of improving contract drafting by reducing ambiguity as suggested above should not be unreasonably high. They could be negligible, especially if a drafter uses the checklists set forth above and has summer associates, contract lawyers, or junior associates perform the task. Aside from the drafter's review time,²¹⁷ the costs can even be almost free if the drafter is willing to have a student perform the task as part of the thesis requirement described above. For standard form contracts used in many deals, the costs per contract could be quite low. Of course, ultimately we need a study of the costs and benefits of improving contract drafting,²¹⁸ but for now we can work with the assumption that the benefits of reducing ambiguity will outweigh the costs for the individual party and for the legal system. And even if the checklists and the analysis suggested above do not result in changes to the contract itself, the party preparing them will have made a more informed decision on whether to amend the contract.

Other practitioners may find that trying to reduce the risk of ambiguity through the analysis and checklists above is an

²¹⁶ R. Posner, *supra* note 16, at 1582, 1602.

²¹⁷ Admittedly, this time would be more than the famous three and a half minutes described in GULATI AND SCOTT, *supra* note 15.

²¹⁸ But the difficulty of empirical investigation of contractual behavior has been noted. E. Posner, *supra* note 31, at 863.

exercise in obsessive pickiness. After all, a dispute may never arise from any of the issues noted above and the importance of the ambiguities depends on the nature of unanticipated events and future extrinsic evidence. And the study of *pari passu* suggests that the institutional structure of the modern large law firm discourages innovation in contract design²¹⁹ and that the bar has perhaps fallen victim to its myths and the herd, not worrying too much about ambiguity because the returns to the firm in terms of volume transactions outweigh the present value of the risk of ambiguity.²²⁰ And the response to the suggestions in this article may be simply "Oh, we couldn't do that—it's never been done before!" But experience suggests to this practitioner that in many cases an individual drafter may have a personal incentive in guarding against ambiguity. Consider the following two questions: Other things being equal, how many lawyers would like to negotiate in front of their colleagues or client a contract they drafted for which the opposing party, in addition to its normal preparation, had done an analysis of the kind described above?²²¹ And how many lawyers would like to be the one lawyer at the negotiations who had done such analysis? Enough said.

Efforts by the drafters themselves to reduce ambiguity, however, will not be sufficient. The analysis of California case law above suggests that changes in the attitude of both practitioners and judges towards *contra proferentem* are needed.²²² I believe the presumption of *contra proferentem* deserves more serious consideration for two policy reasons.²²³ The first is personal responsibility. As a drafter and teacher of contract drafting, I believe that the most effective way to improve contract drafting is to make the drafter responsible. When drafters are confronted with the moral hazard of careless drafting, they

²¹⁹ GULATI & SCOTT, *supra* note 15, at 163.

²²⁰ *Id.* at 6.

²²¹ Pride of authorship may be hard to find in these situations. More likely are comments like "Well, it's the firm's standard form, not mine," or "We inherited this form from the former GC." See the comment in GULATI & SCOTT, *supra* note 15, at 83: "Oh, I guess we weren't in charge of the documents: underwriter's counsel were."

²²² Goetz and Scott's statement that "[t]he risk that a court will apply *contra proferentem* arguably chills the development of innovative contractual language..." seems to this transactional lawyer speculative and unfounded. See Goetz & Scott, *supra* note 89, at 261, 302–03. Perhaps a litigator could assist.

²²³ For some other considerations, see CSERNE, *supra* note 58, at 11–12.

will exercise more care in preparing documents.²²⁴ Second, *contra proferentem* promotes fairness and justice. The drafter has an inherent advantage over the non-drafter. The drafter knows the contract better and has written it to benefit the drafter's client.

These policy considerations pose questions for judges. Can disputes be more accurately characterized as problems of ambiguity and dealt with more effectively that way? Can the disadvantages of being the drafter of a commercial contract really be overcome simply by arguing that both parties are sophisticated, that the contract was negotiated, that the contract was "jointly" drafted when the ambiguous provision was not, or that the term "drafter" includes the non-drafter as well? Is it reasonable to make the application of the presumption depend on whether the contract was one of adhesion or whether the parties had unequal bargaining power? Shouldn't *contra proferentem* be treated like other presumptions, such as that of negative implication, without judicial interpretations that limit its application? After all, isn't the presumption a last resort as is and isn't it true that the interpretation suggested by *contra proferentem* must be reasonable so the risk of judicial abuse is small and less than allowing judges to determine the parties' "objectively reasonable expectations"? Do the "fundamental considerations of policy" underlying *contra proferentem* mentioned by Justice Tobriner suggest that clauses precluding the application of *contra proferentem* should be unenforceable as against public policy?²²⁵ In sum, it seems to this practitioner that acquiring a deeper understanding of this presumption and giving it thoughtful, broad, and consistent application would increase certainty, improve contract drafting, and help reduce the risk of ambiguity and litigation.

This working hypothesis seems to pose questions for scholars and a challenge for existing contract doctrine. Corbin's view, the prevailing one in contract doctrine, sees the written document not as the contract, but only strongly persuasive evidence of it and views the parties' intentions as more important

²²⁴ As discussed *supra*, the specific language of California Civil Code §1654 emphasizes the drafter causing the ambiguity.

²²⁵ Such a rule makes sense when one considers the presumption's close connection with unconscionability. See RESTATEMENT (SECOND) OF CONTRACTS §201, com.. "sometimes the result [of the application of *contra proferentem*] is hard to distinguish from a denial of effect to an unconscionable clause."

than certainty.²²⁶ But this focus on the parties' intentions, as noted above in the discussion of section 1649 of the California Civil Code and section 201 of the Restatement, is only on the parties' intentions at the time of signing the contract. But an unanticipated event is by definition something that the parties did not have any intentions about at the time they signed the contract. Doesn't this fact suggest that the conclusion that intentions trump certainty be reexamined? But if ambiguity is ubiquitous and unanticipated events unavoidable, how much certainty can we ever attain? It is unclear to this practitioner how theory might address these questions. But it seems clear that theory needs to start the inquiry from practice—the fact that an unanticipated event is by definition something that the parties did not have any intentions about at the time they signed the contract. And it would be advisable to combine theory and practice in a virtuous cycle. As Chairman Mao put it in the Little Red Book, "Understanding starts with practice, after experiencing practice we gain an understanding of theory, and then we need to return back again to practice."²²⁷ Or, in the words of Nassim Nicholas Taleb, we should go from problems to books, from books to problems, and finally from problems back to books again.²²⁸

Finally, I would like to address one future event that is not unanticipated—my students' discovery somewhere of a contract that I had drafted some years ago. My plea to them—with apologies to the drafter of the contract that follows—is the same one that a senior partner made to me when I was a young associate many years ago—"Now, don't be too tough on my standard form."!

²²⁶ CORBIN, *supra* note 10, at §25.4. Eric A. Posner has made a similar point. "Corbin's mistake is that, in assuming that the purpose of contract law is to enforce the intentions of the parties, he overlooks the fact that the parties, in addition to their ordinary contractual intentions, have intentions about how courts should evaluate their contracts in case of dispute." E. Posner, *supra* note 89, at 570.

²²⁷ 毛泽东语录 [The Sayings of Chairman Mao] 180 (1969). English translation is mine.

²²⁸ Taleb, *supra* note 37, at 290. One might infer from Gulati and Scott another virtuous cycle: "from transactional lawyer to litigator, from litigator to transactional lawyer, from transactional lawyer to litigator." GULATI & SCOTT, *supra* note 15, at 164.

Exhibit 1

Certain portions of this exhibit, as indicated by [***], have been omitted, pursuant to a request for confidential treatment under Rule 24b-2 of the Securities Exchange Act of 1934. The omitted materials have been separately filed with the Securities and Exchange Commission.

EXHIBIT1: LICENSE AND MANUFACTURING AGREEMENT²²⁹

BETWEEN

ABC, INC.

AND

XYZ COMPANY LIMITED

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²²⁹ The names of the parties have been changed and certain other information deleted. All emphasis has been added.

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LICENSE AND MANUFACTURING AGREEMENT

This LICENSE AND MANUFACTURING AGREEMENT (this “Agreement”) is effective as of June 24, 2011 (the “Effective Date”) by and between:—

ABC Inc. a company incorporated under the laws of Delaware, USA having a principal place of business at [deleted] St. Manchester, NH 03101, United States of America (“Licensor”); and

XYZ COMPANY LIMITED, a company incorporated under the laws of the Hong Kong Special Administrative Region of the People’s Republic of China at Tai Po, New Territories (“the LICENSEE”),

(Licensor and the Licensee are each referred to herein by name or, individually, as a “Party” or, collectively, as the “Parties”).

WHEREAS:

Licensor is a biopharmaceutical company having certain proprietary rights, technologies and data related to dietary supplements and potential drug agents developed from complex carbohydrate chemistry.

The Licensee is a Hong Kong Asia-based pharmaceutical company with a vertically integrated platform engaged in development, manufacturing, design, marketing, sales, logistics and distribution of pharmaceutical and other health care products.

By an option agreement dated July 7, 2010 (“Option Agreement”) as set out in Exhibit 1, DEF Company Ltd. (the “Optionee”) was granted an option by Licensor (the “Option”) to enter into a license and manufacturing agreement according to the terms stipulated in the Option Agreement. Optionee has designated the Licensee as its nominee to enter into this Agreement.

Licensor and the Licensee wish to further develop, manufacture and commercialize the Products (defined hereinafter). Accordingly, Licensor desires to grant to the Licensee, and the Licensee desires to obtain from Licensor, certain rights, licenses and sub-license rights pertaining to the

Territory (defined hereinafter) and the possible first right of offer, all subject to the terms and conditions set forth here-in-below.

Subject to the terms and conditions set forth below, Licensor desires to manufacture and sell the Products (defined hereinafter) to the Licensee, and the Licensee agrees to have the Licensee engage in the following:

market and sell such Products (defined hereinafter) in the Territory; and

manufacture, market and sell such Products upon the setting up of the Licensee's manufacturing facilities.

NOW IT IS HEREBY AGREED as follows:

1. DEFINITION(S)

In this Agreement including the Recitals, except where the context otherwise requires, the words and expressions specified below shall have the meanings attributed to them below:—

“Additional Territory”	means all countries and territories in the world except the Territory and the USA;
“Additional Territory Licensed Product(s)”	means any product for human or veterinary use, the research, development, manufacture, use, sale, offer for sale, import or export (collectively, “Exploitation”) of which, is based upon or incorporates Licensor Technology or, but for the license granted in this Agreement, the Exploitation or which would infringe any Licensor Patents in any country in the Additional Territory;
“Affiliate”	means with respect to either Party, any person or entity that, directly or indirectly, through one or more intermediaries, controls, is controlled by or is under common control with such Party, for so long as such control exists.

For purposes of this Section only, “control” means

direct or indirect ownership of fifty percent (50%) or more (or, if less than fifty percent (50%), the maximum ownership interest |

permitted by applicable law) of the stock or shares having the right to vote for the election of directors of such corporate entity, or

the possession, directly or indirectly, of the power to direct, or cause the direction of, the management or policies of such entity, whether through the ownership of voting securities, by contract or otherwise;

**“LICENSOR
Know-How”**

Any proprietary information, trade secrets, documented techniques, materials and data owned or controlled by Licensor during the Term or which are acquired by or developed for Licensor by a Third Party during the Term, including but not limited to discoveries, formulae, materials, reagents, proprietary methods, processes, test data (including pharmacological, toxicological, clinical and manufacturing information and test data), and analytic and quality control data, which is necessary or useful to research, develop, make, have made, use, sell, offer for sale, import or export the Products, provided however, that Licensor Know-How that is the subject of the licenses and other rights granted to Licensee hereunder shall extend only to those applications of any of the foregoing items that are associated with specifically defined carbohydrate chemistry formulation; Licensor Know-How does not include Licensor Patent Rights.;

**“LICENSOR
Patents”**

means the patents which includes:

All patents and patent applications of any kind anywhere in the world as more particularly listed in the Exhibit 6 owned or controlled by Licensor during the Term or which are acquired by or developed for Licensor by a Third Party during the Term (together with all divisions, continuations, patents of addition, substitutions, registrations, re-issues, re-

examinations or extensions of the foregoing) and which are necessary or useful to research, develop, make, have made, use, sell, offer for sale, import or export the Products, provided, however, that Licensor Patents that are the subject of the licenses and other rights granted Licensee hereunder shall extend only to those applications of any of the foregoing items that are associated with NDS or its drug candidate equivalent;

All patent applications that may hereafter be filed by or on behalf of Licensor which either are based on or claim priority from any of the foregoing patents and applications; and

All patents which may be granted pursuant to any of the foregoing patent applications;

“LICENSOR Technology”	means Licensor Patents and Licensor Know-How relating to NDS or its drug candidate equivalent only;
“Business Day(s)”	means a day (other than a Saturday or a Sunday) on which licensed banks are generally open for business in Hong Kong;
“Effective Date”	means the date of this Agreement as set forth above;
“EMA”	means the European Medicines Authority;
“EMA Costs”	means external contracted costs resulting in a specific fee charged and a deliverable documented output for EMA meetings, animal tests, and human tests, resulting in a competent authority submission only;
“FDA”	means the United States Food and Drug Administration, or any successor agency thereto;
“FDA Costs”	means external contracted costs resulting in a specific fee charged and a deliverable documented output for FDA meetings, animal tests, and human tests, resulting in a competent

	Regulatory Authority submission only;
“Force Majeure”	means the force majeure as referred to and defined in Clause 20.7 of this Agreement;
“Hong Kong”	means the Hong Kong Special Administrative Region of the People’s Republic of China;
“MAA”	means the Marketing Authorization Approval of a new drug application for permission to initiate marketing, sale, testing and food supplement registration), licenses, registrations or authorizations necessary for the marketing and sale of such Product, filed with: the FDA in accordance to the FDA Code of Federal Regulation Title 21 Part 314 Section 50 et. Seq (21 C.F.R. 314.50 et. Seq); the EMA; or any other Competent Regulatory Authority.
“Product(s)”	means initially Territory Licensed Product(s) and from time to time, as the same may be added to this Agreement, Additional Territory Licensed Product(s), details of which are set out in Exhibit 7;
“Prosecution and Maintenance”	means with respect to a patent or patent application, the preparing, filing, prosecuting and maintenance of such patent or application, as well as re-examinations, reissues, requests for patent term extensions and related matters with respect to such patent or application, together with the conduct of interferences, the defense of oppositions and other similar proceedings with respect to the particular patent or patent application; and ‘Prosecute and Maintain’ shall have the correlative meaning;
“Qualified Person”	means a person qualified and accepted by competent authority to batch release and to assure quality and acceptance by a competent authority;
“Reference	means the official materials submitted to the

Material(s)”	regulatory authority in support of the regulatory label and approval of Products;
“Regulatory Authority”	means federal, national, multinational, state, provincial or local regulatory agency, department, bureau or other governmental entity with authority over the discovery, advancement, manufacture, commercialization or other use or exploitation (including the granting of MAA) of the Products in any jurisdiction, including the FDA, the European Medicines Agency (EMA), the State Food and Drug Administration (SFDA) in the People’s Republic of China and the Ministry of Health Labor and Welfare (MHLW) in Japan;
“NDS”	means the trademark, namely “NDS”, registered in (*) and owned by (*) and such trademark is adopted in the manufacture, sale, marketing, promotion, distribution and advertising of the Products, details of which are set out in Exhibit 2
“Term”	means the term as defined and set out in Clause 16 of this Agreement;
“Territory”	means the following territories:- People’s Republic of China; Hong Kong Special Administrative Region; and Macau Special Administrative Region;
“Territory Licensed Product(s)”	means any product, the research, development, manufacture, use, sale, offer for sale, import or export (collectively, “Exploitation”) of which is based upon or incorporates Licensor Technology or, but for the license granted in the Agreement, would infringe any Licensor Patents in any country in the Territory;
“Third Party”	means any person or entity other than Licensor, the Licensee or their respective Affiliates;
“USA”	means the United States of America; and

“US Dollars” means United States dollars, the lawful and the sign currency of the United States of America.
“US\$”

2. LICENSE GRANT

Licensor hereby grants to the Licensee a sole and exclusive license to use the Licensor Technology in The Territory, with the right to grant, sublicenses, subject to the conditions described in this Agreement, under the Licensor Technology, to enable the Licensee to:

- (a) bottle, label, use, commercialize, market, distribute, sell, have sold, offer for sale and import and export; and
- (b) research, develop, make, have made, manufacture
- (c) the Products in the Territory, practice any method, process or procedure or otherwise exploit the Licensor Technology, and to have any of the foregoing performed on its behalf by a Third Party, subject to Clauses 2.2 and 2.3 hereinbelow.

Both Parties agree that

- (i) Clause 2.1(a) shall be active and in force from the Effective Date; and
- (ii) Clause 2.1(b) shall be contingent upon establishment of oversight quality control batch release and quality assurance requirements set forth by Licensor and agreed upon by both Parties.

Insofar as the license granted in Clause 2.1 is concerned, sale and distribution in the Additional Territory shall be restricted to Products for human and veterinary use.

The Licensee and Licensor have agreed that Licensor shall both (a) initiate a clinical trial at a cost not to exceed [***] (such amount, up to [***], “the “Clinical Study Fund”), and (b) as Licensor’s investment in the promotion of a market for Licensor’s products, provide Product to Licensee having an aggregate value (at the pricing described in Exhibit 3) equal to the amount of the Clinical Study Fund as further described below. Specifically, Licensee and Licensor have agreed that:

(i) the results, documents and other information related to the clinical trials of the Products conducted under the auspices of and financed by the Clinical Study Fund can be used by either Party; and

(ii) upon the Licensee's request, Licensor shall supply and deliver to Licensee, Products having an aggregate value equal to the amount actually set aside in the Clinical Study Fund and committed to clinical trials as described in clause 2.4(i) at the time of the request for Product, at the agreed prices set out in Exhibit 3 to this Agreement. In other words, if [***] has been committed and paid into the Clinical Study Fund for clinical trials then Licensee may request [***] in Product at the agreed price. The Licensee is not required to pay for the aforesaid amount of Products, except by means described herein.

Both Parties agree and acknowledge that the prices set out in Exhibit 3 (List of Prices) have been agreed upon as the final prices of the Products. Should there be any proposed change in prices, both Parties must sign a written agreement for such change.

3. ROYALTY AND PAYMENT

Subject to Clause 3.2, the Licensee shall pay to Licensor a royalty of US Dollars [***] of revenue on a quarterly basis, based on the sales and distribution of the Territory Licensed Products (excluding those manufactured and supplied to Licensor) in the Territory as invoiced to the Licensee for the duration of the Term, in accordance to Clause 3 below ("Royalty Payment"). For the avoidance of doubt, the aforesaid Territory Licensed Products must be manufactured based on the existing Licensor Patents.

In the event that the Licensee invents, develops, obtains and registers new patents ("New Patents") based on the Licensor Patents in the name of Licensor, the Licensee shall pay to Licensor a royalty of US Dollars [***] of revenue on a quarterly basis based on the sales and distributions of the aforesaid products in the Territory as invoiced to the Licensee for the duration of the Term provided that the aforesaid products manufactured according to the New Patents, not the existing Licensor Patents.

The Licensee shall pay the Royalty Payment of a year to Licensor within 30 days upon the expiry of a quarter in a year. In other words, the Licensee shall pay the Royalty Payment to Licensor in the following manner:

(i) on or before the 30th day of April for the first quarter (i.e. from January to March in a year);

(ii) on or before the 30th day of July for the second quarter (i.e. from April to June in a year);

(iii) on or before the 30th day of October for the third quarter (i.e. from July to September in a year); and

(iv) on or before the 30th day of January for the forth quarter (i.e. from October to December in a year).

Both Parties agree that the Royalty Payment shall be paid to Licensor's bank account as set out in Exhibit 4.

Both Parties agree that, to determine the sales and distribution of the Products, any Product shall be regarded as distributed or sold by the Licensee or its sub-licensee after one hundred and twenty (120) days of receipt of invoice by the Licensee or its sub-licensee, or if not invoiced, when shipped or delivered by the Licensee or its sub-licensee.

The Licensee and its sub-licensees shall keep complete and accurate accounts of all Products distributed and sold and shall permit Licensor at Licensor's own expense [if audit discloses underpayment of royalty, then Licensee pays for audit] and through an independent certified accountant of international standing to be agreed by both Parties, to audit such accounts in accordance to the following:

(i) at least sixty (60) days' prior written notice prior to the audit;

(ii) no more than once each calendar year solely for the purpose of determining the accuracy of the Royalty Report (defined hereinafter) and Royalty Payment; and

(iii) the obligation of the Licensee and its sub-licensees concerning audit of their accounts shall be terminated three (3) years after the date of issue of an audit report.

(iv) Licensee will assemble relevant records, including those of sub-licensees as a mechanism for determining aggregate

price of Products sold and adjustments that may impact royalties payable to Licensor.

Royalty Payment shall be net of any deductions or withholdings which are required to be deducted under any relevant legislation in any country.

If the Licensee or its sub-licensee is obliged to pay royalties to an independent Third Party for the right to make, manufacture, use, commercialize, market, distribute or sell the Products, the Licensee shall be entitled to deduct from the Royalty Payment due to Licensor the said royalty payment actually made to such Third Party.

The Licensee shall provide Licensor with a royalty report stating the gross sales of the Territory Licensed Products and provide a calculation of the Royalty Payment amount due ("Royalty Report") within ninety (90) days after the 31st day of March, the 30th day of June and 30th day of September in each year during the Term .

4. JOINT EXPENSES FOR MAA & REFERENCE MATERIALS

Pre-MAA

The Parties acknowledge and agree that where a Party incurs expenses arising from MAA filing for the Products), the other Party referencing such MAA shall contribute the MAA filing costs ("Joint Expenses"). A Party has absolute discretion to choose whether to reference such MAA and which part of a MAA should it references to. In other words, a Party is entitled to reference part of the documents and/or information in a MMA process at its sole discretion.

The portion of Joint Expenses to be contributed by each Party shall be agreed upon in writing prior to incurring the Joint Expenses on a fair, reasonable and arm's length basis. If no such written agreement is entered into between the Parties, the Party incurring the cost for the MAA shall be solely liable for it.

Post-MAA

Both Parties agree that Licensor shall be solely responsible for all MAA costs outside the Territory and the Licensee shall be

solely responsible for all MAA costs incurred in the Territory unless otherwise agreed by both Parties.

Notwithstanding the basic payment obligations in Clause 4.3, both Parties agree that reimbursement of the costs incurred by a Party in filing and obtaining a MAA shall be in accordance to Exhibit 5 and Clause 4.5 below. For the avoidance of doubt, if a Party just references part of the documents and/or information (“D&I”) in a MAA, the costs to be shared by both Parties according to Exhibit 5 should be the costs arising from or in connection with that particular D&I.

Where reimbursement and repayment is payable pursuant to Clause 4.4, the Party owing such reimbursement or repayment shall via telegraphic transfer to the account details set forth in Exhibit 4 within one hundred and twenty (120) days after the use of and/or reference to a MAA or part of a MAA.

Reference Materials

In the event that a Party requests (“the Requesting Party”) Reference Materials created by the other Party (“the Providing Party”) whether for a MAA or not, the Requesting Party shall pay the Providing Party up to 50% of the actual costs of the Providing Party in accordance with its record for establishing such Reference Materials, subject to the condition that Reference Materials which a Requesting Party wishes to obtain must be Reference Materials which obtained MAA not more than 1.5 years before such request.

Where reimbursement and repayment is payable pursuant to Clause 4.6, the Party owing such reimbursement or repayment shall via telegraphic transfer to the account details set forth in Exhibit 4 within one hundred and twenty (120) days after the use of Reference Materials.

For all other costs and expenses in relation to matters not referred to in Clause 4, the Parties shall negotiate in good faith and at arms’ length the payment arrangement for costs incurred in the 2 years prior to MAA.

The paying party shall forthwith notify the receiving party of the payment and upon successful transfer of the payable amount, the receiving party shall issue an acknowledgement of receipt to the paying party within 14 Business Days thereafter.

5. APPROVALS AND CO-OPERATION

In furtherance of the Agreement, the Licensee shall have the right to obtain, or procure the obtaining of all MAA. Licensor shall provide all reasonable assistance and disclosure of MAA and/or Reference Materials as necessary or as requested by the Licensee (or its sub-licensee) to aid their manufacturing of the Products and their efforts to obtain MAA, and charge only a minimum expense for administrative purposes.

Subject to Clause 4 above and other payments as herein provided, each Party agrees to use commercially reasonable efforts to make its personnel reasonably available, upon reasonable written request by the other Party in relation to license rights, at their respective places of employment to consult with the other Party on matters and issues related to MAA obtained during the Term.

Each Party (the “Enabling Party”) agrees to cooperate with the other (the “Filing Party”), at its written request, to comply with specific requests of any applicable Regulatory Authority (such as requests to inspect clinical trial sites), with respect to data supplied or to be supplied by the Enabling Party to the Filing Party for filing with such Regulatory Authority. In this regard, the Enabling Party agrees to provide reference rights to the Filing Party, or to provide to applicable Regulatory Authorities copies of relevant manufacturing data specifically requested by the Filing Party, which is reasonably necessary for the Filing Party to obtain, proceed towards and/or maintain regulatory approval for the Products in accordance with this Agreement

Assistance beyond initial transfer of Licensor Technology

In connection with the performance of this Agreement, each Party will use its best reasonable efforts to provide assistance to the other Party as such other Party may reasonably request if it involves new technology and requires travel to other country or territory. The requesting Party shall reimburse the reasonable costs and expenses incurred by the assisting Party in providing such assistance.

The Licensee shall at its discretion register this Agreement with all relevant patent offices or governmental authorities and Licensor shall provide all reasonable assistance as may be

requested by the Licensee; provided, however, that nothing herein shall be deemed an agreement to transfer or assign ownership to Licensee of any Licenser Technology

If Licensee files for patent protection of any Licenser claims, the filing will be made in the name and on behalf of Licenser, who shall be identified as the owner of the technology subject to such filing.

6. REPRESENTATIONS, WARRANTIES AND COVENANTS

General Representations and Warranties

Each Party represents and warrants to the other that, as of the Effective Date:

it is duly organized, validly existing and in good standing under the laws of the jurisdiction of its incorporation, and it has full corporate power and authority to enter into this Agreement and to carry out the provisions hereof;

it is duly authorized to execute and deliver this Agreement and to perform its obligations hereunder, and the authorized representative executing this Agreement on its behalf has been duly authorized to do so by all requisite corporate action; and

this Agreement is legally binding upon it and enforceable in accordance with its terms, and the execution, delivery and performance of this Agreement does not conflict with any agreement, instrument or understanding, oral or written, to which it is a party or by which it may be bound, nor violate any material applicable law.

Licenser's Representations and Warranties

Licenser represents and warrants to the Licensee that as of the Effective Date:

Licenser owns and/or has an absolute and unfettered right to all Licenser Technology which include patents and know-how that are developed or acquired by or for Licenser during the Term as well as what Licenser owns or controls as of the Effective Date, a list of which is set out in Exhibit 6, but which may change from time to time as new patents and know-how are obtained;

Licensor Technology is solely and beneficially owned by Licensor, and Licensor has not placed, or suffered to be placed, any liens, charges or encumbrances on or against the patents or patent applications on the Licensor Patents or the Licensor Know-how, and that Licensor has full right and authority to grant to the Licensee the licenses granted herein with respect to such patents, patent applications and know-how in the Territory.

the Licensor Patents are valid and existing, and no issued or granted patents within the Licensor Patents are invalid or unenforceable to the best of their knowledge;

Licensor has not granted, and will not during the Term grant any right to any Third Party which would conflict with the rights granted to the Licensee hereunder, nor has entered and will not enter any agreement with or assignment to any Third Party nor permit any encumbrance which would be inconsistent or otherwise conflict with the terms of this Agreement;

Licensor has no knowledge that any Third Party has any right, title or interest in or to any of the Licensor Technology;

the Licensor Technology to the best of its knowledge is not subject to any litigation, judgments or settlements against or owed by Licensor;

the Licensor Technology is not subject to any funding agreement with any government or government agency;

Licensor has disclosed to the Licensee all material information of which Licensor is aware as to whether the research, development, manufacture, use, sale, offer for sale or importation of the Products infringes or would infringe issued or granted patents or other intellectual property rights owned by a Third Party, and that the Licensee's practice, use and exploitation of the Licensor Technology in accordance with this Agreement will not infringe or misappropriate any patent rights or other intellectual property rights of any Third Party;

Licensor has not received any notice of:-

any threatened claims or litigation or investigations seeking to invalidate or otherwise challenge the Licensor Technology or Licensor's rights therein; or

alleged infringement of any Third Party patent rights or intellectual property rights in connection with the use and exploitation of the Products;

none of the Licensors Patents are subject to any pending re-examination, opposition, interference or litigation proceedings. Licensors shall provide to the Licensee regular updates of all Licensors Patents pertaining to any stage being reached in any of the foregoing events; and for all pending patents granted for Licensors technology;

To the best of Licensors knowledge, there is no unauthorized use, infringement or misappropriation of any of the Licensors Technology by any Third Party in the Territory, including by any current or former employee or consultant of Licensors and its Affiliates. Licensors shall promptly inform the Licensee of any misappropriation or infringement of the Licensors Technology of which Licensors becomes aware; and

Licensors is not aware of any action, suit or inquiry or investigation instituted by any Third Party which questions or threatens the validity of this Agreement.

Licensors declares that all representations, warranties and any other documents (including the Certificated of analysis of NDS chewable tablet (Exhibit 8) and the Declarations of Good Manufacturing Practice (Exhibit 9)) are true and accurate.

7. INDEMNITIES

INDEMNIFICATION BY LICENSEE. Licensee shall, up to the maximum amount of its product liability insurance, indemnify, hold harmless and defend Licensors, its Affiliates and their respective directors, officers, employees and agents ("Licensors Indemnitees") from and against any and all suits, investigations, claims, costs, demands, liabilities, losses, damages, and expenses, including reasonable attorneys' fees (collectively, "Losses") arising from or occurring as a result of a third party's claim, action, suit, judgment or settlement against a Licensors Indemnitee that is due to or based upon: (a) any breach of any representation or warranty of Licensee hereunder; (b) the failure of Licensee to perform any of its duties or obligations set forth in this Agreement; (c) Licensee's misuse or adulteration of Product, or combination of Product with other products without Licensors's

express acknowledgement and approval, or sale and disposition of Product for applications or uses other than those for which the Product is intended, and (d) any act of gross negligence or intentional misconduct by Licensee or any of its sublicensees in connection with any action or transaction under this Agreement, including the further processing, formulation, storage, labeling, promotion, use or sale of Product while in the possession or control of Licensee or its sublicensees.

INDEMNIFICATION BY Licensor. Licensor shall, up to the maximum amount of its product liability insurance, indemnify, hold harmless and defend Licensee, its Affiliates and their respective directors, officers, employees and agents (“Advance Indemnitees”) from and against any and all Losses arising from or occurring as a result of a third party’s claim, action, suit, judgment or settlement against an Advance Indemnitee that is due to or based upon: (a) any breach of any representation or warranty of Licensor hereunder; (b) the failure of Licensor to perform any of its duties or obligations set forth in this Agreement; (c) any act of gross negligence or intentional misconduct by Licensor in connection with any action or transaction under this Agreement, including manufacture, testing, handling, packaging, labeling, storage or supply of Product while it is in the possession or control of Licensor or its Affiliates. Licensor shall have no liability under this Section 7.2 for any infringement based on the use of any Product if the Product is used in a manner or for a purpose for which it was not reasonably intended. Licensor’s obligations under this Section 6.2 shall survive termination or expiration of this Agreement.

8. FORECAST OF PRODUCT SUPPLY AND SALES

Supply

The Licensee shall have a first priority offer to supply Licensor’s requirements for the Products for commercial use in the Additional Territory. Licensor shall, however, retain the right to manufacture or otherwise obtain the Products, in the Additional Territory.

Subject to Clause 8.1, in the event that the Licensee (once manufacturing has commenced) fails to accept any order of Licensor for sale of the Products in the Additional Territory or

accepts but fails to fulfill such an order, in each case due to an event of Force Majeure that lasts for a continuous period of one hundred and twenty (120) days, Licensor shall be permitted to arrange with other manufacturers or suppliers for the fulfillment of such orders (to the extent of any shortfall from the supply of the Products by the Licensee) on any terms that are reasonable.

Within a reasonable time after Licensee resumes full supply of the Products after an event of Force Majeure Licensor shall cease sourcing of Products from manufacturers or suppliers other than Licensee, and shall resume its relationship with Licensee on terms consistent with the terms that preceded the event of Force Majeure

Right of First Refusal

Subject to Clause 8.1, in the event that the Licensee is unable to manufacture sufficient Products to meet the orders placed by Licensor or its Affiliates (the "Licensor Group") for sale and distribution in the Additional Territory, whether such inability is due to changes in market conditions, regulatory conditions or other factors but excluding an event of Force Majeure, Licensor may set up manufacturing facilities in the Additional Territory subject to the Licensee having the right of first refusal to invest in any such manufacturing facilities, either on its own, or together with Licensor and other Third Party in such proportion as the Licensee may deem appropriate. Licensor shall determine the terms and conditions, and provide written explanation of the details of such investment and the economic and political reasons justifying the explanation to the Licensee. The Licensee shall have thirty (30) Business Days from the date of receipt of the written explanation to evaluate the investment and exercise its right of first refusal.

Forecasts

Subject to Clause 8.1, no later than three (3) months prior to its second year of commercial sale of the Products, Licensor shall provide the Licensee with a twelve-month (12-month) rolling forecast of Licensor's or its designee's commercial requirements of the Products in the Additional Territory, broken down by month and updated monthly on a rolling twelve-month (12-month) basis, with an allowed monthly variation of twenty percent (20%).

Subject to Section 8.1 and before the Licensee can manufacture the Product on its own, no later than three (3) months prior to its second year of commercial sale of the Products, the Licensee shall provide Licensor with a twelve-month (12-month) forecast of the Licensee's purchase order forecast of the Products in the Territory, broken down by month and updated monthly on a rolling twelve-month (12-month) basis, with an allowed monthly variation of twenty percent (20%) until the Licensee manufactures the Product.

Purchase Orders

Subject to Clause 8.1, Licensor shall submit purchase orders for the Products that are consistent with quantities forecast in the first three (3) months of each rolling forecast. All purchase orders submitted shall be agreed upon between Licensor and the Licensee and constitute firm orders binding on the Parties. Payment terms of each Product shall be determined and revised by the Licensee from time to time by mutual agreement. Pricing of sales may be adjusted due to raw material increases supplied by Licensor.

Subject to Section 8.1, the Licensee shall submit purchase orders for the Products that are consistent with quantities forecast in the first three (3) months of each rolling forecast until the Licensee can manufacture the Product on its own.

9. BRANDING

Each Party will be responsible for filing, registering and maintaining its own worldwide brand names and trademarks for the Products, at its own expense. All Products provided by the Licensee to Licensor hereunder shall display the name of the Licensee as manufacturer of such Products. Each of Licensor and the Licensee may use its own brand name, or that of the other Party, to identify the Products.

If one Party uses the brand name or trademark of the other Party in connection with the Products, the manner of use of the other Party's brand name and/or trademark (as the case may be) shall first be submitted to the other Party for approval of design, color, and other details, and shall in any event comply with the other Party's usage and quality control and quality assurance guidelines as reasonably established from time to time and as

registered with the competent authority. All approvals required under this section shall not be unreasonably withheld or delayed.

10. PROSECUTION AND MAINTENANCE

Licensor shall be responsible for the Prosecution and Maintenance, and all costs and expenses associated therewith, of the Licensor Technology worldwide, unless otherwise stated in a mutual agreement in writing. However, in the Territory, the Licensee shall be responsible for all costs.

Licensor shall consult in good faith with the Licensee regarding matters stated in Clause 10.1, including the withdrawal, abandonment or cessation of Prosecution and Maintenance of any Licensor Technology covering the Products. If Licensor determines to withdraw, abandon or otherwise cease to Prosecute or Maintain any of the Licensor Technology covering the Products, then Licensor shall provide the Licensee with one hundred and twenty (120) days' written notice prior to the date on which such withdrawal, abandonment or cessation of Prosecution and Maintenance would become effective. In such event, the Licensee shall have the first right, but not the obligation, to take over at the Licensee's expense the Prosecution and Maintenance of such Licensor Technology, and in such event, such Licensor Technology shall be assigned to the Licensee at the nominal price of USD1.00 (and such Licensor Technology shall thereafter be expressly excluded from the Licensor Technology stipulated herein).

Licensor shall provide the Licensee with regular updates and records of all matters stated in Clauses 10.1 and 10.2.

The Licensee shall have the right to be granted with a license by Licensor in relation to any continuation, divisional, re-issues of any of the Licensor Patents.

11. NEW INTELLECTUAL PROPERTY

The Licensee will own all new intellectual property related to the Products that is conceived or reduced to practice by the Licensee during the Term. New IP that is related to improvements modifications, enhancements, etc. to the Licensor patents (for example the New Patents as referred in Clause 3.2),

upon Licensors request, the Licensee will grant a royalty-free exclusive license of such new intellectual property to Licensors on terms to be agreed between the Parties similar to the terms and conditions in this Agreement

The Licensee shall be required to disclose where improvements to the intellectual property are developed by the Licensee.

If the new developments are not under or within the Licensors claims, the Licensee shall be required to offer the license to the same to Licensors on reasonable commercial terms.

12. ENFORCEMENT

The Licensee shall have the right to determine the appropriate course of action to enforce any patent rights relating to the Licensors Technology in the Territory, or otherwise to abate the infringement thereof. The Licensee, upon discovery of an executed or potential patent infringement, shall notify Licensors within fourteen (14) days of discovery. In the event Licensors does not take such action as determined by the Licensee in respect of any infringement of the Licensors Technology within thirty (30) days of request by the Licensee to do so, the Licensee may take such action in its own name or in the name of Licensors and Licensors shall provide all assistance and information as the Licensee may request to enable the Licensee to take appropriate action in respect of any infringement of the Licensors Technology. Licensors and the Licensee shall each bear one-half (1/2) of the cost and expense of any such action.

All damage receivables as a result of such actions shall be utilized first to reimburse each Party for the cost and expense of any such action and shall thereafter be equitably allocated between Licensors and the Licensee based on the Parties' relative damages attributable to the underlying claim.

13. MANUFACTURING FACILITIES

The Licensee shall purchase or establish and maintain one or more manufacturing facilities for the manufacture of the Products at its own expense.

Both Parties agree and acknowledge that the manufacturing facilities may be used to manufacture products other than the Products and to manufacture the Products for Third Parties. This right must be exercised within five (5) years or it becomes non-exclusive as to the manufacture. Such manufacturing facility will be in compliance with internationally accepted standards for GMP, FDA, quality control and quality assurance.

With regard to a decision on making the investment to establish and maintain one or more manufacturing facilities for the manufacture of the Products, both Parties agree that, prior to the Licensee deciding to proceed with the establishment of the manufacturing facilities,

(i) Licensors has to provide the Licensee a forecast of its purchase orders of the Products; and

(ii) They should agree on the price of the Products manufactured and supplied by the Licensee to Licensors.

The Licensee shall be responsible for the maintenance and repair of all equipment used in the manufacture of the Products in accordance with applicable laws and consistent with good industry practice.

14. EVENT OF DEFAULT

Even if gross default of performance by the Licensee occurs and no execution to cure has been taken in sales or in manufacturing after the receipt of notification of default by Licensors, the Licensee shall have the absolute and unfettered right to retain and to continue the use of the Licensors Know-How, the Licensors Patents, the Licensors Technology (collectively "Intellectual Property") for the research and the manufacturing in the territory of:

any Products which the Licensee obtains/ procures or intends to obtain MAA for (in accordance to Clause 11); and

Any other new products until termination date.

Further to Clause 14.1 above, the Licensee shall have the right to manufacture only if curable defaults have been cured, to sell and to distribute these new drugs within the Territory, using a brand name other than Licensors should Licensors so request, and/or at the discretion of the Licensee.

Subject to Clause 11, Licensor shall have the right to continue to use the intellectual property which the Licensee has contributed to the development of and shall have the right to continue to manufacture, distribute and sell the Products which use the intellectual property in any jurisdiction except in the Territory.

15. CONFIDENTIALITY

Except to the extent expressly authorized by this Agreement or otherwise agreed by the Parties in writing, the Parties agree that the receiving Party shall keep confidential and shall not publish or otherwise disclose or use for any purpose other than as provided for in this Agreement any confidential or proprietary information or materials furnished to it by the other Party pursuant to this Agreement (collectively, "Confidential Information") or the terms and conditions of this Agreement. Notwithstanding the foregoing, Confidential Information shall not be deemed to include information or materials to the extent that it can be established by written documentation by the receiving Party that such information or material:

(i) was already known to or possessed by the receiving Party, other than under an obligation of confidentiality (except to the extent such obligation has expired or an exception is applicable under the relevant agreement pursuant to which such obligation established), at the time of disclosure;

(ii) was generally available to the public or otherwise part of the public domain at the time of its disclosure to the receiving Party;

(iii) became generally available to the public or otherwise part of the public domain after its disclosure and other than through any act or omission of the receiving Party in breach of this Agreement;

(iv) was independently developed by the receiving Party as demonstrated by documented evidence prepared contemporaneously with such independent development; or

(v) was disclosed to the receiving Party, other than under an obligation of confidentiality, by a Third Party who had no

obligation to the disclosing Party not to disclose such information to others.

Each Party may use and disclose Confidential Information of the other Party or the terms and conditions of this Agreement as follows:

(i) under appropriate confidentiality provisions substantially equivalent to those in this Agreement, in connection with the performance of its obligations or exercise of rights granted to such Party in this Agreement;

(ii) to the extent such disclosure is reasonably necessary in filing for, prosecuting or maintenance of patents, copyrights and trademarks (including applications therefore) in accordance with this Agreement, complying with the terms of agreements with Third Parties, prosecuting or defending litigation, complying with applicable governmental regulations, filing for, conducting preclinical or clinical trials, obtaining and maintaining regulatory approvals (including MAA), or otherwise required by applicable law or the rules of a recognized stock exchange, provided, however, that if a Party is required by law or stock exchange to make any such disclosure of the other Party's Confidential Information it will, except where impracticable for necessary disclosures (for example, in the event of medical emergency), give reasonable advance notice to the other Party of such disclosure requirement and, except to the extent inappropriate in the case of patent applications, will use its reasonable efforts to secure confidential treatment of such Confidential Information required to be disclosed with key financial terms blanked;

(iii) in communication with existing investors, contracted consultants, advisors (including financial advisors, lawyers and accountants) and others on a need-to-know basis, in each case under appropriate confidentiality provisions substantially equivalent to those of this Agreement; or

(iv) to the extent mutually agreed to by the Parties.

16. TERM

The term of this Agreement (the "Term") shall commence on the Effective Date and continue in force on a product-by-

product basis with respect to each country anywhere in the world until the later of:-

(i) the last of the applicable Licensor Patents with valid claims to expire covering a Product in such country expires; or

(ii) seven (7) years after the first material commercial sale of a Product in a particular country, whichever Term is greater Paid-Up, Non-Exclusive License on Expiration

Upon the expiration of this Agreement on a Product-by-Product and a country-by-country basis, the Licensee shall have a non-exclusive, fully paid-up, royalty-free license in such country to research, develop, make, have made, manufacture, use, sell, offer for sale, import and export that particular Product (and to have any of the foregoing activities regarding such Product performed by any Third Party on behalf of the Licensee).

17. TERMINATION

This Agreement can be terminated by a Party ("Non-Defaulting Party") if and only if: -

(i) the other Party ("Defaulting Party") fails and/or refuses to pay to the Non-Defaulting Party pursuant to this Agreement and the payment is not settled after serving a twelve (12) months prior written notice to the Defaulting Party; or

(ii) after the manufacturing facilities are established by the Licensee and the Licensee begins to manufacture the Products, the Licensee fails to use its best endeavours to maintain the quality of the Products which is evidenced by a scientific report issued by an international reputable scientific laboratory or university and the Licensee does not cure this and continues to fail in this aspect one hundred and twenty (120) days after receipt of written notice by Licensor of such failure. For the avoidance of doubt, the written notice issued by Licensor should enclose the aforesaid evidence and set out the curing measures to be complied with by the Licensee in details; or

(iii) a winding up order is granted by a Court against the Defaulting Party.

18. DISPUTE RESOLUTION

Disputes

If the Parties are unable to resolve any dispute or other matter arising out of or in connection with this Agreement, either Party may, by written notice to the other Party, have such dispute referred to the Chief Executive Officers of Parties for attempted resolution by good faith negotiations within sixty (60) Business Days after such notice is received. In such event, each Party shall cause its Chief Executive Officers to meet (face-to-face or by teleconference) and be available to attempt to resolve such issue. If the Parties should resolve such dispute or claim, a memorandum setting forth their agreement will be prepared and signed by both Parties if requested by either Party. The Parties shall cooperate in an effort to limit the issues for consideration in such manner as narrowly as reasonably practicable in order to resolve the dispute.

Arbitration

In the event that the Parties are unable to resolve any such matter pursuant to Clause 17.1 and 17.2, then either Party may initiate arbitration pursuant to this Clause 18.2. Any arbitration under this Clause 18.2 shall be conducted by and in accordance with the applicable rules of the International Chamber of Commerce ("ICC") by a single independent arbitrator with significant experience in arbitrating matters related to biopharmaceutical industry and mutually agreed by the Parties; provided that if the Parties are unable to agree on a single arbitrator within thirty (30) days of notice of the dispute, the arbitrator shall be selected by the senior executive of the ICC in Paris. In such arbitration, the arbitrator shall select an independent technical expert with significant experience relating to the subject matter of such dispute to advise the arbitrator with respect to the subject matter of the dispute. The place of arbitration shall be in (i) the State of California, USA, if initiated by the Licensee or (ii) Hong Kong, if initiated by Licensor. The costs of such arbitration shall be shared equally by the Parties, and each Party shall bear its own expenses in connection with the arbitration. The Parties shall use good faith efforts to complete arbitration under this Clause 18.2 within six (6) months following the initiation of such arbitration. The arbitrator shall establish reasonable additional procedures to facilitate and complete such arbitration within such six (6) month period. All arbitration

proceedings shall be conducted and all evidence and communications shall be in English, provided that any written evidence originally in a language other than English shall, insofar as practicable, is submitted in English translation accompanied by the original or true copy thereof. Attorney's fees will be paid to prevailing party.

Equitable Relief

Nothing in this Agreement shall limit the right of either Party to seek to obtain in any court of competent jurisdiction any equitable or interim relief or provisional remedy, including injunctive relief.

19. GOVERNING LAW

This Agreement and any dispute arising from the performance or breach hereof (including arbitration proceedings under Clause 18.2) shall be governed by and construed and enforced in accordance with the Laws of the State of California in the U.S., without reference to conflicts of laws principles.

20. MISCELLANEOUS

Assignment

This Agreement shall not be assignable by either Party to any Third Party without the prior written consent of the other Party. Notwithstanding the foregoing, either Party may assign this Agreement, without the written consent of the other Party, (i) to an Affiliate, or (ii) to an entity that acquires all or substantially all of the business or assets of such Party to which this Agreement pertains (whether by merger, reorganization, acquisition, sale or otherwise), and agrees in writing to be bound by the terms and conditions of this Agreement. No assignment or transfer of this Agreement shall be valid and effective unless and until the assignee/transferee agrees in writing to be bound by the provisions of this Agreement. The terms and conditions of this Agreement shall be binding on and inure to the benefit of the permitted successors and assigns of the Parties.

Except as expressly provided in this, any attempted assignment or transfer of this Agreement shall be null and void.

Notices

Any notice, request, delivery, approval or consent required or permitted to be given under this Agreement shall be in writing in the English language and shall be deemed to have been sufficiently given if delivered in person, transmitted by facsimile (receipt verified) or by reputable international-express courier service (signature required) to the Party to which it is directed at its address or facsimile number shown below or such other address or facsimile number as such Party will have last given by written notice to the other Party.

If to Licensor, addressed to:

ABC Inc.
[deleted] St.
Manchester, NH 03101
Attention: [deleted]
Telephone: [deleted]
Facsimile: [deleted]

If to the Licensee, addressed to:

XYZ Co.,
Ltd [deleted]
Tai Po Industrial Est.
Tai Po, New Territories, Hong Kong
Attention: [deleted]
Telephone: [deleted]
Facsimile: [deleted]

Waiver

Neither Party may waive or release any of its rights or interests in this Agreement except in writing. The failure of either Party to assert a right hereunder or to insist upon compliance with any term or condition of this Agreement shall not constitute a waiver of that right or excuse a similar subsequent failure to perform any such term or condition. No waiver by either Party of any condition or term in any one or more instances shall be construed as a continuing waiver of such condition or term or of another condition or term.

Severability

If any provision hereof should be held invalid, illegal or unenforceable in any jurisdiction, the Parties shall negotiate in good faith a valid, legal and enforceable substitute provision that

most nearly reflects the original intent of the Parties and all other provisions hereof shall remain in full force and effect in such jurisdiction and shall be liberally construed in order to carry out the intentions of the Parties as nearly as may be possible. Such invalidity, illegality or unenforceability shall not affect the validity, legality or enforceability of such provision in any other jurisdiction.

Entire Agreement/Modification

This Agreement, including its Exhibits, sets forth all of the covenants, promises, agreements, warranties, representations, conditions and understanding between the Parties and supersedes and terminates all prior agreements and understanding between the Parties. Subsequent alteration, amendment, change or addition to this Agreement which is agreed upon between the Parties within 60 days of the Effective Date shall be binding upon the Parties if and only if reduced to writing and signed by the respective duly authorized representatives of the Parties.

Relationship of the Parties

The Parties agree that the relationship of Licensor and the Licensee established by this Agreement is that of independent contractors. Furthermore, the Parties agree that this Agreement does not, is not intended to, and shall not be construed to, establish an employment, agency or any other relationship. Except as may be specifically provided herein, neither Party shall have any right, power or authority, nor shall they represent themselves as having any authority to assume, create or incur any expense, liability or obligation, express or implied, on behalf of the other Party, or otherwise act as an agent for the other Party for any purpose.

Force Majeure

Except with respect to payment of money, neither Party shall be liable to the other for failure or delay in the performance of any of its obligations under this Agreement for the time and to the extent such failure or delay is caused by earthquake, riot, civil commotion, war, terrorist acts, strike, flood, or governmental acts or restriction, or other cause that is beyond the reasonable control of the respective Party (a "Force Majeure" event). The Party affected by such Force Majeure event will provide the other Party with full particulars thereof as soon as it becomes aware of the

same (including its best estimate of the likely extent and duration of the interference with its activities), and will use diligent efforts to overcome the difficulties created thereby and to resume performance of its obligations as soon as practicable. If the performance by the affected Party of any obligation under this Agreement is delayed owing to such a Force Majeure event for any continuous period of more than one hundred twenty (120) days, the other, unaffected Party shall have the right to terminate this Agreement upon sixty (60) days' prior written notice; provided that such Force Majeure event has not ended during such sixty (60) day period.

Compliance with laws/other

Notwithstanding anything to the contrary contained herein, all rights and obligations of Licensor and the Licensee are subject to prior compliance with, and each Party shall comply with, all laws, including obtaining all necessary approvals required by the applicable agencies of the governments of the United States, the Territory and foreign jurisdictions. In addition, each Party shall conduct its activities under this Agreement in accordance with good scientific and business practices.

Interpretation

The captions and headings used in this Agreement are for convenience only, and are to be of no force or effect in construing or interpreting any of the provisions of this Agreement. Unless otherwise specified to the contrary, references to Clauses or Exhibits mean the particular Clauses or Exhibits of this Agreement, and references to this Agreement include all Exhibits hereto.

Unless the context otherwise clearly requires, whenever used in this Agreement: (i) the words "include" or "including" shall be construed as incorporating, also, "but not limited to" or "without limitation;" (ii) the word "day" or "year" means a calendar day or year unless otherwise specified; (iii) the word "notice" means notice in writing (whether or not specifically stated) and shall include notices, consents, approvals and other written communications contemplated under this Agreement; (iv) the words "hereof," "herein," "hereby," "hereunder" and derivative or similar words refer to this Agreement (including any Exhibits) as a whole, and not to any particular provision of this

Agreement; (v) the word “or” shall be construed as the inclusive meaning identified with the phrase “and/or”; (vi) provisions that require that a Party or the Parties “agree,” “consent” or “approve” or the like shall require that such agreement, consent or approval be specific and in writing, whether by written agreement, letter or otherwise; (vii) words of any gender include all genders; (viii) words using the singular or plural number also include the plural or singular number, respectively; and (ix) references to any specific law, rule or regulation, or article, section or other division thereof, shall be deemed to include the then-current amendments thereto or any replacement law, rule or regulation thereof. Neither Party shall be deemed to be acting “by or under authority” of the other Party for purposes of this Agreement.

Counterparts

This Agreement may be executed in two or more counterparts by original or facsimile signature, each of which shall be deemed an original, and all of which together, shall constitute one and the same instrument.

IN WITNESS WHEREOF, the Parties have executed this Agreement in duplicate originals by their duly authorized

ABC, INC.,

XYZ COMPANY LIMITED,

By:

By:

[deleted]

[deleted]

Director, President

Director

representatives as of the Effective Date.

Readers with comments should address them to:

Preston M. Torbert
preston.torbert@bakermckenzie.com

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