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Drafting The Consideration Provision Of A Contract

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Drafting consideration provisions properly is critical. Clients rarely forget—or forgive—when they have to pay too much or get too little.

THE CONSIDERATION PROVISION of a contract sets forth its financial terms. There are always two elements: first is a statement of what the consideration is, and the second is the promise to pay. These two elements generally appear in a contract in one of two ways. They are either stated separately as in Example 1, or they are conjoined as in Example 2:

• Example 1—"The Employee's salary is $120,000 per year (the "Salary"). The Employer shall pay the Employee her Salary in equal

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monthly payments, payable on the last Business Day of each calendar month";

- Example 2—"The Owner shall pay the Contractor $10,000 contemporaneously with the signing of this Agreement and $25,000 upon completion of the Project."

Although some consideration provisions are straightforward as in Examples 1 and 2, others are sophisticated and require careful crafting. What follows are guidelines that will help you tailor the consideration provision in your contract so that it accurately reflects the business deal.

Guideline 1: Answer The Basic Questions

The consideration provision should answer the questions of who is paying what to whom, when, why, and how.

Guideline 2: State The Amount Of Consideration Payable

This answers the question of "what?":

- "The purchase price is $ 40 million";
- "The monthly rent is $2,500";
- "The purchase price is 20,000 shares of the Company's Class A Common Stock".

Typically, consideration is money, shares, or promissory notes. It can also be the assignment of rights or the assumption of liabilities. Even if you are using a general definition section in the contract, it is often preferable to define the consideration in this "amount" section. Clients find it extremely frustrating flipping back to the definition section to find out whether the other party is paying them the correct amount. However, to preclude any ambiguity, avoid defining terms in context. Instead, include a separate subsection in which you define any necessary terms.

Assignment Of Rights

Regarding the assignment of rights, imagine that Colossal Construction Corp. owes Tong's Machinery, LLC, $100,000 and intends to pay that amount no later than year's end. If Tong's Machinery is in need of cash now, it can assign to its bank its right to payment from Colossal Construction. In exchange, the bank will pay Tong's Machinery a discounted amount, say, $90,000. Thus, the consideration in this transaction is the assignment of the right to payment and the return payment of $90,000.

Assumption Of Liabilities

As noted, the assumption of liabilities is an additional kind of consideration. For example, assume that Darnell Winston purchased Blackacre last year for $75,000 and paid $50,000 with his own money and the remaining $25,000 with money that he borrowed from a bank. That $25,000 is now a liability of Darnell. Further, assume that Darnell is now offering Blackacre for sale for $100,000. If Phyllis Wright pays Darnell $100,000, Darnell must use $25,000 of that amount to repay the bank. After that payment, he nets $75,000.

Darnell receives	$100,000
Darnell pays the bank	($25,000)
Darnell nets	$ 75,000

Alternatively, if the bank agrees, Phyllis could assume Darnell's liability to the bank. In that event, Phyllis would pay Darnell only $75,000, the same amount he would have netted if Phyllis had paid him $100,000 in cash. In addition, Phyllis would assume Darnell's $25,000 liability to the bank. In the end, she will still pay $100,000 for Blackacre, but she will pay $75,000 to Darnell and $25,000 (plus interest) to the bank. So, whether Phyllis pays $100,000 in cash, or assumes the $25,000 liability and pays $75,000 in cash, both parties end up in essentially the same financial position.

In the real world, a buyer is in a slightly different financial position if it assumes a seller's liabilities to third parties. First, a buyer may not have to pay the seller's liabilities immediately. Instead, the buyer may be able to pay them over time, either in accordance with the seller's agreements with the third parties or in accordance with an arrangement it can negotiate. This delayed payment could be a substantial advantage to a buyer. Second, a buyer could also negotiate with the third parties to reduce the amount to be paid, thus obtaining a discount.

Stub Period

When stating what the consideration is, think through whether there is, or should be, a stub period payment. A stub period is a period less than a calendar year that occurs when a contract term begins or ends in the middle of a calendar year. For example, if an employee began work on September 15th, there would be two stub periods. The first would occur in the first year of the contract term and would be from September 15th through the end of that calendar year. The second would occur in the final year of the contract term and would be from January 1st through September 14th, the last day of the contract term. In both instances, if the employee is entitled to a bonus based on the company's performance for each fiscal year, the parties might need to provide special rules to calculate the bonus for the stub periods such as a pro rata calculation of the bonus.

Draft the obligation of the payor using the active voice: "With respect to each month of the Term, the Tenant shall pay the Rent to the Landlord by certified check no later than the first day of that month."

Guideline 3: State Who Is Paying What To Whom

Draft the obligation of the payor using the active voice: "With respect to each month of the Term, the Tenant shall pay the Rent to the Landlord by certified check no later than the first day of that month."

Some drafters violate this rule by drafting a declaration or by providing that the payee has a right to payment. A declaration is a statement of fact to which both parties agree. It affords neither party any rights or remedies on its own. It is akin to a stipulated fact in litigation. Don't write "The Executive is to be paid $10,000 on the last business day of each month." (This is a declaration.) Nor should you write "The Executive is entitled to a salary of $10,000 each month, payable on the last business day of each month." This establishes a right.) Write it this way: "The Company shall pay the Executive $10,000 on the last business day of each month."

Multiple Payees Or Multiple Forms Of Consideration

If consideration is payable to more than one party or there is more than one form of consideration, use a chart to specify the type and amount of consideration payable to each party. For example:

Section 2.03 Payment of Consideration. The Buyer shall deliver to each Seller the consideration set forth opposite that Seller's name:

	Cash	Subordinated Debt	Equity Shares
Shareholder A	$20 million	$5 million	1 million Class A Shares
Shareholder B	$70 million	$17.5 million	3.5 million Class A Shares
Shareholder C	$10 million	$2.5 Million	.5 million Class A

This format leaves no doubt as to what each person is receiving and is preferable to a general statement that each party is to be paid its allocable share of each kind of consideration.

Guideline 4: State When The Consideration Is Payable

In answering the "when" question, be specific:

- "Lessee shall pay the Rent to Lessor no later the first day of each month";
- "At Closing, Buyer shall pay Seller the Purchase Price in immediately available funds."

If there are any stub periods, provide for appropriate payment dates. Also, consider whether there are timing issues if, for example, the contract term does not coincide with the fiscal year. For example, assume a license agreement term begins on March 15th. Are payments to be made at the end of every three months based on a term beginning on March 15th (i.e., June 14th, September 14th, December 14th, and March 14th), or are payments to be made at the end of each calendar quarter (i.e., March 31st, June 30th, September 30th and December 31st)? Finally, consider whether any payment should be accelerated or delayed. In loan agreements, mandatory prepayments of principal are often required if the borrower sells equity securities, borrows more money, or sells substantially all of its assets.

Guideline 5: State How The Money Is Payable

State clearly what form the consideration will take. The typical choices include personal check, company check, bank check, certified check, and immediately available funds:

- "With respect to each month of the Term, the Lessee shall pay the Rent to the Lessor by certified check no later than the first day of that month."

The form of payment is important because it determines when a payee will have access to the funds, and that reflects an allocation of risk between the parties. Specifically, recall that when a payor presents its check to a payee, it is not the equivalent of a payee's receipt of cash. A payee must present the check to its bank and that bank must receive payment from the payor's bank. The funds must be "collected." Once collected, the funds become "good funds," on which the payee can draw. Therefore, when paid by check, a payee takes the risk as to a payor's creditworthiness and others' demands on the payor's cash. A payee's ultimate risk is that it will perform but not be paid because the payor's form of payment did not give the payee immediate access to the funds.

Some forms of payment are more risky for a payee than others. The most risky are personal checks and company checks. With respect to both these forms, the payee is not actually in receipt of funds that it can spend until its bank collects payment from the payor's bank and credits it to the payee's account. Despite this risk, many payees are willing to accept a personal or company check. For example, employers invariably pay employees with a company check.

Cashier's Checks

Less risky for a payee are cashier's checks (also known as bank checks) and certified checks. A cashier's check is a check that a bank issues from its own account. It is the bank's promise to pay the payee. (A payor applies to its bank for a cashier's check, at which time the bank takes the money from the payor's account and issues its own check to the order of the payee.) Therefore, when a payee accepts a cashier's check as payment, its risk is the bank's creditworthiness, not the payor's. As most banks are creditworthy, a cashier's check is considered a secure form of payment with limited risk to the payee. Note that the payee does not have access to the funds until it deposits the cashier's check.

Certified Checks

A certified check is a check as to which a bank has segregated sufficient funds from the payor's account to ensure full payment of the check's amount. To turn a check into a certified check, the payor presents its check to its bank and requests that it be "certified." The bank then segregates the funds and marks the check "certified." Thus, the payee is assured that the payor's account will have sufficient funds available to meet its obligation to the payee. Again, the payee does not have access to the funds until it deposits the certified check in its own account.

Cashier's checks or certified checks are often used when the amount of payment is known several days before a closing. For example, car dealers are generally unwilling to deliver ownership of a car to a purchaser who presents his personal check. Too much money is at risk. Instead, the dealer is willing to accept a cashier's check or a certified check.

Wire Transfers

In complex, sophisticated transactions with significant sums at risk, many payees refuse to take any risk of nonpayment and insist that they be paid concurrently with the consummation of the transaction. Also, payees generally want immediate access to the money so that they can invest it or otherwise use it.

Imagine an acquisition of an office tower with a purchase price of $25 million. No doubt, the seller will not want to deliver the deed and then have any concern as to credit risk. It will want funds that are the equivalent of cash. To achieve this end, the buyer wire transfers immediately available funds from its bank account to the seller's bank account. A wire transfer is an electronic transfer of funds that occurs using a system that the Federal Reserve maintains. The funds, when a payee receives them, are immediately available to the payee for any use, be it investment or payment to another. The funds do not need to be collected from the payor's bank or deposited by the payee.

If a wire transfer involves multinational parties or parties located in different cities, ask the client in which city the payor should make the funds immediately available. Are the funds being transferred to an account in New York City, Detroit, or Tokyo? An obligation to pay by wire transfer is generally drafted along the following lines: "The Owner shall pay the Contractor the downpayment by wire transfer of immediately available funds in Chicago."

"Cash"

Some drafters provide that a payee should be paid in "cash," rather than immediately available funds. Do not do this. "Cash" is currency (dollar bills and coins), and it is most unlikely that the parties intend the payor to arrive with bushels of dollar bills. Although the use of the word "cash" is unlikely to cause a problem at a closing, when drafting, you should say what you mean.

After running the numbers, send the hypotheticals to your client to make sure that she understands how the formula will work, both when the transaction is a success and when it is a failure. (Clients do not like surprises.)

Guideline 6: Be Clear About Separate Payments

If money is payable for more than one reason, make sure that the terms for each payment conform to the defined guidelines. For example, if an employer is to pay an employee a salary and a bonus, create separate payment sections for each of these two types of payments and then in each section, state the appropriate amount, when the payment is due, and so on. Treating the two types of payments separately will help you analyze whether there are different business issues associated with each of the payments (for example, when is the bonus paid?)

Guideline 7: Consider Whether Any Of The Consideration Should Be Contingent

For example, in acquisitions, sometimes a buyer of a business will pay a small amount of money upfront and agree to pay additional consideration based on the business's performance after the acquisition. These arrangements are common when a buyer purchases a relatively new business whose product is not yet well established. This arrangement is known as an earn-out. For a more detailed discussion of earn-outs, *see* Lou R. Kling & Eileen Nugent, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* §17.01 (1992).

Guideline 8: State Formulas Accurately

If payment is based on a formula, make sure that the formula is unambiguous. For example, earn-outs are often based upon a percentage of profits. Similarly, royalty payments are often calculated by multiplying gross revenues times a stated percentage. While the formulas may at first appear simple, they generally involve accounting concepts that you need to consider carefully.

Some of the most common drafting errors occur when crafting a formula. To make certain that a formula works as intended, run multiple hypotheticals to see what answers are obtained when numbers are plugged into the formula. Be sure to include in the hypotheticals numbers far outside the range that the client expects. Calculations sometimes result in negative amounts, and the parties need to address what happens in this circumstance.

Get Both Principals To Check The Formula

After running the numbers, send the hypotheticals to your client to make sure that she understands how the formula will work, both when the transaction is a success and when it is a failure. (Clients do not like surprises.) Once your client is satisfied with the formula and the hypotheticals, send them to the other side for their review and approval. With luck, this process will root out any differences at a time when they can be resolved—without litigation. As the final step in this process, with the approval of all principals, annex the hypotheticals as an exhibit to the contract. They will become a legislative history of sorts, setting forth the parties' understanding of the formula at the time of contracting.

CONCLUSION • Although these guidelines cannot guarantee that a consideration provision will never be contested, careful adherence to them will significantly reduce that possibility. But remember that these guidelines are guidelines, not rigid, inflexible rules. Each contract is different, and sensitivity to those differences will help you draft a clear and nuanced agreement.

PRACTICE CHECKLIST FOR

Drafting The Consideration Provisions Of A Contract

Consideration provisions may seem simple, but that simplicity can be deceptive. Drafting the clauses properly takes some work, but it can be aided by following a few guidelines.

- Guideline 1: Answer who is paying what to whom, when, why, and how.
- Guideline 2: State the amount of consideration payable.
- Guideline 3: In stating who is paying what to whom, draft the obligation of the payor in the active voice.
- Guideline 4: State when the consideration is payable with precision.
- Guideline 5: State how the consideration is payable. Specify the form.
- Guideline 6: If the consideration is payable for more than one reason, be sure to state the details of each payment separately.
- Guideline 7: If the payment of the consideration is contingent, describe the contingency in detail.
- Guideline 8: If the payment is based on a formula, set forth the formula—and be sure that the client verifies it!