The Falsity of Forms, Updated and Expanded

A Baker's Dozen (and More) of Things You Need to Know about Business Contracts

(Including "The Candy Jar Speech, "The Documents Look 'OK' to Me Fallacy," "The You Want a Priest Not a Lawyer Mistake," "The Doctor's Office Speech," the "Skyscraper Speech," and other useful 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 can be said about clothes and for most of the important things in life: Our mate, our friends, car, 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. Tailored. The overriding reason why a form will not serve as a contract is because a *form* by definition is not tailored. By "tailored" I mean the contract is designed to optimize the strengths of the client and contract and to minimize their weaknesses. A current example of this is the independent contractor agreement. This area of employment and contract law has undergone a sea change over the last few years. Under current law there are certain requirements, in addition to the old IRS "20 questions," which must be met to lawfully be and be treated as a contractor. Factors now include the right to refuse the work, to schedule the job, to hire employees, sell the contractor's company, etc. Arizona has a statute which if followed goes a long way to establish independent contractor status. However, with each client we must determine which criteria the client can meet, and those it can't. We then draft the agreement around the positive points. The agreement must be tailored to the client. This is the opposite of a form.

a. *Statutes.*

i. Workers Compensation. The above is also an example where a statute affected legal practice and the contract used. Arizona's workers' compensation statute (where "employee" versus "independent contractor" is a critical question) lists the criteria necessary to be an independent contractor and allows the independent contractor to sign a "Declaration" regarding same. Naturally, the statute changed the practice and the content of independent contractor agreements.

ii. The LLC Operating Agreement. A 2018 amendment to Arizona's Limited Liability Act introduces a checklist of terms which must be discussed with the client and upon which the client(s)' decision is necessary. The intent is to reduce subsequent

litigation; namely, partnership disputes and business divorce, by requiring consideration and decision of certain important items upfront when the company is formed. Thus, by statute, if the LLC operating agreement were ever a standardized agreement, it is not now – and can't be, by law. So much for the form…

2. Getting What You Pay For (The Candy Jar Speech"). To quote myself:[1] *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 customer and vendor 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, i.e. the assets. Look at the *contract* and *what it says about* the candy jar, i.e. the assets, because the terms of the purchase agreement determine whether you get a good deal and what you pay for."[2] In short, "Fall in love with the deal, not the property."

a. *Representations and Warranties*. Another way to make the above point is to say: "In purchasing a business, or piece of equipment, etc., *you are buying the seller's representations and warranties about the business, or equipment*, e.g. free of liens, good condition, etc. (Our list of business representations and warranties for a buyer in a business sale is about three pages long. That is the heart of the deal for the buyer.) And the principal of the seller company must sign both as a company representative and personally.[3]

3. Statement of Work. Many contract disputes are caused by the lack of a clear Statement of Work. The seller thinks the job means x; the buyer thinks that the job means x +1, or in any case that the +1 should be included in the original deal. The buyer often tries to get "extra" for his money. Or, the parties learn that something different or in addition is needed. This is what I call the "rolling specs" problem. Something new is needed; the question is who pays for it. A good contract, well followed, will stop the "job creep." A good contract sets forth very clearly and precisely the "specifications' of the job, warrants that the work will conform to those specifications, and disclaims warranties and remedies for anything else. This is true for a product or service.[4]

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[1] "I often quote myself. It adds spice to the conversation." George Bernard Shaw.

[2] 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."

[3] We explain why in a consultation.

[4] Submitting a contract to the buyer is also a good way to prevent arguments over whether the product or service was ordered in the first place. When in doubt, send the contract. If they don't sign it, there is no duty to perform.

a. *Definitions.* A corollary of the above point is the importance of *definitions*. In Germany the negotiation of the *meaning* of terms may be given the same attention as negotiating the terms themselves. In contrast, in the U.S. it is not uncommon to have even key terms left undefined. A form contract may lack these key definitions. This causes disputes later.

b. *Your Definition*. An often-overlooked drafting device is to define key terms for your benefit. One place to do this is the "boilerplate" at the end of most contracts. For example, "force majeure" (which allows delay of performance) usually means an "Act of God" like a flood. But, in supply contracts we will define this term to include labor or materials shortages. Often "boilerplate" is just blocked and copied into the agreement without much thought as to what the provisions actually say or thinking how they could be better for the client. This is a terrible waste of advantage because usually these definitions go right on through because even many attorneys are not used to going through those terms one by one and defining their content.

4. Fit. The form may not be correct for your type of business or customer. 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.

5. Transaction. 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. An evolving body of case law is establishing the rules for internet commerce. Some forms of agreement, e.g. "You use, you agree" may not survive, in which case the seller needs a new agreement.

6. Completeness. A form contract or other document 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 Don't Want a Lawyer; You want a Priest Mindset." 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 could do with more time, notice and involvement.

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.

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.

e. Broker Agreements. 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?").[5]

7. Special Needs. The form may not address special issues important to your business. For example, the firm had a client which made fixtures for supermarkets, but one supermarket did not accept timely delivery. (Think a supermarket number of trade fixtures in the typical shop.) 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.

8. Knowledge of Local Law. 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. This matters because the employment agreement we draft and use everyday in Arizona would go in the trash in California.

9. Tailored for the Other Side. The form may be a contract tailored for a party on the other side of the transaction. The agreement you adopt may have favored the seller in the last transaction, but you are the buyer. Obviously, some terms important to the buyer may be lost.

10. The Lawyer as Advocate. 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. That is their job – not just to draft, but to advocate.

11. 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 and they are constantly receiving updates. 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, or had, good contracts, the dynamic nature of law is a good reason to have them reviewed every few years. This ensures that you are taking advantage of all applicable law and not relying on provisions that are no longer accepted.

a. *Example: Independent Contractor Agreements*. Recently a potential client was negotiating a $300,000 independent contractor agreement. She was to be the contractor. The draft agreement was written by a well-respected *litigation* firm but not one that I run to in transactions. The agreement was excellent *if it had been written five years ago* but it was way out of sync with current law, including new Arizona statues. The draft agreement did/would not protect the hiring company from her claim of employee status, with accumulated benefits, penalties and interest.

[5] This is not to disparage business brokers or their service. They know the market and can be very helpful. I am just talking about the general principle that brokers should do the brokering, lawyers the lawyering, etc.

And, in spite of her intent not be an employee, due to the defective agreement she might be treated as one as a matter of law. This could mean employment taxes like social security and unemployment might be due and taxes owed personally, rather than by her company, etc.

12. Wrong Agreement. Worse, opposing counsel had drafted the wrong type of agreement. The agreement might have been O.K. otherwise, but not for this transaction. The problem was that the agreement was drafted as the purchase of the *entity*; that is, the membership interests (like shares of stock) of the LLC instead of its *assets*. Normally, a business purchaser will only buy the entity where essential licenses, non-assignable contracts, government qualification and referral, or highly favorable workers compensation and other experience ratings are in place. Otherwise, about 90% of the time the buyer will buy the *assets.* The reason: If you buy the entity *you buy its debt* which could be taxes even the seller does not know about. But, if you buy the assets the unknown liens don't follow (unless the entire transaction is a sham against a creditor, which is different. Thus, to do this deal properly this firm had to redraft the purchase agreement, and the seller will have to "eat" the cost of the wrong agreement plus reviews, negotiation and revisions to the new one. As you can see from this example, the time to get the firm involved is when you are thinking about buying a business or making a deal. The firm can then counsel you on what to look for and furnish you with several articles that we have written on the subject.

13. Unlawful, 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[6] 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.[7] Obviously, if the browse wrap term is unenforceable, then there is no contract at all. That result can be devastating to the affected business.

14. Very Favorable 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.

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[6] 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.

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

a. *Example: Non-Competition Clause*. 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. *Non-Solicitation Clause*. 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. Again, the law in this area is evolving and the agreement must conform to current law.

c. *Major Competitors*. 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, like J.C. Penny, that did not specialize in mattress sales and where the former employee's specialized knowledge of mattresses was less threatening to Mattress City.

d. *Tortious Interference*. 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. However, the client could get into trouble if it solicited the customers or employees in an improper manner, e.g. selling off of confidential, insider information,[8] 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 base its claims.

[8] Like, "I know what you are paying because I worked there. I can give you a better deal."

15. Unworkable. A form may include terms that won't work for the client. Recently, a client came to the firm because the operating agreement which came from a nationally known online form-service required unanimous consent for even ordinary course of business decisions. Not only is this unworkable, but it was contrary to the client's intentions. The client had both the money and the business experience, but under the operating agreement the minority owner had veto power on even everyday company operations. So, not only a proper agreement, but also consultation and advice were necessary.

16. Lack of Knowledge in the Practice Area. In another case, a do-it-yourself business seller used a sample online agreement, but the seller used a sample contract designed for an *asse*t 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.

a. *Trademarks*. Although not strictly a contract case, this is a lack of knowledge and experience case: In another matter involving the use of a form, the client filed for a federal trademark through a nationally known online service. The online service 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. Working with an attorney would have avoided this problem.

17. Taxes, Taxes, Taxes. Taxes may be the "tail that wags the dog" in many transactions. For example, taxes vary in redemption or cross-purchase of stock, and in asset versus equity sales. In the purchase of a business by asset sale federal tax law requires the buyer and seller to agree to the "Allocation" of the purchase price to the various assets, e.g. goodwill, inventory, furniture, fixtures and equipment, non-competition, etc. This is a prime example of what is always true in contracts: the parties and their lawyers are *adverse*. The respective legal counsel know the benefits of Allocation to their client and *advocate* in favor of their client. The consequences of not knowing the tax ramifications of your business transaction can be huge. And the advice needed precludes the use of a form.

Conclusion.

Above is more than a "baker's dozen" of reasons why 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.[9]

Bonus.

Below are some "One Minute Lectures" of practical advice. They continue the reasons why using a lawyer to get a good agreement is important.

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 ligation attorney to sue or defend under it, especially if the action requires emergency legal proceedings. As with preventative medicine, under a cost-benefit analysis, "preventative law" is a "no-brainer."

Taking Knowledge for Granted. 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 estimated legal costs to draft proper business purchase sale documents. This is in spite of the fact that (a) perhaps unknown to the seller – who may have a "form mentality" about legal 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.

Double Standards. 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 of 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. Were I a cynic I would say the lawyer's services are more valuable because the lawyer has no stake in the outcome except to have a satisfied client; the lawyer is not paid a commission to close the deal. The broker is not paid unless it does.

The Skyscraper Speech. 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 they liked him), or likes doing so, but because he knows they help him

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

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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