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THE LEGAL PAD

A Newsletter of Current Business and Legal Matters

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EXCLUSION OF CONSEQUENTIAL DAMAGES: A PROVISION FOR EVERY SALES CONTRACT

By Richard Prosser
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Representing sellers and distributors of goods is a large component of our practice. The most significant portion of this representation is litigation, meaning our client is in a dispute with a current – soon to be former – customer, informal negotiations have failed and a lawsuit has been commenced. When a dispute arises from the sale of goods, the dispute, by its nature, is almost always a contract dispute. Typically, one party has sold goods of some sort to another and the other is dissatisfied with the purchased product. In this sort of dispute, the issue is often not whether there is a legitimate basis for the purchaser's dissatisfaction, but whether the seller is responsible for the purchaser's damages – and if responsible, the limits of responsibility. The limits of responsibility are defined by contract law. Contract law defines the remedies and damages available to the injured purchaser – in legal parlance, the non-breaching party.

Although the law is static, certain aspects of its application can be modified by agreement through the terms of the governing contract. One such aspect that can be modified is the available damages. For sellers, a valuable modification is the exclusion of consequential damages.

WHAT ARE CONSEQUENTIAL DAMAGES?

With the sale of goods, consequential damages essentially are the additional costs and injuries tied causally to the defective goods, i.e., damages beyond repair or replacement of the goods. Examples might include: labor costs incurred in installing and then having to remove defective goods, or property damage incurred from installing or attempting to make use of defective goods. By excluding these types of damages, a seller can greatly reduce its exposure, effectively limiting liability to the cost to repair or replace the goods.

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POTENTIAL IMPACT OF EXCLUDING CONSEQUENTIAL DAMAGES

Such a limitation on damages is obviously valuable, but from a practical standpoint, it can be outcome determinative. The types of disputes that end up in litigation are frequently driven by the injured parties' belief that they are entitled to the types of damages that constitute consequential damages. If these damages are eliminated from the equation, there is less likelihood of litigation, and if there is litigation, there is increased likelihood of settlement.

HOW TO EXCLUDE CONSEQUENTIAL DAMAGES

So, the obvious question for sellers is: how can I exclude consequential damages? The simple answer is to include an express exclusion in the contract terms. If the transaction is a sale of goods on credit, the contract will most often be in the form of a credit application. If it is a COD transaction, the contract will most often be in the form of a purchase order, or invoice, or combination thereof. Either way, the contract document is the place for the exclusion, and the simplest exclusion is to state exactly what you mean, for example: "Seller excludes all consequential damages incurred as a consequence of the breach of the terms hereof."

CAVEAT AND CONCLUSION

A caveat is necessary if you intend to employ an exclusion of consequential damages in your contract documents – or rely upon an exclusion, if you already incorporate such a provision. There are limits to the enforceability of exclusion provisions dependant upon the specific facts and circumstances of the sales transaction. In certain instances, enforceability may be at issue. For this reason, you should seek the advice of a licensed attorney before employing and relying upon a consequential damages provision.

NORTH CAROLINA'S NEWEST CORPORATE FORM – THE L3C

By Chad Cochran
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On August 3, 2010, the North Carolina legislature joined a growing state trend when it created an entity called the low-profit limited liability company (L3C). Currently, seven other states allow the L3C which is a vehicle designed to facilitate traditional, charitable funding with a twist. Similar to traditional non-profit forms, such as a 501(c)(3) corporation, an L3C must exist for a charitable purpose. However, unlike traditional charitable vehicles, the L3C is allowed to enjoy annual profits so long as that profit is not the organization's primary purpose. The idea behind the L3Cs is to gather private for-profit investments to further socially-beneficial goals.

Republican State Senator Jim Jacumin represents one of the L3C entity's largest backers. Sen. Jacumin envisions a structure where nonprofit and community foundations could form an L3C to partner with struggling businesses and industries. For instance, private investors might use an L3C and for-profit investments to purchase and upgrade an outdated furniture factory. In order to preserve jobs in rural communities, the L3C could then lease the factory back to the manufacturer at competitive rates.

Unlike traditional vehicles, an L3C must satisfy three requirements:

- The company must "significantly further the accomplishment of one or more charitable or educational purposes," and would not have been formed but for its relationship to the accomplishment of such purpose(s);
- "No significant purpose of the company is the production of income or the appreciation of property" (although the company is permitted to earn a profit); and
- The company must not be organized "to accomplish any political or legislative purposes."

The entire premise of the L3C is that investments into them should qualify as Program-Related Investments (PRIs) for federal tax purposes. If L3Cs can qualify as PRIs, then private foundations will begin investing millions if not billions into L3Cs throughout the country. Unfortunately, the IRS has not yet ruled upon whether North Carolina's newest entity qualifies for this beneficial treatment. Until that ruling hits the books, North Carolina's newest entity represents a good idea on hold.

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HEALTHCARE CHANGES ON THE HORIZON: THE ABCs OF HSAs AND FSAs

By Cody Loughridge
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As the landscape of modern healthcare in the United States continues to change, we've become inundated with an increase of new "catch phrases" and acronyms. Terms like HSAs and FSAs have forever become part of the American lexicon. But what do they mean and are they right for you and your business in the years ahead?

One acronym which continues to grow in popularity is "HSA". A HSA (health savings account) is a medical savings account available only to those Americans who are enrolled in a HDHP (high deductible health plan). A high deductible health plan is a health insurance plan with lower premiums and higher deductibles than traditional health care plans. This account is generally funded by an employer in lieu of a more traditional heath care plan. Often, the individual account holder can likewise contribute to this account directly. Once funds are deposited into the account, the funds are used for "qualified medical expenses", without any tax liability or penalty. The ability of the individual account holder to use the funds for qualified medical expenses as they see fit is widely considered a benefit of the HSA system. In essence, the individual, and not a health insurance company, is the gatekeeper to his or her own medical expenses. Moreover, the funds deposited into the HSA account roll over from year to year and continue to accumulate if not spent during that year. This allows an individual to save for future health care expenses and expenditures. One major change in HSAs for 2011 is the treatment of OTC (over the counter) medications. Beginning in early 2011, OTC medications can no longer be purchased with HSA funds. An additional change to take place in 2011 is the penalty against the withdrawal of HSA funds for non-qualified expenses. Currently, non-qualified uses of HSA funds are taxed as income and are subject to a 10% tax penalty. Unfortunately, this penalty is scheduled to increase to 20% in 2011.

FSAs are likewise growing in recognition. A FSA (flexible spending account) allows an employee to set aside a certain portion of his annual earnings, pre-tax, to cover certain medical expenses. Unlike a HSA, the FSA is purely funded by the individual. FSAs differ from HSAs in that FSAs are generally seen in conjunction with more traditional health care systems, as opposed to HSAs, which are seen with the high deductible heath plans. FSAs are generally used to cover medical expenses that may not be covered by their traditional health insurance, such as vision or dental expenses. The biggest perceived draw back to the FSA is that unused funds are lost and forfeited and are generally applied to future administrative costs or allocated as taxable income among all plan participants. Until 2013, there was no cap on what an individual could contribute. However, starting in 2013, there will be a limit of $2,500.00 per year in pre-tax contributions to the account. Similarly to the HSA, beginning in 2011, FSA funds cannot be used to purchase OTC medicines. Instead, medicines to be purchased with FSA funds will require a prescription.

In determining which healthcare system or plan is right for you, your family or your business, it's of the utmost importance to keep abreast of the coming changes. Websites like www.healthcare.gov can be a valuable resource in staying on top of the continuing modifications to health care in the United States and can provide important information to consider when determining the type of health care system your business provides its employees.

LOOKING FOR ASSETS TO COLLECT A JUDGMENT

By James Vann
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In the movie Urban Cowboy, Johnny Lee sang "looking for love in all the wrong places". The North Carolina Supreme Court in Kinlaw vs. Harris recently heard a case which could be summarized "looking for assets in all the wrong places". The issue before the Court was whether a debtor's property was free from execution and thereby allowing the debtor to keep the property.

Pursuant to the law in North Carolina, when a creditor obtains a judgment against an individual debtor, the creditor can look to have the assets of the debtor taken and sold to satisfy the judgment. But, the debtor is allowed to keep certain property as "exempt from execution" which means that the creditor cannot take those protected assets to satisfy the judgment.

Exempt property is property owned by an individual debtor (not a corporation, business, LLC, etc) which is specifically allowed to be protected by the debtor from being used in satisfying a judgment against the debtor. Thus, exempt property can be saved by the debtor from being sold to satisfy a debt of the debtor.

What is an Execution? An Execution is a Court Order to the Sheriff of a particular County. This Execution gives the Sheriff the right to look for, collect and sale assets owned by the debtor in order to have the judgment paid to the creditor.

In this recent case, the creditor obtained a judgment against the debtor in the sum of $567,000! The debtor owned two individual retirement accounts (IRAs) solely in his name. The debtor was recently divorced and in the settlement agreement with his former spouse, the debtor received the IRAs and an airplane (yes a plane) and the former spouse received others assets. The debtor made several withdrawals from the IRA accounts in order to pay the federal government for a Medicare fraud claim and other penalties, hospital costs and extraordinary business and personal expenses. The creditor argued that because the debtor had made these types of withdrawals from the IRA accounts, the debtor could no longer claim the IRA accounts as exempt or protected.

Unfortunately for the creditor, the Court did not agree. The Court concluded that the IRA accounts retained their exempt status and in fact the debtor could keep the funds in the IRAs protected. However, the Court did indicate that there "may be some circumstances under which withdrawn funds are no longer exempt from execution". As you can imagine, the Court did not go into detail of the circumstances whereby the withdrawn funds are allowed to be taken. The Court quoted from an earlier case when they said "Trial courts have broad discretion to fashion equitable remedies to protect innocent parties when injustice would otherwise result." In doing so, Courts typically look to the conduct of both parties in weighing the factors.

We have seen similar circumstances when a debtor takes cash from an exempt account and moves them in a manner which allows the creditor to be able to take the funds for satisfaction of the judgment. For example, if the debtor in this case had moved funds from the IRAs to his checking account for general purposes or for living expenses, the creditor would much more likely to have won their argument. Likewise, had the debtor transferred a substantial portion of his funds to his IRAs around the time when the judgment was obtained, the Court might have come to a different conclusion.

What is the lesson to learn from this case? If you are a creditor, it is wise to review the debtor's assets prior to issuing credit to the debtor. If the debtor has substantially all or a large portion of their assets in protected accounts such as IRAs, remember that such accounts are protected from creditors.

If you have questions about collecting judgments, exempt property or Executions, please feel free to call us.

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