

Drafting Business Contracts (with checklists)

1. Introduction

Contracts are a fundamental part of the law; like tax law, contract law touches nearly every aspect of an attorney's practice. Business contracts range across an incredibly broad area, and include a myriad of specialized types of contracts – Uniform Commercial Code agreements, commercial real estate transactions, software licensing agreements, master services agreements with associated scope of work documents, etc. As an introductory course, we'll address quirks of business contracts in general, but will avoid most of the specialized agreements as they require their own course.

Business contracts usually do not involve two individual parties; rather, they involve two or more entities that each employ multiple people – many of whom will be involved in executing the business contract. A simple contract for the sale of widgets will require executives to negotiate and agree on the terms, managers and operational personnel to recognize, schedule and meet deadlines for deliverables, administrative personnel to shepherd orders through the business process and submit or pay invoices, and back-end workers to engage in quality control, packaging, shipping and so forth. A good business attorney should understand the clockwork behind the client's operations, so that the real-world implications of contract language are considered in advising, negotiating and drafting business contracts.

Furthermore, the world is only becoming more complex as it is 'simplified' by technology. This means that the business processes, systems and workers necessary to fulfill a contract are also more complex. As an attorney, it is generally not difficult to draft a business contract that is legally enforceable on its face – but it is very difficult to draft a contract that meets your clients' needs without knowing the industry, business and processes of your client.

Taking the time to know your client, their industry and the particular deal being struck in a business contract means that an attorney cannot be a mere technician, ensuring

that the drafted contract meets legal requirements. An attorney advising a business must also wear the hat of a businessperson – a skill set that is generally not taught in law school. This generally requires the attorney to engage in an informal course of self-education; frequently, insight can be gained from your clients – observing their successes and failures will provide a significant education that can inform your practice.

2. Basics

A. Definition

A contract is a legally enforced agreement between two or more competent parties who have each promised to do, or refrain from doing, some lawful act. Business contracts start from the same basis as all contracts. Under Pennsylvania law, the basic principles of contract have long been established - to be enforceable, the following three conditions must be met: (1) both parties must manifest an intent to be bound by the terms of the agreement; (2) the terms must be sufficiently definite to be enforceable; and (3) the agreement must be supported by consideration.¹ In general, the first element of contract formation is established through evidence of offer and acceptance.²

B. Interpretation-The Canons of Construction

It is helpful to have an understanding of how courts interpret contracts when drafting them. The principles of contractual interpretation are in some ways similar to statutory construction. It is helpful to be cognizant of a few key canons during the drafting process. First, it is well established that the interpretation of any contract is a question of law for the court.³

¹ Lombardo v. Gasparini Excavating Co., 385 Pa. 388, 123 A.2d 663, 666 (Pa. 1956); Stelmack v. Glen Alden Coal Co., 339 Pa. 410, 14 A.2d 127 (Pa. 1940); J.W.S. Delavau, Inc. v. Eastern America Transport & Warehousing, Inc., 2002 PA Super 336; 810 A.2d 672, 681 (Pa. Super. 2001) (citing Biddle v. Johnsonbaugh, 444 Pa. Super. 450, 664 A.2d 159, 163 (Pa. Super. 1995); Linnet v. Hitchcock, 324 Pa. Super. 209, 471 A.2d 537, 540 (Pa. Super. 1984); Cardamone v. Univ. of Pittsburgh, 253 Pa. Super. 65, 384 A.2d 1228 (Pa. Super. 1978)).

² Reed v. Pittsburgh Bd. of Public Educ., 862 A.2d 131, 134 (Pa. Commw. 2004); Koken v. Steinberg, 825 A.2d 723, 729 (Pa. Commw. 2003); Yarnall v. Almy, 703 A.2d 535, 538 (Pa. Super. 1997); Jenkins v. County of Schuylkill, 441 Pa. Super. 642, 658 A.2d 380, 383 (Pa. Super. 1995).

³ Currid v. Meeting House Restaurant Inc., 869 A.2d 516, 519 (Pa. Super. 2005).

C. Language, Clarity and Plain Meaning

The goal of that task is to ascertain the intent of the parties as manifested by the language of the written instrument itself.⁴ When a written contract is clear, its meaning must be determined by its contents alone.⁵ Courts will ascribe the ordinary and plain meaning of the words used.⁶ As such, when a contract is clear courts will not modify the terms from what the parties have expressly adopted.⁷ Therefore, it is key to ensure that the ordinary meaning of the words you use to draft the contract accurately express the parties' expectations.

D. Ambiguity

Where contract terms are susceptible to different constructions or more than one reasonable interpretation those terms will be deemed ambiguous.⁸ The fact that parties disagree as to the meaning of a provision does not alone render a contract ambiguous. Rather, a contract is ambiguous if a court cannot determine its meaning in context without special knowledge.⁹ Courts will then consider extrinsic or parol evidence presented by the parties to resolve the ambiguity.

E. Construed Against Drafter

Under the doctrine of *contra proferentum*, any ambiguous language in written contracts is construed against the party that drafted the contract.¹⁰ This is particularly the case where the drafting party was represented by counsel and the other party was not, though that is seldom seen in commercial contracting.

⁴ Standard Venetian Blind Co. v. Am. Empire Ins. Co., 503 Pa. 300, 305, 469 A.2d 563, 566 (1983).

⁵ Lesko v. Frankford Hosp.-Bucks Cnty., 609 Pa. 115, 123, 15 A.3d 337, 342 (2011).

⁶ Lenau v. CoeXprise, Inc., 2014 PA Super 207, 2014 WL 4696215 (2014).

⁷ Hutchison v. Sunbeam Coal Corp., 513 Pa. 192, 198, 519 A.2d 385, 388 (1986).

⁸ Ramalingam v. Keller Williams Realty Group, Inc., 2015 PA Super 172, 121 A.3d 1034 (2015).

⁹ Neducsin v. Caplan, 2015 PA Super 158, 121 A.3d 498 (2015).

¹⁰ Wert v. Manorcare of Carlisle PA, LLC, 124 A.3d 1248 (Pa. 2015).

F. Reasonable and Rational

Rationality and reasonableness are important canons of construction. Courts will invariably seek the most reasonable interpretation that allows the purpose of the contract to be fulfilled and will avoid tortured interpretations that negate the purpose of the deal.¹¹

G. Consideration

Within the realm of consideration lies another pitfall – ‘intending to be legally bound.’ Pennsylvania’s Statute of Frauds states that “a written release or promise, hereafter made and signed by the person releasing or promising, shall not be invalid or unenforceable for lack of consideration, if the writing also contains an additional express statement, in any form of language, that the signer intends to be legally bound.”¹² The words ‘intending to be legally bound’ appear frequently in ending clauses just before the signature lines. This means that you must carefully consider whether your client needs all or part of the contract to be enforceable regardless of consideration – and whether your client needs to ensure that they can abandon their obligations if they do not receive consideration. It may seem counter-intuitive, but there are a number of situations in which your client will want the contract to be effective regardless of consideration – releases, confidentiality agreements, assignments and guarantees can fall into this category. If this is true, then you will want to ensure you provide for specific remedies if consideration fails, but the ‘intending to be legally bound’ language must remain.

H. Structure of a contract

The purpose of a written contract is to memorialize a deal between parties, define the basic terms, and allocate risk as contemplated.

¹¹ Maloney v. Valley Medical Facilities, Inc., 2008 PA Super 32, 946 A.2d 702 (2008), judgment aff’d, 603 Pa. 399, 984 A.2d 478 (2009).

¹².” 33 Pa. Code Sec. 6.

I. The Parties

When preparing a contract, the first step is to properly identify the parties. Identify the parties in the preamble with descriptions and full legal or corporate names. While seemingly basic, it is particularly important to name the correct legal entity with corporate parties as any error or ambiguity can affect enforceability of the contract. Corporate structures can be complex. It is good practice to check official records of the state in which the corporate entity you represent is domiciled or incorporated to ensure the correct entity is named, and to obtain representations as to the identity of the corporate party from the officer(s) executing the contract on its behalf.

J. Term and Termination

Define the term of the contract and the process for termination. The term is simply the duration of the commercial agreement. Terms can be time based, project based, or relationship based. Renewal provisions can be automatic or conditional but must be spelled out. Without such definitions, parties that continue the contractual relationship after the term can unintentionally alter their agreed terms by course of dealing, subsequent oral modification or waiver.¹³

The termination provisions allow a party to end a contract before the term expires and addresses right of parties after termination. Early termination provisions state circumstances that justify ending the contract and usually involve a material uncured breach or violation of law by one party. The provisions must then state the procedure by which to notify the other party of breach and termination. It is good practice to include termination notification procedures because parties may terminate contracts without notice for serious breaches in the absence of such provisions.¹⁴ Termination provisions

¹³ Note that while most contracts expressly prohibit oral modification and waiver, Pennsylvania law generally allows parties to subsequently modify contracts where the statute of frauds does not apply. Donnelly & Sues, Inc. v. Lilley, 393 Pa. 32, 142 A.2d 284 (1958)(A written agreement may be modified by a subsequent oral agreement).

¹⁴ LJL Transp., Inc. v. Pilot Air Freight Corp., 599 Pa. 546, 962 A.2d 639 (2009).

can also set obligations and rights of the parties after termination, such as termination payments or a final accounting.

K. Recitals

Recitals explain the purpose of the contract. Recitals can be helpful to state the purpose of the contract in a succinct manner. Determine how detailed you want the recitals to be as any inconsistency with the body of the contract can create ambiguity and frustrate your ability to enforce your client's understanding of the deal.

L. Definitions

Definitions are necessary to clarify the understanding of the parties as undefined terms can create ambiguity if the meaning does not comport with your client's understanding. Definitions allow you to restrict or expand a dictionary definition or explain terms specific to an industry or deal. Although the definitions are generally the first section after the recitals, prepare the definitions after you finish drafting the contract.

M. Covenants and Conditions

The covenants and conditions are the operative provisions of the contract. The covenants set forth the basic right and obligations of the parties. Covenants are ongoing promises to act or refrain from acting for the life of the contract. Conditions are specified facts or circumstances that exist at a particular point in time and trigger other contractual obligations. They are often drafted in an "if-then" format.

Covenants and conditions are deal-specific and memorialize exactly how the parties promise to act to accomplish the purpose of the contract. It is important to draft these provisions in as clear a manner as possible so the parties understand the language. Parties often return to these operative provisions when there is a dispute or misunderstanding during the course of dealing.

The drafter will spend most of his or her time on these provisions. Avoid passive sentence structure in covenants as this erodes the distinction between covenants and

conditions. This is important because a breach of a condition has different legal ramifications than a breach of covenant or obligation.¹⁵ Depending on how the contract is structured, breach of one may give a party grounds avoid a transaction whereas breach of another may give rise to monetary damages.

Price and payment provisions are the basic financial terms of the deal and are specified in the covenants. Any payment structure that is formula base, occurs over time, with interest or is variable must be specifically described in this section to avoid ambiguity.

N. Representations, Warranties and Indemnification

Representations memorialize background information, or assumptions, about the parties and the deal. Parties make standard representations to each other about outlines of the deal. In this way, the representations form the basis of the parties' performance obligations as well as any indemnification obligations.

O. Representations and Warranties

The standard representations include the identity and resources of the parties, the operative terms or covenants and the subject of the contract. The representations provide a basis for a claim if a party makes misrepresentations or breaches any warranty. Parties can sometimes use these provisions to disclaim implied warranties arising by operation of law, such as warranties of fitness, quality, merchantability or condition. Implied warranties arise mostly in the context of product distribution or a sales contract. As jurisdictions vary greatly on the operations of implied warranties and how express is

¹⁵ See MDY Indus., LLC v. Blizzard Entm't, Inc., 629 F.3d 928 (9th Cir. 2010), as amended on denial of reh'g (Feb. 17, 2011), opinion amended and superseded on denial of reh'g, No. 09-15932, 2011 WL 538748 (9th Cir. Feb. 17, 2011) (analyzed distinction between breach of condition and covenant).

properly done or even allowed, the drafter should always research the specific warranties at issue.¹⁶

Finally, avoid overly detailed, restrictive warranties or representations as these can become the basis for litigation down the road. Unlike breached covenants or obligations, which give rise to damages for breach of contract, a false representation may give a party a right to rescind or void the contract ab initio with different remedies. The parties' attorneys will want to discuss whether and how to limit such remedies with their client, and negotiate any limitations with the opposing party.

P. Indemnification

Indemnification is a method of allocating risk among the parties in a predictable way. If all goes well in the contractual relationship, no one looks at these provisions a second time. However, as indemnification rights encompass claims and damages to third parties, they are frequently invoked and may be the most important provisions of a contract.

Indemnification provisions expressly shift risk from one party to the other for anticipated costs under specified circumstances. However, they are subject to strict interpretation against the party seeking indemnification under Pennsylvania law. In Pennsylvania, a party may contractually shift all liability onto another party, even liability for its own negligence. However this extreme form of indemnification must be specifically stated in the contract to be enforced.¹⁷

Further, these provisions will be narrowly construed.¹⁸ The character of the exposure on indemnification is so hazardous, and unusual, that the drafter must explicitly

¹⁶ Borden, Inc. v. Advent Ink Co., 701 A.2d 255 (Pa. Super. Ct. 1997).

¹⁷ Bernotas v. Super Fresh Food Markets, Inc., 581 Pa. 12, 863 A.2d 478 (2004); Ratti v. Wheeling Pittsburgh Steel Corporation, 758 A.2d 695, 702 (2000); Ruzzi v. Butler Petroleum Co., 527 Pa. 1, 8, 588 A.2d 1, 4 (1991); Perry v. Payne, 217 Pa. 252, 6 A. 553 (1907).

¹⁸ Bernotas, supra, 581 Pa. 12, 863 A.2d 478.

state the exact obligations being shifted in unmistakable language.¹⁹ Pennsylvania courts will not read into an indemnification obligation words of general import. For example, negligence is different from gross negligence.

Q. Content

Indemnification generally involves one party accepting the duty to defend and the duty to indemnify. The duty to defend requires payment of the other parties' attorney's fees and court costs while the duty to indemnify obligates a party to pay the any judgment against the indemnified party. As such, the obligations ripen at different stages in any dispute.

R. Scope

Pennsylvania law recognizes three forms of indemnification; broad form, intermediate form and comparative or pro-rata. Under a broad form, the indemnitor assumes all liability of the indemnified party, regardless of fault. This is an onerous obligation and is subject to the most strict scrutiny in Pennsylvania.²⁰ With the intermediate form, the indemnitor assumes all liability except that which is due to the indemnitee's sole fault. This can also be interpreted as conditional indemnification.²¹ Under the pro-rata form, each party will indemnify the other only for its own negligence or fault. The pro-rata form is the most common form, also referred to as mutual indemnification and is essentially a restatement of the common law.

S. Conditions and Procedure

Because indemnification is an extreme form of exposure, the events that trigger the indemnification obligation must be clearly stated. Events such as a contractual breach, improper use of intellectual property, negligence and compliance with law or

¹⁹ Pittsburgh Steel Co. v. Patterson-Emerson-Comstock, Inc., 404 Pa. 53, 171 A.2d 185 (1961); City of Wilkes-Barre v. Kaminski Bros., Inc., 804 A.2d 89 (Pa. Commw. Ct. 2002).

²⁰ Hackman v. Moyer Packing, 423 Pa. Super. 378, 621 A.2d 166 (1993).

²¹ Kiewit Eastern Co. Inc. v. L&R Construction Company, 44 F.3d 1194 (3d Cir. 1995).

regulations must be specifically stated to avoid litigation over the indemnification obligation itself.

Moreover, because indemnification is linked with insurance obligations, the contract must state the exact procedures to notify the other party of a tender of claim. Often the indemnitor will have to report the tender to its own insurance carrier to follow through on its indemnification obligation. Finally, because insurance coverage is the main vehicle to comply with an indemnification obligation, the contract should include an insurance provision stating what type of coverage is required as well as the limits, if possible an obligation to name the indemnitee as an addition insured, and should require production of certificates of insurance to the indemnitee each year.

T. Remedies and Limitation of Liability

Remedies for breach, delay or other irregularities can be limited or altered by the contract. The remedies will vary greatly based on the content of the deal and should be tailored to be deal specific. Such provisions may include cumulative remedies which provide contractual remedies in addition to remedies at law, not in substitution. Equitable remedies contemplate situations where monetary damages cannot cure a breach and provide injunctive relief or specific performance. A provision may allow the non-breaching party to substitute a new party to complete the contract performance. Liquidated damages require payment of a fixed amount based on an agreed formula where it is difficult to estimate monetary damages. Sole remedies limit the parties to private contractual relief.

Contractual remedies may be constrained when the contract is subject to a state's commercial code. The applicable code should be reviewed routinely when drafting sales or service contracts.²² These provisions can be as useful as indemnification provisions and are heavily negotiated.

²² See 13 Pa.C.S. § 2719(a).

Contracts can also limit the measure of damages. Many provisions address or waive indirect damages, such as consequential, incidental special or punitive damages. Consider these damages carefully in the context of the deal. Lost revenues or profits may not be incidental. These provision must be consistent with any insurance provisions to ensure both parties have sufficient coverage in place. Also consider carve-outs for fraudulent or intentional behavior.

Damages provisions can also place monetary caps on liability relating to the contract in the form of a dollar amount, contractual fees or a percentage of contractual fees. Frequently, these take the form of limitations on liability in the amount of the contract price.

U. Dispute Resolution Provisions

Dispute resolution provisions allow parties to voluntarily avoid litigation in the context of any legal dispute and submit to the jurisdiction or a mediator or arbitrator. Such contractual provisions are valid and enforceable in Pennsylvania Dispute resolution provisions sometimes require both mediation and binding arbitration.

V. Mediation

Mediation is a non-binding dispute resolution mechanism that provides an alternative to litigation. A mediator mutually selected by the parties facilitates settlement through structured negotiation. In the context of contractual alternative dispute resolution, mediation is often required as preliminary step, or a cooling off period, before binding arbitration.

W. Arbitration

Arbitration is an agreement to submit a dispute to the jurisdiction of a non-judicial fact finder to hear and determine that dispute.²³ In structure, an arbitration is similar to an abbreviated bench trial. Benefits of arbitration over litigation include quicker resolution

²³ Rekun v. Pelaez, 2009 PA Super 113, 976 A.2d 578 (2009); Midomo Co., Inc. v. Presbyterian Housing Development Co., 739 A.2d 180 (Pa. Super. Ct. 1999).

and reduced legal fees – but not always. Discovery in arbitration has expanded in recent years, and the costs of the arbitrator can be a significant additional expense to the case – obviating any reduction in legal fees that would otherwise occur.

Pennsylvania courts favor agreements to arbitrate.²⁴ The issue of whether a dispute is subject to arbitration is for the court, not the neutral.²⁵ The court will determine whether there is a valid agreement to arbitrate and whether the dispute is within the scope of the agreement.²⁶ Parties should consider whether to arbitrate carefully. Once it is determined that a dispute is subject to binding arbitration, the authority of the arbitrator is final and not appealable in the absence of fraud or mutual mistake of fact.²⁷ An arbitrator can make a significant error of law, and there is no recourse. Therefore, the choice of arbitrator is crucial – ensure that your client has the ability to choose an arbitrator competent in the areas of law that impact the dispute.

Dispute resolution provisions should be drafted to explicitly address scope or what types of disputes are subject to the provision. This is important for a court to enforce jurisdiction of the neutral. Provisions should also address obligation to pay fees, any required negotiation period prior to a binding process.

There are many arbitral services. The parties should review the rules and fees of a particular arbitral service before writing it into the contract. The dispute resolution proceeds smoothly and is more cost effective when all parties understand the procedure from the outset. It is important for your client to understand how to invoke dispute resolution so that it is enforceable, binding and no rights are waived in the process.

²⁴ Quiles v. Financial Exchange Co., 2005 PA Super 250, 879 A.2d 281 (2005); McCarl's, Inc. v. Beaver Falls Municipal Authority, 847 A.2d 180 (Pa. Commw. Ct. 2004).

²⁵ Ross Development Co. v. Advanced Bldg. Development, Inc., 2002 PA Super 219, 803 A.2d 194 (2002).

²⁶ Smith v. Cumberland Group, Ltd., 455 Pa. Super. 276, 687 A.2d 1167 (1997).

²⁷ Titus & McConomy v. Jalisi, 713 A.2d 646 (Pa. Super. Ct. 1998).

3. Boilerplate Provisions

While not substantive, boilerplate provisions have important legal implications. Commercial boilerplate tends to address the same topics but the details of the provisions must be deal specific to be effective.

A. Severability

Severability clauses preserve the bulk of the contract in the event that one provision is determine by a court of law to be unenforceable or illegal. While courts have the authority to sever specific clauses if they wish, the presence of a severability clause makes it more likely that the court will preserve the rest of the contract.

B. Integration Claus

An integration clause states that the writing constitutes the entire agreement of the parties. An integrated agreement is not subject to interpretation by parol evidence.²⁸ These clauses are incorporated to prevent a party to the contract from introducing evidence external to the contract itself to change the meaning of the negotiated provisions.

C. Attorney's fees

Pennsylvania, like most jurisdictions, adheres to the American rule, where the parties to litigation are responsible for their own counsel fees unless provided by some recognized exception.²⁹ One such exception is a contractual agreement to shift liability for attorney's fees for litigating disputes between the parties. Courts will uphold attorney's fees provisions that are not unreasonably favorable to the drafter, are not unconscionable and when the fees incurred are reasonable.³⁰

²⁸ Yocca v. Pittsburgh Steelers Sports, Inc., 578 Pa. 479, 854 A.2d 425 (2004).

²⁹ ACE American Ins. Co. v. Underwriters at Lloyds and Companies, 939 A.2d 935, 946 (Pa. Super. Ct. 2007).

³⁰ Bayne v. Smith, 2009 PA Super 11, 965 A.2d 265 (2009).

Attorney's fees provisions generally shift the cost to enforce the contract, or collect on the contract, to the losing party. Where attorney's fees are awarded to the prevailing party, that party must fund litigation until resolution, then move to collect attorney's fees. At that point the court will generally determine whether the fees were reasonable. When drafting or reviewing any such provision, identify when the obligation to pay fees ripens to determine if the provision is an acceptable exposure for your client.

D. Governing law/jurisdiction

As a general matter, contractual disputes are governed by the law of the place with the greatest interest in the transaction.³¹ However, choice of law provisions explicitly state what law the parties agree will apply to the contract and avoid unnecessary choice of law arguments in the context of a dispute. These provisions ensure predictability that the contract will be construed under the laws the parties had in mind at the time of negotiation. This also increases the likelihood that a court will enforce your contract the way you advised your client it would. Choice of law provisions are generally enforced by Pennsylvania courts.³²

Provisions that specify jurisdiction and venue help the parties have predictability as to where the dispute would take place. The closest venue to your client, its operations and where you are admitted to the bar is generally the best and most convenient – but important differences in state laws may impact your decision to choose both the applicable law and the venue for any litigation.

E. Assignment

The purpose of an assignment clause is to specifically state what contract rights may be assigned or to prohibit assignment outright. Such a provision requires consent of both parties. A specific assignment clause is useful because as a general rule any contract

³¹ Budtel Associates, LP v. Cont'l Cas. Co., 2006 PA Super 370, ¶ 8, 915 A.2d 640, 643 (2006)

³² In re Allegheny Intern., Inc., 954 F.2d 167 (3d Cir. 1992); Nationwide Mut. Ins. Co. v. West, 2002 PA Super 282, 807 A.2d 916 (2002).

may be assigned in Pennsylvania unless the contract itself so prohibits.³³ An assignment clause therefore gives the parties more control over the privity element.

While rights and benefits, for the most part, may be assigned,³⁴ obligations generally cannot be assigned to avoid liability.³⁵ Parties can also make assignment of conditional rights or future rights that may arise pursuant to contract.³⁶ Review and draft these provisions carefully because they can significantly affect your client's ability to enforce the contract, or address a lack of performance as contemplated.

F. Force Majeure

A force majeure clause enumerates situations that excuse one party's non-performance for major events beyond the control of the parties. Force majeure clauses must be carefully crafted to address major risks inherent in certain industries. For example, excuse of non-performance for freight embargoes may be applicable to a stevedoring or shipping contract but not to a contract for medical billing services. Force majeure, and its cousin, impracticability of performance, can be difficult defenses to prove.³⁷ This is another reason to take care with the drafting to really address the context of the deal.

G. Waiver

Waiver provisions prevent unintentional or implied waiver of a contractual provision. Waiver can be inferred from the circumstances or when one party allows the other to believe a provision will not be strictly enforced by their behavior.³⁸

³³ Nolan v. J. & M. Doyle Co., 338 Pa. 398, 13 A.2d 59 (1940).

³⁴ Note that assignability varies greatly according to the type of contract involved. The general rule does not necessarily apply to employment contracts, personal contracts or sales contracts subject to a commercial code and the drafter should always review the body of law applicable to the type of contract at issue.

³⁵ Am. Jur. 2d, Assignments § 15.

³⁶ Chiropractic Nutritional Associates, Inc. v. Empire Blue Cross and Blue Shield, 447 Pa. Super. 436, 669 A.2d 975 (1995).

³⁷ Allegheny Energy Supply Co., LLC v. Wolf Run Min. Co., 2012 PA Super 163, 53 A.3d 53, 78 U.C.C. Rep. Serv. 2d 410 (2012).

³⁸ Den-Tal-Ez, Inc. v. Siemens Capital Corp., 389 Pa. Super. 219, 566 A.2d 1214 (1989).

H. Amendments only in writing

As noted above, express provisions prohibiting amendments except by writing do not effectively prevent oral modification under Pennsylvania law.³⁹ Courts will determine whether there was a waiver by examining the circumstances of original agreement and the behavior of the parties under the agreement.⁴⁰ Those oral modifications must be specific and direct, leaving no doubt as to the intention of the parties to modify the contract.⁴¹ Express amendment provisions however do make it more difficult to prove an oral modification as a defense to breach of contract.

I. Counterparts

An execution in counterparts provision creates convenience. It simply allows each party to sign its own copy of the contract to avoid having each party circulate and sign the same copy. This allows for speedier execution for geographically dispersed parties. They have seen increasing use in the digital age – and as it is impossible to predict the complications that might arise at closing, it is wise to include them in every contract.

J. Electronic signatures and seal

Under Pennsylvania law, an electronic signature is legally valid wherever the law requires a signature.⁴² Although contracts do not need to be signed to be valid, an electronically signed contract is enforceable. Again, it is wise to include this provision to ensure no untimely delays in execution.

The statute of limitations for a breach of contract claim in Pennsylvania is four (4) years.⁴³ However, when an ‘instrument’ is executed under ‘seal’ the statute of limitations

³⁹ Carlos R. Leffler, Inc. v. Hutter, 696 A.2d 157 (Pa. Super. Ct. 1997).

⁴⁰ Bonczek v. Pascoe Equipment Co., 304 Pa. Super. 11, 450 A.2d 75, 34 U.C.C. Rep. Serv. 1362 (1982).

⁴¹ Gloeckner v. School Dist. of Baldwin Tp., 405 Pa. 197, 175 A.2d 73 (1961).

⁴² 73 P.S. §2260.303(a)-(d).

⁴³ 42 Pa. C. S. Sec. 5525(a)(8).

is 20 years.⁴⁴ There has been a question regarding what, exactly, constitutes an ‘instrument’ under the law, as the statute fails to define it. The Pennsylvania Supreme Court resolved the question by simply referring to Black’s Law Dictionary, declining to apply the limited definition of ‘instrument’ as set out in Section 3104 of the Pa Uniform Commercial Code.⁴⁵ The Court defined ‘instrument’ according to its ordinary meaning as “a written document defining rights, duties, entitlements, or liabilities, such as a contract, will, promissory note, or share certificate.”⁴⁶

The result is that any contract executed with the word “Seal” next to the signatures will have a 20 year statute of limitations to enforce it – at least until June 27, 2018, if the statute expires without being renewed.

K. Further assurances

A further assurances clause requires parties to cooperate with each other on additional matters necessary to carry out the contract. While they are generally enforceable, they can invite parties to add extra conditions on each other in the course of performance. These clauses therefore should be narrowly drafted and state the specific further assurances necessary if possible.

L. Headings

As a general rule contract headings do not have legal effect on the interpretation of the language. Contracts therefore often include a provision stating that headings are to be construed as part of the contract.

M. Relationship of the parties

The purpose of a contract is to define the relationship of the parties to each other. It is therefore prudent to include provisions that expressly avoid the implication of a

⁴⁴ 42 Pa. C. S. Sec. 5529(b)(1).

⁴⁵ Osprey Portfolio, LLC v. Izett, 67 A.3d 749, 754 (Pa. 2013).

⁴⁶ Id.

relationship where one party become liable for the actions of the other vis-a-vis third parties. These implied relationships can include partnership, agency or employment.

N. No partnership/agency/employment

A formal written agreement is not necessary to form a general partnership under Pennsylvania law. A general partnership can be formed by any voluntary association to conduct a business activity. But general partnership can bring with it significant tax and liability consequences. A 'no partnership' clause may prevent a party to contract asserting a partnership relationship to shift unintended liability to other parties.

An agency relationship also carries with it potential exposure to the principle for the acts of the agent. Agency relationships can arise by implication in Pennsylvania.⁴⁷ An agency relationship requires no special formalities but requires a showing that one party allowed the other to act on its behalf.⁴⁸ Absent a provision clearly stating otherwise, a party could argue that it became an agent of the other party, with the concomitant liability for its actions.

Employment relationships similarly have regulatory obligations as well as tort and tax liabilities not implicated in a standard contractual relationship. Because the test of an employer is based on the parties' behavior and can also arise by implication, it is best to clearly state that there is no employment relationship in any contract that does not contemplate one.

O. Time of essence

Time is of the essence provisions put a party on notice that delay in performance is an incurable breach. Timing is not considered a material term in a contract unless it is

⁴⁷ Basile v. H & R Block, Inc., 563 Pa. 359, 761 A.2d 1115 (2000).

⁴⁸ Pirilla v. Bonucci, 320 Pa. Super. 496, 467 A.2d 821, 37 U.C.C. Rep. Serv. 872 (1983).

specifically so stated.⁴⁹ Therefore time is of the essence provisions should be included where any delay will have significant effect a party, such as construction.

4. Drafting Shareholder, Partnership and Operating Agreements

Each form of business entity (other than a sole proprietorship) is recognized by statute and may have multiple owners. The relationships between the owners and the entity should be governed by a formal document – a shareholder, partnership or operating/membership agreement, depending on the type of entity. Failure to observe this formality can lead to a piercing of the corporate veil – that is, affixing liability for the business’ obligations on the owners.⁵⁰ What typically occurs, however, is that the owners are deadlocked on a decision, or engage in behavior objectionable to each other, and there is no operating document that settles their disputes. This can lead to a virtual shutdown of the business or to lockouts or worse. Having a thorough agreement in place ensures that each owner not only has a clear understanding of the rights and obligations, but of their remedies as well.

The following sections will briefly discuss the types of business entities in Pennsylvania, and then provide an overview of the issues a business lawyer should consider when drafting a document controlling the operation of the entity.

A. Sole Proprietorship

Sole proprietorships are unincorporated businesses owned by one owner/operator. They have no separate legal existence from their owner; all income is attributable to the owner and the owner is responsible for all liabilities of the business. Although sole proprietorships are estimated to be the most numerous, they are rarely encountered by business attorneys as they tend to be run by unsophisticated owners, do not need much in the way of legal services, and frequently cannot afford legal services they do need.⁵¹

⁴⁹ Easton Theatres, Inc. v. Wells Fargo Land and Mortg. Co., Inc., 265 Pa. Super. 334, 401 A.2d 1333 (1979).

⁵⁰ See Lumax Industries v. Aultman, 543 Pa 38, 669 A.2d 893 (Pa. 1995).

⁵¹ See West’s Pa. Forms, § 2:3.

There are no documentary requirements for this type of business – but a frequent question business attorneys hear from these businesses is whether they should have a shareholder agreement or other documents. The answer is absolutely not – if the business ever becomes marketable, having documents in place that are inconsistent with its nature as a sole proprietorship can harm the deal or increase due diligence costs/decrease selling price. The only legal document that sole proprietorships may need is the registration of a fictitious name – many do operate with a business name that must be registered with the Pennsylvania Bureau of Corporations.⁵² Failure to register the name can expose the owner to liability under both the Fictitious Names Act and the Unfair Trade Practices and Consumer Protection Law.

B. Partnership

A partnership is formed, either intentionally or accidentally, when two or more persons or entities engage in a business together. Like a sole proprietorship, no documents need to be filed to create a partnership, but a partnership agreement must exist. The partnership agreement can be formed intentionally, and be either written or oral, or be formed by conduct.⁵³ Formation by conduct or estoppel is a poor way to back into a partnership – a business attorney should recognize when their client may be forming a partnership so that the appropriate documents can be drafted.

Like a sole proprietorship, income taxes are only paid by the partners, and not the partnership – profits and losses are ‘passed through’ to the partners, who pay taxes on them. The partnership files an ‘informational tax return’ and issues Form K-1s to the partners, indicating their distributive share of profits and losses for the year. This eliminates the ‘double taxation’ of C corporations, which must pay income taxes themselves, and whose shareholders must pay tax on the remainder distributed to them.

Like sole proprietors, partners are liable for the debts of the partnership, and for the actions of other partners. This type of partnership is a ‘general partnership,’ and is

⁵² See Pa. Fictitious Names Act, 54 Pa. C.S. § 301, et seq.

⁵³ See Murphy v. Burke, et al., 454 PA. 391, 196-398 (Pa. 1973).

the type of partnership formed by default or if another type is not chosen.⁵⁴ However, Pennsylvania provides for ‘limited liability partnerships’, wherein partners in such an entity are not responsible for the debts of the business or each other (except in certain circumstances, such as debts occasioned by their own behavior).⁵⁵ Furthermore, Pennsylvania provides for ‘limited partnerships’ comprised of limited partners and a general partner. Limited partners have limited liability, but also limited ability to control the business of the entity; the general partner has both the liability and the control provided by statute.

C. Corporations

Corporations are the traditional form of business entity, and have more formalities to observe and generally a more complicated governing structure than the partnerships and limited liability companies. Required annual meetings, regular governmental filings and observance of rules regarding shareholders, directors and officers increase the administrative burdens of operating a corporation.

Corporations come in two primary flavors – C and S. These reflect the sections of the Internal Revenue Code applicable to them; the fundamental difference is that an “S Corporation” is a corporation for which the shareholders have made an ‘S Election’ under 26 U.S.C. § 1361 et seq. The effect of an S election is to treat the corporation as a pass-through entity, like a partnership. Furthermore, there are significant limitations on who may own stock in an S Corporation; no foreign persons or corporate entities (except for certain trusts) may own S Corporation stock, and there may not be more than 100 shareholders. Furthermore, there must only be one class of stock in an S Corporation; while there can be some difference in control between shareholders, any economic preferential treatment of a shareholder runs the risk of a second class of stock being created. Should any of the requirements of an S Corporation not be met, the S Election fails, and the company reverts to a C Corporation. If a failure is not caught in time, and

⁵⁴ See 15 Pa.C.S. § 8311.

⁵⁵ See 15 Pa.C.S. § 8201, et seq.

the company proceeds as if it were still an S Corporation, the additional layer of taxation of a C Corporation can create a significant tax obligation for the company.

In addition, the strict requirements of an S Corporation make buying and selling these entities, and raising capital for them, more difficult. Additional due diligence must be done in a purchase or merger of an S Corporation, to ensure that tax liability does not exist. When raising capital, both the company and the contributor (lender, new shareholder, etc.) want to ensure that preferential treatment of the contributor (which is frequently required in some fashion for new capital) does not create a second class of stock, and terminate the S election.

D. Limited Liability Companies

Limited liability companies (LLCs) are a partnership-corporation hybrid; essentially, they are limited partnerships without general partners. They are passthrough entities, as are partnerships, but have the limited liability for owners as do corporations. They require far fewer formalities to operate, and have become very popular for the creation of new business entities. Furthermore, they are far more flexible than corporations – allocations of profit and loss can be made quickly and without transferring ownership interest, and management does not require a board or officers. LLCs may be managed solely by the members.

E. Drafting the Agreement

The following are issues to consider when drafting any business ownership agreement.

- i. Is the business starting from scratch, or continuing an existing business? This is necessary to know to determine how and where the assets of the new entity will be contributed, and whether liabilities might be assumed.
- ii. What assets are being contributed? Frequently, small and medium sized businesses expect owners to contribute not only cash, but intangible assets such as their work or their contacts and relationships. Consider whether the company needs to

retain these assets in some form, and whether withdrawal should be allowed, and whether/how a withdrawing owner would be compensated for their continued use.

iii. What is the purpose of the entity? Will the entity exist and operate only for a very specific, narrow purpose (i.e. “managing and renting the property located at 123 Main St.”), or for ‘any purpose allowed by law?’

iv. How are profits and losses being allocated? In a C Corporation, these can be varied between shareholders by issuing different classes of stock; such variation is not allowed in an S Corporation. In an LLC or partnership, these can be varied by agreement.

v. How is capital being raised? If loans are made by the owners, ensure that there are separate documents reflecting the loans and providing for commercially reasonable interest rates – otherwise, either the company or the lending owner might encounter tax issues. Further, if the company is an S Corporation, ensure that preferential treatment of a lending owner does not cause the S election to fail.

vi. Will the entity provide for benefits (both ERISA benefits, such as health insurance and 401(k) plans) and perks (i.e. automobile reimbursement, home office costs, etc.).

vii. If an LLC or partnership, designate a tax matters member or partner for the IRS to contact. Further, consider whether an obligation by that person to notify the others should be drafted in the agreement.

viii. Determine how and when owners will have access to books and records. Owners’ attorneys want to ensure that they have maximum access, but manager and company attorneys may want to put limits on the access to avoid unnecessary work and disruption.

ix. Are there restrictions on transfer of ownership interests? If certain members are indispensable, the remaining members will want to ensure they cannot withdraw. Most owners will not want the others to transfer their interest to unknown

third parties – yet most will want to be able to sell and get their equity back when needed. The balance between these interests is frequently struck by requiring or allowing the entity or other owners to buy an owners' interest if the owner leaves – but at a price and payment schedule that can be tolerated without damaging the entity's operations. Pricing can be problematic: it can be fair market value set by an appraiser or by the owners themselves at an annual meeting; book value; EBITDA (earnings before interest, taxes, deductions and amortization), possibly with a multiplier used in the entity's industry; original purchase price or some other scheme. Further, can an owner give their interest to a spouse or child without approval of the other owners? If payment does not occur, does the selling owner have a clawback right to retrieve their equity interest? If the entity needs cash to continue operating, can it suspend payments for a period of time? If one owner has a good deal pending to sell their interest, do other owners have a 'come-along' right to get at least part of their equity purchased at the same time? It is usually in all parties' best interest to have these issues set out clearly and thoroughly at the time of formation.

x. Can an owner be forced to transfer their interest? Especially in service-oriented businesses, where owners provide service instead of capital, and in professionally licensed businesses where owners must have licensure (i.e. health care), it may be critical to require an owner who is terminated or otherwise unable to provide services as an employee to transfer their interest to the entity or the other owners. Not providing for a sell-back may jeopardize the company's professional LLC or PC status, and impact the licensure of the other owners or even whether they can bill services to the federal government. It is rarely in anyone's interest to allow a terminated owner to retain their interest.

xi. Who controls the entity? If a partnership, LLC or close corporation, who are the managing owners, and what limits are there on their powers? Do minority/noncontrol owners have veto rights on certain issues? Do managers have only limited powers? Frequently, limits are provided on amounts a manager can spend, on whether they can bring or settle litigation, on whether they can sell or transfer assets

or invest in non-business related property or interests, on whether they can hire or fire employees and on whether a manager can alter the fundamental business operations of the entity. In all instances, whether and how a quorum is set, meetings are called, notices are given and when proxy votes are allowed should be considered. Annual meetings are required for corporations, but consider whether all entities should have a process for special meetings to vote on certain issues (i.e. purchase offers, unusual or critical losses, business opportunities, etc.), and who can call them (i.e. managers vs. shareholders).

xii. How are owners compensated? Are they employees as well? If so, they should have employment agreements. Do they take profits annually, and how are they divided? Are any owners paid for their services as officers, managers or board members? If a pass-through entity, does the entity have an obligation to pay out at least as much as the tax obligation from the owners' K-1 forms (pass-through entities may realize income for tax purposes that passes through to the owners, but not distribute the income – and by year end, may not even have the cash to distribute)?

xiii. Do the owners want the company to indemnify them from acts taken in the business? Do the owners want to indemnify officers or managers? Should the indemnity be limited in scope or amount? Should the indemnity require that all acts indemnified must have been taken in good faith or not knowingly or recklessly in violation of the law or an obligation? Do the owners want to avoid such indemnity to ensure that their managers and officers are 'kept honest' by a lack of an indemnity shield?

xiv. Is the business one that requires a professional entity (i.e. P.C. or PLLC?). If so, ensure that the owners are licensed and the entity meets the necessary requirements.

xv. What is the term of the entity? Is it perpetual? Partnerships and LLCs will dissolve if an owner leaves, unless provisions are made for continuity. Lack of perpetuity can impact sale value of the entity, and can, if not managed correctly, leave

the owners without a liability shield if the entity terminates automatically on a condition or event.

xvi. Do the owners want restrictive covenants between them? If so, what are the geographic and temporal limits? Do they change depending on whether the owner was terminated as an employee for cause or not? Do owners get to ‘take with them’ the relationships they brought to the entity? What are the consequences of violation? Will the entity have to post a bond to obtain preliminary injunctive relief?

xvii. How will the owners handle disputes arising out of the agreement? What law applies to the agreement, and in what forum or location should the dispute be brought? Should the agreement require alternative dispute resolution? If so, is it mediation prior to litigation, or arbitration? Who pays the ADR provider’s costs? Who pays the costs of enforcement/attorneys’ fees? Are there any liquidated damages that should be considered?

xviii. How will the entity be wound up when it terminates? While the entity’s respective statute provides for this process, it is useful to ensure that your client’s needs are met. How will an accounting of the assets of the entity be made? Who will do this work, and will they be paid for it? Certain decisions must be made during windup, including potential litigation decisions – who makes them?

5. Drafting Purchase and Sale Agreements

Purchase agreements for the sale of a business or its assets are complex undertakings, regardless of the size of the transaction. All of the risks and considerations of a large transaction are generally present in a small transaction, which can make the legal and accounting costs of a small transaction prohibitive. Be careful of the impulse to ‘shave corners’ in a small transaction to save the client legal costs – and if you do, ensure that the risks of such shaving are set out in writing to the client and approved. We will address, below, a number of issues to consider in drafting agreements for the sale of a business or its assets.

There is always a difference between the ‘deal’ and the ‘transaction.’ The deal is the goal of the client in conducting the transaction; the transaction is the legal structure for the deal. As clients are not attorneys, and generally do not structure their deals along transaction lines, these do not align completely – ensure you advise your client on gaps between them. This is most noticeable in letters of intent.

The following is a list of specific areas of concern for both buyer and seller’s attorneys to review in an agreement for the sale of the assets or equity of a business.

A. Letters of intent

Most business attorneys have had clients come to them with letters of intent that have been signed by both parties – and which is, unbeknownst to the client, a binding contract. Within the context of business contracts, a common pitfall with offers and acceptance is the ‘letter of intent.’ Frequently, these are drafted by clients before they involve attorneys, as common wisdom assumes them to be nonbinding. This is not always true, and can lead to contracts being formed accidentally. Preliminary negotiations, both written and oral, do not create a binding contract – and these situations occur regularly in business.⁵⁶

⁵⁶ See Mazzella v. Koken, 739 A.2d 531, 536 (Pa. 1999) (holding that a counter-offer which changed the terms of an offer was not a contract); Essner v. Shoemaker, 143 A.2d 364 (Pa. 1958) (finding that a draft contract executed by only one party was not binding on the other); Onyx Oils & Resins, Inc. v. Moss, 80 A.2d 815 (Pa. 1951) (holding that an agreement in a stock purchase contract to come to ‘mutually agreeable terms’ on a shareholders’ agreement and voting trust was an ‘agreement to agree’ and not enforceable); Upsal Street Realty Company v. Rubin, 192 A. 481 (Pa. 1937) (holding that a unilateral offer not signed by both parties and contemplating a future agreement and containing a right to revoke was not a contract); Highland Sewer and Water Authority v. Forest Hills Municipal Authority, 797 A. 2d 385 (Pa. Commw. 2002) (holding that a memorandum of understanding in which the parties agreed to negotiate and agree to the essential terms of a ‘lease/purchase’ agreement is not a contract); GMH Associates, Inc. v. The Prudential Realty Group, 752 A.2d 889 (Pa. Super 2000) (holding that a letter of intent which specifically disclaimed that it was a contract and subsequent acceptance of an offer which changed the terms of the offer, was not a contract); Joyce D. Olson v. North American Industrial Supply, Inc., 658 A.2d 358 (Pa. Super. 1995) (agreement to sell shares for amounts to be determined later omitted material term and was an ‘agreement to agree’ and unenforceable); Philmar Mid-Atlantic, Inc. v. York Street Associates, 566 A.2d 1253 (Pa. Super. 1989) (a letter of intent that stated it was not binding, and discussed an agreement to negotiate lease terms was not enforceable); Pennsylvania Associates of State Mental Hospital Physicians v. Commonwealth of Pennsylvania, 557 A.2d 825 (Pa. Commw. 1989) (citing Independent State Store Union v. Pennsylvania Labor Relations Board, 547 A.2d 465 (Pa. 1988) (stating that memoranda of understanding between a government employer and a union during negotiations was

However, “[w]here parties have settled upon the essential terms, the intent to later formalize the agreement by writing does not prevent the formation of a contract.”⁵⁷

Inexperienced executives or business owners who are rushing to complete a deal may sign a letter of intent that addresses all essential terms and does not specifically state that the letter is not binding. This may result in your client being bound by what they thought was a preliminary and nonbinding document. Educating your clients who are willing to listen, or being involved when any deal structure is reduced to writing, are the only tools you have to ensure your clients do not fall into this trap.

A properly drafted letter of intent generally contains terms of how negotiations will continue. Confidentiality of the negotiations is generally required, as well as exclusivity – that is, the buyer does not want the seller to enter into negotiations with third parties while talks are ongoing. This removes a tool from seller to find a better price or move the process along, but can reassure a buyer that the seller is serious about the deal. Exclusivity clauses can lead to liability for the seller, so they should not be agreed to lightly. These terms are generally noted as binding on the parties, regardless of whether price and other terms are still being negotiated.

A letter of intent will generally describe the assets or equity to be sold, the purchase price or the formula for determining the price, a timeline of the due diligence process and closing, as well as other agreed-on terms. Ensure that these terms are specifically set forth as not binding on the parties in the letter of intent.

B. Assets or Equity?

A buyer can purchase either the assets of a business or the equity ownership of the business (i.e. the business entity itself). With equity comes the liabilities of the entity, as well as any non-assignable rights. With assets come only the assets purchased – which

not a contract); William R. Liss v. Sheldon J. Liss, 2002 Phila Ct. Com. Pl. LEXIS 89 (*holding that a letter of intent which was expressly conditioned on the parties agreeing to a subsequent agreement was not a contract*).

⁵⁷ Philmar Mid-Atlantic, Inc. v. York St. Assocs. II, 56 A.2d 1253, 1255 (Pa.Super. 1989) (citing Field v. Golden Triangle Broadcasting, Inc., 305 A.2d 689, 693 (1973)).

will not include non-assignable rights. Conventional wisdom is clear – buyers should always attempt an asset purchase, and sellers should always attempt an equity sale. This is because of the issue of potential hidden liabilities – the seller wants to get rid of them, and the buyer wants to avoid them. Known liabilities will be reflected in the purchase price, but hidden liabilities (which may not even be known to the seller) are generally not.

There are times, however, when an equity sale is necessary (i.e. the seller won't sell otherwise, or there are non-assignable assets (such as contracts) that cannot be sold by the seller). It is possible to put amounts in escrow for a period of time to determine if such hidden liabilities appear – and then adjust the purchase price accordingly against the escrowed portion of the buyer's monies. Negotiating the terms and amounts of such escrow can take up a significant part of the attorneys' time on such a deal.

C. Uniform Fraudulent Transfer Act and Bulk Sales Laws

Pennsylvania has adopted the Uniform Fraudulent Transfer Act, 12 Pa.C.S. § 5101, et seq., (“UFTA”) to protect creditors against the debtor's transfer of assets made to avoid the creditor's obtaining the assets. 69 Pa.C.S. § 529 requires that a business entity must give notice to the PA Department of Revenue if it intends to sell 51% or more of its assets or stock to a third party, so that the Commonwealth can pursue any taxes owed against such assets. The Commonwealth will issue a ‘Bulk Sales Clearance Certificate’ if no such taxes are owed.

Buyers' attorneys must keep a close eye on what is being sold, and require that the seller obtain a Clearance Certificate as a condition of payment or closing – or escrow necessary amounts against taxes that might be owed. The parties will want to ensure that the assets transferred are sold for a reasonable arms-length price to avoid liability under the UFTA, or Buyers' attorney will want to consider escrowing part of the purchase price.

Both sides will want to review whether other states' fraudulent transfer or bulk sales laws apply; if the seller or the assets are in another state, such states' laws will have to be reviewed for any potential impact on the transaction.

D. Security

Many asset or equity purchase agreements include a note or payment over time by the buyer. If you are representing the seller, it is important to obtain a security interest against the payments. This can be the buyer's own assets (whether personal or business), the assets themselves, or even a forced resale back of all or a percentage of the equity sold. To ensure that the seller has a quick remedy, a confession of judgment clause in the note is essential. The security obligation should be recorded with the Pennsylvania Department of State by the filing of a financing statement. Failure to do so will leave the seller as an unsecured creditor, who won't recover much, if anything, owed.

E. Environmental Liabilities

Environmental liabilities associated with real estate cannot be avoided by a buyer; the Comprehensive Environmental Response, Compensation & Liability Act (CERCLA) makes clear that liability for contaminated land under the Act is the responsibility of the owner of the land, regardless of who actually contaminated the land.⁵⁸ There are some exceptions, and the Small Business Liability Relief and Brownfields Revitalization Act (codified within 42 U.S.C. 9601, et seq.) was passed to protect certain innocent buyers from such liability – but it cannot be ignored when a business transaction included real estate. Innocent buyers must conduct “all appropriate inquiry” to be insulated from liability. Buyer and seller can allocate liability for potential liability as well as provide for indemnity. These issues are complex and beyond the scope of this chapter, but attorneys for both parties should recognize when potential environmental issues exist.

⁵⁸ 42 U.S. Code § 9607.

F. Allocation of Purchase Price

In the sale of assets, there are generally a number of different kinds of assets sold – inventory, goodwill, operating assets, real estate, accounts receivable, etc. While the sale price reflects what the buyer will receive, it is what the seller receives after taxes that is the true value for the seller. The parties are required to report to the IRS (on a Form 8594) the allocation of purchase price of assets sold to the federal government, which will result in the tax treatment of the sale price – how the income is taxed to seller and how the buyer can depreciate the assets bought.⁵⁹

Proper allocation of the purchase price can result in more income realized by the seller – and potentially increase the buyer’s costs. A buyer will want the purchase price allocated to quickly depreciable assets – inventory, accounts receivable, equipment, etc. The seller will want the price allocated to assets that will provide capital gain, such as goodwill. Both sides should avoid allocating much value to a restrictive covenant, as the tax effect is bad for both buyer and seller.

No matter which side you are on, it is important to negotiate the allocation of the asset purchase price, and to have it memorialized in the agreement – even using the Form 8594 as an exhibit or schedule. The allocation must be ‘appropriate’ under the statute, or the IRS will ignore the allocation – therefore, don’t be greedy – have a good reason for the allocation that you negotiate. Unless you have a tax background, get a tax attorney or good CPA involved to handle this part of the deal.

G. Transfer Taxes

Depending where the assets lie, certain states have transfer taxes or tax stamps required before assets or real estate can be sold. Again, a tax attorney or CPA should assist you in addressing this issue – but it needs to be determined prior to final purchase price negotiations. The taxes may significantly impact the value of the deal, and both sides should be aware of them – and be able to negotiate with each other on who pays

⁵⁹ See 26 U.S.C. § 1060.

them. Depending on each side's then-current tax position, such taxes may have less impact on one side than the other.

H. Confidentiality Agreement

Both sides frequently want the terms of the deal to be confidential; not only do they want competitors, family members and former partners to be kept in the dark, but current employees as well. This is a standard provision in business purchase agreements.

I. Employment issues

If the buyer is purchasing equity or retaining employees, then the buyer's attorney needs to review the potential employee liabilities – including ERISA benefits and contract obligations. If the enterprise has 100 or more employees (with some exceptions), and there will be a plant closing or mass layoff under the WARN Act immediately before or after the transaction, buyer will want to ensure that the WARN Act requirements are met, including providing 60 days' written notice to the Commonwealth and to the employees.⁶⁰ This notice period can impact the closing date and other conditions of the deal, and should be reviewed closely to ensure that it can be accommodated.

If the business is a union shop, successor liability and union relationship must be evaluated as part of the transaction. The buyer may have no choice but to assume the union contract.

J. Assumption of Liabilities

If the buyer is buying equity, or there is a merger, the liabilities follow the entity. If the buyer is buying assets, liability will follow only if (a) buyer assumes liability expressly; (b) there is a de facto merger; (c) the transaction is a mere continuation of the original business; (d) the transaction is a fraudulent attempt to avoid liability; (e) there is inadequate consideration for the sale and failure to provide for the seller's creditors (more

⁶⁰ 29 U.S.C. 2101, et seq.

of a frustration of creditor issue than a fraud issue); (f) the product line exception (relating to continuity of manufacturing product line by a buyer); (g) the duty to warn by a successor of defects in a predecessor's products; and (h) liability imposed by statute (i.e. environmental liability). Each of these potential circumstances should be evaluated by the buyer's attorney prior to the agreement being executed, as they may affect the purchase price, or require indemnity.

K. Employment of Seller's Team

Frequently the buyer needs the seller, or certain of the seller's top employees, to remain with the business to transfer their knowledge and relationships to the buyer and the buyer's team. This cannot be underestimated – and ensuring that the seller's team remains in place long enough to do the job can be critical. Therefore, as exhibits to the purchase agreement, the seller and team should agree to employment contracts keeping them in place long enough to satisfy the buyer. The seller's team will want assurances of compensation and employment term, and the buyer will want assurances of work they will perform, transfer of knowledge and relationships, noncompetition agreements and term of their employment.

L. Material violations

Ensuring that representations and warranties are true is critical – frequently, they are the basis for the underlying deal. The buyer will want to ensure that they are designated as 'material' to the transaction, so that a recovery can be made if they are false. Seller will want limitations on both the scope of the representations and warranties, as well as the length of time buyer can seek a remedy. Most importantly, seller should require a notice and cure period for any potentially false representation and warranty. Some false representations cannot be cured, but if they can, seller will want the opportunity to do so. A typical term for cure is 30 days. Seller will also want a knowledge qualifier – they don't want to be liable for facts of which they could not, in the exercise of due care, be aware.

M. Course of business

During the time period between the letter of intent and closing, the buyer will want the seller to agree they will continue their operations in the normal course of business and not alter or reduce their operations to the detriment of the business or assets.

N. Subordination

If there is seller financing, the buyer may want the seller to agree to a subordination agreement with the buyer's other lenders, to ensure that buyer does not violate its own obligations to the lenders by allowing a third party (seller) to take a primary position in a secured asset of buyer.

O. Asset lists

Regardless of whether there is an equity or an asset sale, buyer will want specific asset lists to be made part of the agreement as schedules. These will be finalized during due diligence, and allow the parties to have a more concrete basis for their price negotiations.

P. Promissory notes

Frequently, the purchase price is not fully paid at closing. Buyer will have to provide a promissory note for subsequent payments. This will be an exhibit to the agreement, and both parties will promise to execute the note at closing. Frequently, in addition to the payment terms, interest rate and default provisions, the note will contain or be ancillary to a security agreement and a confession of judgment clause. Buyers will want to avoid these, but any smart seller will demand both.

Q. Variable payments

Payment is not always set in stone; payments can be based on profitability or sales volume over a period of time after closing, avoidance of potential liabilities, assumption of liabilities, guarantees of future employment, etc. All of these should be carefully

considered, and a tax attorney or CPA should advise on the tax effects of each if included in the transaction.