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 Skyscraper Speech," and other valuable information.)

By Donald W. Hudspeth

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: 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.* A form may be missing critical terms. This leads to:

   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 other important terms, 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.

D. Ordinary Transactions: With everyday transactions, such as the sale of products and services, the contract terms are carefully drafted in advance by the business owner and attorney. Important terms in a business sales contract include limitations and disclaimers of warranty, limitations of remedies, governing law, venue and jurisdiction and, perhaps, arbitration.

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 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 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. Current. 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[1] 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.[2] Obviously, if the browse wrap term is unenforceable, then there is no contract at all. That result can be devastating to the affected business.

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[1] 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.

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

9. 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. Examples are employee non-competition and non-solicitation provisions in employment agreements.

A. The 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.

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.

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 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 about $10,000 to correct this mistake, and it is a mistake that would not have happened with proper representation.

Conclusion

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. 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.[3]

The typical tailored agreement for our firm's usual business-owner client will cost from $1000 to $2500, $5,000 at the most, except for unusually complex or large transactions. Its benefit, as shown here, can literally be a million dollars both to the employer and former employee. A tailored agreement may determine the viability of both the old and new business. I call this the "difference between doctor visits and hospital or emergency room care." From a cost-benefit point of view, the decision to have a well drafted agreement is a "no-brainer."

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.

[3] Seminars for lawyers stress the important of good contract terms for a good litigation outcome.

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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