Drafting a Better Severability Clause

This article was originally published on October 1, 2013 in *Corporate Counsel*.

by Eric Fishman and Robert James

Eric Fishman
Litigation
+1.212.858.1745
eric.fishman@pillsburylaw.com

Robert James
Finance
+1.415.983.7215
rob.james@pillsburylaw.com

Eric Fishman is a partner at Pillsbury Winthrop Shaw Pittman, where he represents both industrial companies and financial institutions in complex disputes arising out of purchase and sale agreements, procurement contracts, leveraged leases, credit default swaps, reinsurance contracts, and partnership and LLC operating agreements. These cases also frequently involve fraud, fiduciary breach, and equitable claims. Robert James is a partner at Pillsbury Winthrop Shaw Pittman, co-leader of Pillsbury's energy industry team, and a member of the firm's governing board.

Boilerplate clauses are most useful when they make a needed change to the background law for the contract or clarify how that law will be applied. A candidate for improvement on this standard is the common severability clause.

One of the most frequently used variations declares:

"If any term of this Agreement is to any extent invalid, illegal, or incapable of being enforced, such term shall be excluded to the extent of such invalidity, illegality, or unenforceability; all other terms hereof shall remain in full force and effect."

Parties understandably want to address the uncertain status of a contract in the event a term has been invalidated or cannot otherwise be enforced. But we question whether this clause is an improvement on background principles.

As an initial matter, in many special cases there is a fallback provision provided by law when a term in a contract fails. If, for example, a liquidated damages provision is deemed a penalty, the injured party may nonetheless usually recover its actual damages. (See, e.g., UCC § 2-718). If, to take another example, a limited and exclusive remedy "fails of its essential purpose"—as when the seller's warranty is limited to repair, but the warranted good cannot, in fact, be repaired—the law permits the buyer to resort to any other available remedy. (See, e.g., UCC § 2-719). In these types of situations, the severability clause really serves no purpose.

Even where there is no special rule, the common clause adds little to the background principles where the invalid clause is incidental to the contract's main purpose—for example, if a choice of law provision cannot be enforced because it lacks a reasonable nexus to a transaction. In such situations, "a court may nevertheless enforce the rest of the agreement in favor of a party who did not engage in serious misconduct if the performance as to which the agreement is unenforceable is not an essential part of the agreed exchange." (Restatement [Second] of Contracts § 184 [1981]).

Thus, a severability clause tends to matter most when (i) the law does not provide a default rule and (ii) the invalidated or unenforceable term is *essential* to the transaction. And in *that* case, the common clause quoted above may steer towards an undesirable result. Do parties really intend to leave otherwise intact a contract in which a provision

essential to its making can no longer be enforced and a fallback provision is not provided as a matter of law?

Needless to say, the invalidity of one key provision can result in an exchange materially different from the bargain initially struck. For example, if a best efforts clause is found to be too vague to enforce (*see, e.g., Timberline Dev. LLC v. Kronman* [N.Y. App. Div. 2000]), the standard form severability clause would nonetheless require the beneficiary of that clause to adhere to every other part of the transaction as if nothing had changed. The same result would hold if one who provided very valuable consideration could not enforce a non-compete provision (because unduly restrictive), a warranty exclusion (because not sufficiently conspicuous), a "most favored nations" clause on pricing terms (because a disincentive to the seller to lower prices and thus anticompetitive), a prospective release of fraud claims (because against public policy), or a host of other provisions.

It is thus essential that a severability clause not only ensure the survival of the remaining contract; it should also address what *else* happens in the event of severance.

One strategy here is to state in the severability clause that, in the event of invalidity or unenforceability, the parties shall undertake to modify the contract so as to effect the original intent of the parties as closely as possible. The problem with this approach is that contractual provisions are almost always invalidated in the context of litigation; thus, a clause requiring the parties to renegotiate is not apt to lead to a successful resolution. The better practice is to provide for judicial or arbitral modification of the term.

But even a "modification" provision does not fully address the problems posed by severance. In many instances, an invalidated provision simply cannot be modified. This can occur, for example, when a non-compete clause does not have terms that can readily be deleted, and the dispute is venued in a jurisdiction that only permits "blue-penciling" (i.e., crossing-out, as opposed to rewriting clauses). It will also happen when a provision is too vague to enforce; in that situation, by definition, the parties' intentions cannot be determined. Or it can happen when a provision is simply invalidated as against the public policy of a jurisdiction (e.g., an antiassignment provision), making the search for a permissible modification difficult.

In these and other situations, the economics of the transaction may be materially impacted by severance. Accordingly, in drafting a severability provision, parties should further consider including an economic adjustment clause that compensates the beneficiary of the unenforceable term when its deletion materially and adversely impacts such party and a near equivalent cannot be provided. Only when the unenforceability of a term is due to serious misconduct of a party—as when one is estopped from invoking an exclusion of consequential damages by reason of egregious or bad-faith conduct—would the economic adjustment clause be inapplicable.

To be sure, such an economic adjustment clause can invite litigation. But as noted, these issues tend only to arise in the context of already pending disputes; an economic adjustment clause is thus not apt to create new litigation. And in the absence of an economic adjustment clause, litigants have a cost-free incentive to try to invalidate contractual provisions and secure a deal far better than the one originally negotiated. Putting a price on invalidating terms can deter frivolous challenges and help to preserve the economics of a deal as originally negotiated.

In light of these considerations, parties may wish to consider incorporating into their contracts a severability clause along the following lines:

"If any term of this Agreement is to any extent illegal, otherwise invalid, or incapable of being enforced, such term shall be excluded to the extent of such invalidity or unenforceability; all other terms hereof shall remain in full force and effect; and, to the extent permitted and possible, the invalid or unenforceable term shall be deemed replaced by a term that is valid and enforceable and that comes closest to expressing the intention of such invalid or unenforceable term. If application of this Severability provision should materially and adversely affect the economic substance of the transactions contemplated hereby, the Party adversely impacted shall be entitled to compensation for such adverse impact, provided the reason for the invalidity or unenforceability of a term is not due to serious misconduct by the Party seeking such compensation."

A clause of this complexity, of course, may not be necessary in many contracts. For a party that perceives its key provision to be legally vulnerable, though, the above clause resolves uncertainty about what happens when a material term is invalidated or unenforceable; preserves the economics of the transaction; and reduces the incentive of parties in litigation reflexively to challenge all burdensome provisions. In these respects, the modified clause represents an improvement over both the background law and that old familiar standard severability clause.

Pillsbury Winthrop Shaw Pittman LLP