The Falsity of Forms©

Ten things You Need to Know about Business Contracts

(Including "The Documents Look 'OK' to Me Fallacy," "The You Want a Priest Not a Lawyer Mistake," "The Candy Jar Speech," "The Doctor's Office Speech," the "Skyscraper Speech," and other useful information.)

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Business contracts are like shoes: One size does not fit all nor is one pair suitable for all occasions. The same is true for most of the important things in life: Our mate, our friends, car, clothes, etc. For this reason, there are a number of problems with using standardized "("form") agreements such as those you get online or from a friend.

1. Fit: Buying a form document is a little like buying a suit, or even just a shirt, off the rack without even looking at its size, let alone its suitability. The form may not be correct for your type of business. Different law applies to products and services (and in some cases intellectual property) and some companies sell both. The sale of goods domestically is covered by the Uniform Commercial Code, as are many transactions in software and data. Services, on the other hand, are covered by the common law. The international sale of goods is covered by the Contracts for the International Sales of Goods ("CISG"); other international contracts may be governed by the Unidroit Principles of International Commerce. In some countries, intellectual property is a separate body of law.

2. Customer: The form may not fit the transaction. Sales contracts change according to the means of sale and customer. A business may sell products in a store, online, through distributors or company representatives, locally, nationally or internationally. How and where you do business, and where the other party is, affect the type of contract you use. A distributorship agreement, particularly an international distributorship agreement is a "magnum opus" and completely different than the contract for the sales of goods or services directly to the end user.

3. Completeness. To quote myself: *It is not the subject matter of your contract, e.g. business assets, that you get when you buy or sell something. What you get is* ***what the contract says*** *about what you are buying or selling.* This leads to what I call the "Candy Jar Speech:" The buyer in a business transaction is naturally focused on getting the benefit of the bargain. With a business purchase this typically includes the customers and contracts, the furniture, fixtures and equipment (aka "FF&E) and the intellectual property, including the trademark(s), URL, domain name, website, phone numbers, emails and other brand and contact information. But, exaggerating, I tell my clients: "Don't (just) look at the crystal candy jar filled with the multi-

colored chocolate bars. Look at the *contract* because it is the purchase agreement that determines whether you get the candy or not, i.e. a good deal and what you pay for."[1] In short, "Fall in love with the deal, not the property."

A form contract or other documents may be missing a number of critical terms. Causes for this include:

A. "The document looks 'OK' to me fallacy:" Often the client focuses on the language *in* the form, but does not realize what *is not in it*. For example, I had a self-made millionaire client who was negotiating the purchase of a new business. He asked me to look at the contract late in the afternoon on the day before the Closing. I quickly realized the contract contained none of the representations and warranties essential to a business buyer. (Referring back to the italicized language above, what the client was getting was "not much.") The client had gone through nine drafts and revised the language *in* the document but did not realize what language was *not* in the document. It takes years of law school and considerable knowledge and experience to know *what the form is missing*, e.g. representations and warranties about the accuracy and completeness of financial and other information disclosed, taxes paid, condition of equipment, the absence of liens and litigation, etc. The list goes on.

B. "You want a priest, not a lawyer" mistake: Another problem with the above transaction is that the client came to me at the very last minute. When this happens often the client is looking for the attorney to "bless" the documents, i.e. make the client feel good about the transaction, without the attorney giving or the client receiving a competent review. An attorney who has been outside of the loop of the deal and who does not know the parties' needs and objectives, cannot provide competent advice – at least not the best, most complete, advice that he may otherwise be able to do with more notice.

C. Atypical Transactions: In transactions outside of the ordinary course of business, the contract is typically negotiated by one side presenting a draft and the other side responding to it. With a business purchase, the representations, warranties, and indemnification provisions, among other things, hold the seller accountable for the truthfulness and completeness of financial statements, the condition of the assets and unpaid liens, judgments, taxes or other encumbrances. Obviously this language is essential to the buyer to preserve the value of the deal. But, it is the job of the seller's attorney to reduce the number and strength of such provisions. Thus, a proper contract – and proper contract review – is necessary.

[1] In fact to avoid falling in love with the property instead of the deal many professional investors will not even look at the property until they know the "numbers work." A similar emphasis on the legal terms is advisable.

D. Ordinary Transactions: With everyday transactions, such as the sale of products and services, the contract terms are or should be carefully drafted in advance by the business owner and attorney. Important terms in a business sales contract include a precise statement of work (specifications and deliverables), limitations and disclaimers of warranty, limitations of remedies, governing law, venue and jurisdiction and, perhaps, arbitration. Clients often ask about "asset protection." One of the first places to start in wealth-building and asset protection is to use properly drafted contracts. [2]

Online contract forms may be deliberately incomplete (i) to allow their use by either side of the transaction and to avoid conflicts of law between the various states, or (ii) they may be deliberately designed to avoid issues so that the transaction can close. A typical form agreement obtained online is of the first type. Business broker forms are usually of the second type. Often broker forms lack the necessary representations (and other terms) to protect the buyer (or the seller), or they are drafted to avoid issues. As a result, broker agreements may provide only weak remedies to the parties in the event of breach. Complete agreements require consideration and negotiation of terms. This process can delay or terminate the transaction. A neutral or sterile form, like the online form or broker's agreement, is designed to close the deal, not to protect the parties. (Note, the typical business broker form is well tailored for the broker; it is just not well tailored for the buyer or seller. I have had both the buyer and the seller in my office asking "What just happened?").

4. Special Needs. The form may not address special issues with your business. For example, the firm had a client which made fixtures for supermarkets, but one supermarket did not accept timely delivery. As a result the client was not paid and had his small shop full of these fixtures. And his agreement - not drafted by the firm – did not include a provision for interest or storage fees for late delivery. The absence of these simple terms almost put the client out of business.

5. Licensed and Knowledgeable Legal Counsel. Online forms are not likely to have been written by a lawyer who is licensed in your state and knowledgeable about local law. Lawyers are licensed by state. Some are licensed in several states. But none of us are licensed in all states, and even if we were, we could not use the same agreement because the law varies from state to state.

6. Tailored for the Other Side. The form may be a contract tailored for a party on the other side of the transaction. A common mistake is to think that because an attorney drafted an

[2] Next to business owner "partnership disputes," disputes arising out of design or development agreements can be among the most cantankerous and difficult to resolve. One reason for this is what I call the "rolling specs" problem. The purchaser thinks the contract includes X; the designer or developer does not think so, and there is no precise statement of work for either party to point to. The disagreement negates much of the value of the deal for one or both parties.

agreement, then it must be safe for both sides to use. But, this assumption misses the point that, even in transactions, *lawyers are advocates* and draft contracts to favor their clients. This is another reason why you want the agreement tailored for your side.

7. Out of Date. The form may not be current on the law. The law is dynamic. New case decisions come down every day. This is why there are so many books in law libraries. Given the pace of change and complexity of knowledge in most industries, to quote Alice from Alice in Wonderland, we "must run as fast as we can to stay in one place." Even if you have good contracts, this is a good reason to have them reviewed every few years to be sure you are taking advantage of all applicable law and not relying on provisions that are no longer accepted.

8. Unenforceable Terms. The form may include provisions that are *not* enforceable or no longer enforceable in your state. An example is the automatic renewal term of many online agreements. These agreements require sufficient notice of the renewal and evidence of actual agreement on the new terms, particularly if the terms in the renewed agreement are different than the original agreement. The Ninth Circuit Court of Appeals recently held that a website user did not agree to the arbitration term of Barnes & Noble's website browse-wrap[3] agreement, even though the site had a conspicuous hyperlink located at the bottom of every webpage, because the website failed to otherwise provide notice of the agreement or require an affirmative user action to demonstrate assent.[4] Obviously, if the browse wrap term is unenforceable, then there is no contract at all. That result can be devastating to the affected business.

9. Missing Enforceable Terms. The form may be missing important and valuable provisions because they are not lawful in every state or vary from state to state. Arizona, for example, has law that is pro-business and pro-employer. For the business it is just a shame not to take advantage of that. Examples are employee non-competition and non-solicitation provisions in employment agreements.

> A. A non-competition clause states that the employee may not compete with the former employer by selling a competitive product or service for a certain period and within a certain trade area, or certain market, say luxury cosmetics, after termination. Because public policy supports the employee's right to work, such provisions are closely scrutinized by the courts and not accepted in some states.
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> B. A non-solicitation provision states, for example, that the former employee may not solicit the customers or employees of the business for a period of time, say, two (2) years.

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[3] A browse wrap agreement is a statement placed on a website containing terms and conditions which purport to bind any user who uses the website, without any other manifestation or affirmative agreement by the visitor. While notice of the terms and conditions usually appears on the website, the user is not required to view the provisions of the "agreement" or to undertake any affirmative action indicating an agreement to those terms.

[4] *Nguyen v. Barnes & Noble, Inc*., No. 12-56628, 2014 WL 4056549 (9th Cir. Aug. 18, 2014).

Non-competition and non-solicitation provisions such as these are unenforceable in some states, (e.g. California), but if carefully drafted, are definitely enforceable in other states, like Arizona.

In Arizona the employment agreement *may prohibit for some period after termination the former employee from working for a direct competitor and may specify the competitors*! The value of being able to name the competitors your former employee cannot work for is shown by a case involving boutique mattress stores. When an employee left "Mattress City" (not true name), Mattress City invoked the "major competitor" clause which prohibited the former employee from immediately working for a direct "competitor," defined, say, as a business doing more than fifty percent (50%) of its business selling mattresses. The court enforced this provision. As a result, the former employee could only work in the mattress department of a general merchandise company that did not specialize in mattress sales and where the former employee's specialized knowledge of mattresses was less threatening to Mattress City.

An example of the value of taking advantage of applicable state law can be shown by a case recently handled by the firm. Our client was the Arizona General Manager of a multi-state engineering firm, but not subject to an employment agreement of any kind. Due to the lack of contract non-competition and non-solicitation provisions of the type discussed above, and the public policies in favor of employment and free enterprise, nothing prohibited the client after leaving the company from competing against the former employer, immediately doing business with the former employer's customers or hiring its employees. (The client would not have the right to *solicit* the customers or employees in an improper manner, e.g. selling off of insider information, but the firm counseled the client both before and after his departure to avoid mistakes which could create a legal claim.)

As expected, when the General Manager left the firm, the former employer sued because it was losing business worth about one million dollars a year. But, the case settled quickly because the former employer had no good grounds upon which to sue.

10. Wrong. The form may just be "flat wrong" and a wrong agreement can cause serious problems. Recently, a client came to the firm because the Operating agreement which came with his LegalZoom LLC required unanimous consent for business decisions. Not only is this unworkable, but it was contrary to the client's intentions. He had the money and business experience, but under the Operating Agreement the minority owner had veto power on company operations.

In another case, a do-it-yourself business seller used a sample online agreement, but the seller used a sample contract designed for an asset sale, when the negotiated transaction was the sale of the entity (LLC or corporation). The draft presented to me by the buyer was so flawed we had to just start over. The transaction took more time and cost more money than if the parties had just used attorneys up front.

Although not strictly a contract case, in another matter involving the use of a form, the client filed for a federal trademark through LegalZoom. LegalZoom filed the papers and the client received the trademark. But three months later he received a letter from the legal counsel for the Ivy League colleges because the name he requested included Ivy League. It cost the client thousands of dollars to correct this mistake, and it is a mistake that would not have happened with proper representation.

11. Bonus Point. *Our "form" is free*. You may be thinking. Yes, but it is still hard both to *wait*, say a week, for a tailored agreement *and* to *pay more*, say, three times the cost. (I want to get the deal done. Business, especially an owner-operated business, lives on maneuverability and responsiveness.) I/this firm understands that. That is why we have the "Ten Day Rule" which requires that wherever possible, and where it makes sense, a project is to be in and out the door in ten days.[5] *But the bonus point is this*: It occurred to me while talking to a client about costs and legal documents that: Our form is free! What I mean by that is: We *start* with a sample document or checklist that is already superior to a "form off the rack" because it is from or targeted to your industry and based on prior similar work by the firm. And, we don't charge for that! IT IS FREE. What you pay for is our work to conform that sample to your business, your customer, and your state and special needs. You are not paying for the form; you are paying for the tailoring.

Conclusion; Last Words

An underlying assumption – probably adopted by the client without thinking about it – is that a "contract is a contract," and a "lawyer is a lawyer." But neither legal documents nor lawyers are fungible, like grains of wheat. The assumption that "One is as good as another." is false for the same reason that a Yugo is not a Ford or BMW. The quality of legal documents and the knowledge and expertise of the attorneys who draft them can vary tremendously.

A form is not a contract. Only non-lawyers view a contract as a simple "form." A 'form" is something you fill out and submit, e.g. to go to college, to get a loan, or to provide information. A proper contract is not a simple or standardized form; it is much too important for that. Having a well drafted agreement *tailored to your business* can help your business survive and succeed and make operating your business more profitable and enjoyable. Good business agreements are a vital step in wealth building and asset protection. Having the wrong agreement can give a false sense of security and negatively affect important legal rights and remedies when you need them most. The business owner may not realize what has been lost until litigation shows the contract to be unenforceable or lacking important provisions allowable under local law.[6]

[5] Law firms like businesses have a pipeline of work and each project takes some time to do properly.
[6] Seminars for lawyers stress the importance of good contract terms for a good litigation outcome.

The "Doctor's Office Speech:" Doctor's office visits for preventative medicine cost much less than hospital stays or emergency room surgery. Likewise, it is much less expensive to pay for a well drafted business agreement than to pay the litigation attorney to sue or defend under it, especially if the action requires emergency legal proceedings. The typical tailored agreement for our firm's usual business-owner client will cost from $1,500 to $2500, $5,000 at the most, except for unusually complex or large transactions. Its benefit, as shown here, can be literally $1,000,000 dollars both to the employer and former employee. A tailored agreement may determine the viability of both the old and new business. In contrast the initial advance fee deposit for a litigation matter will be from $3,500 to $10,000 or more. As with preventative medicine, under a cost-benefit analysis, "preventative law" is a "no-brainer."

The "Call Not Received:" One benefit of having a well drafted agreement is that it can discourage others from pursuing litigation. When the would-be plaintiff takes the contract to his lawyer, he learns that (A) the claim has no merit under the contract and (B) even if the claim had some merit, the lawsuit would not have a favorable "cost-benefit ratio." There would be less certainty of a favorable outcome for the same or greater cost. Either A or B dampens the enthusiasm to engage in costly litigation.[7]

Here is an applicable quote from Sun Tzu's The Art of War:[8]

> A physician who belonged to a family of healers in ancient China was once asked which one of his three brothers applied the most wisdom in the healing arts. The famous doctor of ancient China replied,
> "My eldest brother sees the spirit of sickness and removes it before it takes shape, so his name does not get out of the house."
> "My second brother cures sickness when it is still extremely minute, so his name does not get out of the neighborhood."
> "As for me, I puncture veins, prescribe potions, and massage skin, so from time to time my name gets out and is heard among the lords."

We call this "the call not received," i.e. the good contract fixes problems in advance and with a lot less time and trouble. If the "call is received," the client's position is stronger with a well drawn agreement.

There is a saying: "Nothing is impossible for the person who does not have to do it." A corollary of this is the tendency to discount and take for granted the work of others. It is not unusual for a business seller, who may be receiving $500,000 cash at closing in a $1,000,000 deal, to balk at $5,000 in estimated legal costs for drafting a proper agreement. This is in spite of the fact that (A) perhaps unknown to the seller – who may have a "form mentality" about legal

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[7] For more on this topic please see my article "Why People Sue. The Ins and Outs of Commercial Litigation."
[8] From my article *The Maytag Repairman, The Art of War and The Practice of Business Law*, available under the Publications tab at our website, asbuslaw.com or this office.

work -- the project may require fifteen to twenty hours to complete, and (B) a bad contract can result not just in a bad business deal, but also cause life-altering events, including loss of money, loss of business, and even "ruined lives" for oneself and family.

I am often just shocked and amazed at "how peoples' minds work," as my mother would say. The same seller who may balk at $5,000 in legal fees may be paying the business broker its standard 12% commission, i.e. $120,000, right off the top at Closing. I respect brokers' knowledge and their ability to have and market businesses for sale. Still, I just do not see the extreme difference in value between what the broker does and what the lawyer does. Arguably, the lawyer's services are more valuable because the lawyer is not paid a commission to close the deal. The lawyer has no stake in the outcome except to protect and have a satisfied client.

Finally, there is what I call my "Skyscraper Speech:" My building and the buildings around me are filled with lawyers, accountants, business advisers and financial analysts. These professionals could not pay the rent unless clients were using them. And, it seems likely that the clients do not use these firms because they *like* them, but because the clients realize that professionals bring value to the deal or the business. I believe it was Tony Robbins who said: "If you want to be successful, find someone who has achieved the results you want and copy what they do and you'll achieve the same results." I doubt Donald Trump uses his professional advisors because he likes them, or likes doing so, but because he knows they help him succeed. If successful business people use qualified professionals, it is probably a good idea for you to do so as well.

Thank you for your time and attention.

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