CONTRACT PITFALLS IN SMALL BUSINESS OPERATIONS

An Ounce of Prevention . . .

By Matthew Schaap

Contracts are a critical component of the U.S. economy. They establish basic expectations and create a framework for understanding the complex relationships that develop among governments, businesses and consumers.

For business owners, contracts are extremely important. But convincing business owners of this is sometimes difficult.

Adhesion Contracts (Not the Kind from the Glue Factory)

"Adhesion contracts" actually have nothing to do with glue, at least not when lawyers talk about them. A "contract of adhesion" or "adhesion contract" is a standard form contract offered by a powerful party to a weak party, often on a take-it-or-leave it basis. Think cable contracts. Did you negotiate with your cable service provider about its disclaimer of warranties? Of course not: you actually wanted to watch TV.

Americans tend to take for granted the importance of contracts, and contract law. But who can blame them? Americans are awash in take-it-or-leave-it consumer contracts offered by companies ranging from mobile phone providers to garbage haulers. These contracts of adhesion are never negotiated, except perhaps as to pricing.

In this context, consumers have little influence over what the contract terms will be. Seemingly, their only options are to 1) accept the adhesion contract as is or 2) find another company with a more favorable adhesion contract. The problem is that finding a better contract is sometimes difficult in markets where only a few large players participate.

The end result for consumers is helpless submission. This may sound painful, but it's usually not. But because they cannot change adhesion contracts, most consumers don't read them. Consumers find their time is better spent in more productive pursuits, like checking out the latest cat videos on YouTube. (In short, most consumers are content to remain oblivious about adhesion contracts.)

Why Business Owners Should Care About Contracts

The goal of this article is not to convince anyone to read adhesion contracts like Google's Terms of Service (although readers might find that document interesting). The goal of this article is to convince readers, particularly small business owners, to respect contracts and to take them very seriously.

But in many ways, business owners act like consumers when it comes to contracts. They don't carefully review them. Over time, business owners develop anecdotal evidence that reading contracts is not important. In other words, if the failure to read contracts does not result in a tangible consequence, for example, a lawsuit, business owners reason that their relaxed contract practices must be satisfactory. This logic tends to prevail over better judgment, right up to the point when contract litigation begins. It is usually at that stage that regret takes hold, and questions begin. What if I had taken just a half hour to read this contract? Why did I sign this personal guaranty? Why didn't we include a clause that would have protected us more thoroughly? Far too often, business owners ask these questions in the midst of a lawsuit, when it's too late to change the contract.

And here's the big difference: When consumers don't read contracts, the stakes are usually (but not always) pretty low. The satellite radio subscription lapses. The cable gets shut off. No one picks up the garbage. Usually, when there is a breach by the consumer, the arrearages are small, and the financial consequences are minimal. Even the mobile phone contract cancellation penalties pale in comparison to the financial consequences that can result when a small business owner fails to read a three-year copier lease, a 10-year commercial lease, or a master reseller agreement.

This brief article speaks to the risks of improper planning. It encourages business owners to start today, and to define a contract strategy. A business that routinely offers contracts to customers (a rental business, for example), needs to carefully consider not the 50 customers who behave appropriately, but the one customer who does not.

With contracts, words matter. They affect rights. They influence outcomes. Contracts are significant in business, and as with any high-stakes or high-risk business proposition, contracts should be treated as serious documents to be entered into only after serious consideration. Carelessness in this realm can have significant, sometimes devastating consequences for businesses (and individuals) in contract litigation.

By applying the ideas below to your own business, you may develop strategies for protecting the business that provides a livelihood for you and your employees. Your business is important. Protect it.

Don't Let Simple Mistakes Become Major Litigation Headaches

Savvy business owners understand the value of contracts. By answering a few basic questions, small business owners can avoid simple mistakes, which can eliminate, or substantially reduce, major contract litigation headaches in the future.

Should It Be In Writing?

Contracts provide value because they establish the expectations of the parties entering into the contract. When contracts are in writing, these expectations are often easier to see, interpret and understand. Memories of oral representations fade. Documents preserve these representations so that documents may be relied upon, instead of memories. By putting an agreement in writing, many evidentiary issues may be avoided later on when questions arise about the terms of the contract. In some cases, statutes automatically prevent certain agreements from being enforced unless they are in writing. **When in doubt, put it in writing.**

Can It Be Written On A Napkin?

Everyone probably knows someone who brags about writing a million dollar contract on a napkin in a restaurant. Or maybe it's just me. But if you do have an anecdote like this, your favorite litigation attorney probably has plenty of horror stories about similar situations, about clients that did not take proper precautions and ended up signing a poorly drafted, poorly reasoned or incomplete contract. At times, it might as well have been written on a napkin. But this is rarely a wise choice. **When you write it down, think it through; avoid napkin contracts.**

Who Should Sign It?

As a small business owner, particularly in a limited liability entity like an "S" corporation or an LLC, the whole point in forming those entities (or at least a pretty significant one) is to limit personal liability should the business fail. Most small businesses do fail, so it only makes sense for small business owners to use the protections of the entity for their intended purpose: to limit personal risk exposure.

One way to leverage these protections is by making certain that no individual shareholder, officer or director is financially obligated under the contract. Until someone figures out how to allow a legal fiction like a corporation to actually hold a pen, corporations will still always require a human to sign their contracts for them. But the important part is making certain that the human doing the signing is not personally liable under the contract (unless they actually intend to be, which is sometimes the case).

Example 1

For example, a strong contract signature block would read as follows:

XYZ CORPORATION	**[Legal name of entity entering contract]**
______________________________	
John Doe **Its: President**	**[Name of person signing]** **[Title of person signing]**

By signing on the line, John Doe's exposure to personal liability would be limited because it would be clear from the signature block that he was signing on behalf of the corporation, not in his individual capacity. The contract would need to be consistent with this signature block to provide full protection. While there are always exceptions to the general rule about personal liability exposure (such as through veil-piercing arguments), a strict policy about contract signature blocks is a sensible way to avoid some of the most simple and unnecessary exposure to personal liability.

A Word of Caution: Even if a contract is properly drafted to include all of the elements necessary to protect a signer against personal liability, the failure to observe corporate formalities can sometimes lead to creditor arguments designed to "pierce the corporate veil," allowing them to collect debts from the wealth and personal assets of an owner or investor. In other words, although business activity conducted through a corporation usually shields its individual investors from personal risk exposure, this might not be the case if individuals in the corporation fail to follow corporate formalities and generally treat the corporation as a "sham entity."

Example 2

For example, a problem contract signature block would read as follows:

XYZ CORPORATION and **John Doe**	**[Includes name of individual as a party being bound]**
______________________________	
John Doe	**[Name of person signing]** **[No reference to the title of the person signing]**

In this example, unless John Doe intends to expose his personal assets to the other party to the contract, Mr. Doe should use the signature block in Example 1 above, not Example 2. However, there are times when personal guaranties are part of contract negotiations. A landlord may demand a personal guaranty from a commercial tenant as part of a lease. Where a personal guaranty is required, the whole point of the guaranty is to make John Doe personally liable. This means that there are times when John Doe may not be able to structure the deal to avoid personal liability in the event of a breach. However, it is important that small business owners only sign contracts like Example 2 when they actually intend to be held personally liable for performance under the contract.

Example 3

If your business is the party asking for the contract, it's always a good idea to make sure the person signing it on the other end actually has authority to bind the other entity. For example, you might not want to ship goods to XYZ CORPORATION if the signature block looks like this:

XYZ CORPORATION	**[Legal name of entity entering contract]**
______________________________	
John Doe	**[Name of person signing]**
Its: Janitor	**[Title of person signing]**

Attorneys often make arguments about whether a signer or agent had "actual authority" or "apparent authority" to bind an entity to contractual obligations. Needless to say, if the signer was the janitor, your attorney is going to have a very difficult time enforcing that contract (unless it's a contract for cleaning supplies). The point is that the person signing needs to have the authority (actual or apparent) to bind the entity named in the contract. And while it may be easy to avoid being duped by the company janitor, titles in large companies are nearly limitless, and where small companies contract with large ones, they should be careful to understand when a "Purchasing Agent" or "Supply Manager" can sign on behalf of (and bind) a large company.

Brainstorm For Your Business

Planning for the future is exciting, and expanding a business is exhilarating. But when it comes to risk protection, many business owners don't think through their legal options until they experience a costly consequence of a failure to plan. Prudent business owners consider how contracts can support and protect their growing business operations. Careful business owners think about how a strong contract can prevent future pain.

Contracts range from the very basic to the very complex. For a more comprehensive list of contract types, visit this page. But as a business owner, a few basic agreements can form the foundation for a strong start, and can pay dividends in the future. Here are just a few of them:

- **Non-Compete Agreements.** As businesses grow, they hire employees. Key employees are critical to the success of small businesses. However, in many small businesses, key employees are given unfettered access to ideas, operations and business strategies. In many cases, this access fosters loyalty and allows key employees to contribute to the success of the business. However, key employees, particularly good ones, may have aspirations to advance more quickly than their current jobs allow. They may even aspire to be the owner. If they act on these desires, particularly if they do so *en masse*, the result can be devastating to a small business. Customer lists can be compromised, and customer relationships may be damaged beyond repair. A strong non-compete agreement can prevent or discourage these damaging departures before they happen. It can also provide a powerful remedy to small business owners who are faced with damage control after the departure occurs.

- **Non-Disclosure Agreements.** Small businesses are often protective of their information, both technical and financial. Unlike publically traded companies, small businesses do not disclose their financial information to the public. Small businesses may also develop trade secrets, customer lists or other strategic market data that they do not wish to disclose to competitors. By requiring employees to sign non-disclosure agreements or "NDAs," employers can protect their secret or strategic information. NDAs also bolster trade secret protections in litigation because they demonstrate efforts by a business to maintain an idea as "secret," which is important in trade secret litigation.

- **Commission Agreements.** Many small business owners find that a commissioned sales structure motivates sales staff and controls costs. However, many owners are far too informal when explaining commissions and when setting expectations for commissioned sales people. At times, commission payments may exceed commissions earned. If an employee quits, questions arise about whether an employer may recapture overpaid commissions. A strong commission agreement allows employers to avoid many of these questions.

- **Work For Hire Agreements.** Maintaining control over intellectual property is a high priority for any business that deals in intellectual property issues. Tech companies routinely use work for hire agreements to protect intellectual property created by employees on the job. Work for hire agreements allow small businesses to retain ownership of work created by employees on the job. These documents are generally part of a larger framework of intellectual property protection than may involve patent prosecution or copyright protections.

An Ounce of Prevention . . .

Benjamin Franklin is credited with coining the phrase, "An ounce of prevention is worth a pound of cure." This truth, applicable in life, is no less evident in the realm of contract law. Parties often sign contracts without carefully considering the legal impact of the contract. This failure early on can lead to significant consequences, and expense, in the future. Parties may think a proposed contract "looks" complete and ready to sign. But they may lack the experience necessary to understand why additional contract provisions would be beneficial or might prevent future litigation. A little precaution at the beginning, particularly during the drafting and negotiation stage, can prevent or reduce the cost of contract litigation in the future.

The simplest way to understand this reality is by viewing a contract as an instruction manual for the judge or arbitrator who is tasked with interpreting that contract in the future. For example, if ethanol is shipped from point A to point B by rail and the tank car derails in transit, questions might arise over whether the buyer or seller bears the risk of loss. What if the tank car is destroyed because of a faulty length of railroad track, or, in the alternative, an act of God, such as a tornado? The contract could answer these questions. If it does not, the judge will answer these questions using rules taken from outside the contract, which may not be what the parties expect or prefer.

In other words, by answering questions in a contract and describing what the parties expect to happen when certain events occur, the parties can conduct themselves according to these expectations, for example, by purchasing insurance to protect against a risk of loss.

A well-written contract takes into account the parties' unique circumstances and leaves fewer questions unanswered, even when tragedy or unexpected events occur in the future. In the end, prevention costs far less than what it is designed to prevent: litigation.

About the Author

Matthew Schaap is a business litigation attorney who lives and works in Apple Valley. He routinely litigates contract disputes on behalf of business clients. He has been named to the Minnesota Rising Stars® list for the past five consecutive years.

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