

Allocating Risk in Business Contracts: A Guide for California Attorneys



Life is sometimes stranger than fiction — especially when business deals take unexpected turns. What starts as a promising or straightforward transaction can quickly unravel when things don't go as planned (and we're sure you need not be reminded of the year 2020, but case in point).

Contracts aren't just about sealing the deal; they're crucial documents that identify potential risks and dictate how parties share liability. In other words, a good contract anticipates what could go wrong, stipulates who bears the burden and outlines how the consequences will be managed. Risk allocation should be baked into every commercial contract.

Here's a breakdown of the key considerations for California lawyers, including the essential mechanisms, questions to ask before drafting, best practices and common pitfalls that could come back to haunt your client.

The basics of risk allocation

In most instances, it's up to the contracting parties to distribute potential losses, liabilities and unforeseen events using carefully negotiated terms — also known as risk allocation. By adjusting or inserting particular language, you can change or confirm the responsibilities and risks that California law would normally assign in a given situation. For example, a commercial tenant would usually be legally responsible for damage caused by their business operations, but a tailored lease agreement could stipulate that the landlord will handle any HVAC repairs — even if the damage occurs while the tenant occupies the space.

There are four key ways to allocate risk under California law:

1. [Direct assignment](#) of the risk to one party under the contract
2. [Indemnification provisions](#), where one party agrees to cover another's losses or damages, usually involving a third party
3. [Exculpatory provisions or releases](#), which remove a previously existing obligation or claim owed to the beneficiary
4. [Waivers](#), which intentionally relinquish a known right

[Representations and warranties](#) can also shift risk between parties by allocating responsibility for certain facts or conditions and providing remedies if those assurances prove false.

Questions to ask before drafting a risk allocation clause

You can't effectively allocate risk without a thorough understanding of all the potential risks involved and how they might be distributed. Before you put pen to paper (or cursor to screen), consider the bigger picture by asking the following questions:



- 1 What kind of duty or obligation are you planning for?**
Is it rooted entirely in a contract, tort, statute, or something else?
- 2 Who bears responsibility without the agreement?**
If the contract didn't exist, where would the duty naturally fall under applicable laws?
- 3 How broad is the obligation?**
What is the specific scope — does it cover a single task, ongoing responsibilities or future contingencies?
- 4 What commitments have already been made?**
Have the parties already agreed to any warranties, representations or assumptions of liability?
- 5 How much risk do the parties want to shift or remove?**
Are you simply redistributing responsibility or eliminating it completely?
- 6 Should third parties rely on this allocation?**
Is it appropriate for outside parties, such as subcontractors or insurers, to depend on how risks are divided?

Best practices for drafting clauses

When drafting risk allocation clauses, it's essential to be proactive and thoughtful to make sure all parties understand their responsibilities and minimize the potential for disputes.

Be direct and explicit where necessary

While California law often outlines general responsibilities and the circumstances under which they shift, that might not cover the specifics of your agreement. Prevent future disputes with a contract that clearly states when a duty, obligation or risk of loss moves from one party to the other.

Ensure your indemnitor can fulfill its obligations

When drafting an indemnity agreement, ensure the indemnitor has the financial ability to meet their obligations. An indemnity agreement provides protection, but it's only as reliable as the indemnitor's financial capacity or the assets securing it.

Avoid rendering exculpatory provisions unenforceable

Exculpatory provisions remove prior obligations or claims and can relieve parties from liability for another party's conduct, but only if they're carefully drafted. If the clause attempts to waive liability for statutory violations or conflicts with public policy, they'll likely be unenforceable under [California Civil Code §1668](#).

Leverage insurance to protect against certain activities

Using insurance, collateral security or [personal guaranties](#) for particular obligations can be an effective tool for managing and mitigating risk in transactions, safeguarding against potential liabilities and reducing possible financial losses.

Anticipate litigation risks

Consider how a court might interpret vague terms or inequitable provisions and address potential issues proactively. Note that courts will review risk allocations in contracts based on the parties' relative positions. For instance, if both parties are large corporations, a judge will typically respect their ability to allocate risk. However, if one party is a corporate giant and the other is a consumer, the agreement will face more scrutiny to ensure fairness. Staying updated on [California case law](#) and [emerging legal trends](#) will also help you anticipate challenges and refine your strategies to ensure compliance and protect your client's interests.



Don't roll the dice with contracts

With business contracts, there's no room for luck — and may you never have to rue the day your client signed a poorly drafted one. Clear, well-crafted language combined with the appropriate risk allocation vehicle and strategic use of insurance and collateral can prevent costly disputes down the road. A well-drafted contract is not just a legal tool; it can be a crucial barrier between your client's interests and the worst-case scenario.

For risk allocation clause templates, relevant forms, checklists and other CEB insights, get in touch to request a free trial or to schedule a quick demo.



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