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THE LEGAL PAD

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Seasons Greetings from everyone at Vann & Sheridan

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Understanding Sale of Goods Contracts: How to Preserve Your Contract Terms

- By Richard Prosser

"Construction contractors are generally familiar with the application of law to their contracts with subcontractors. Contractors are not so familiar, however, with the nuances of the Uniform Commercial Code and its application to their contracts with suppliers."

This is the summarized opening to an article I recently came across in a construction law journal. For me, these words leapt off the page because it gave credence to a proposition I had personally believed true for some time: general contractors are not as adept in their dealings with suppliers as they are in their dealings with owners and service-subcontractors.

Of course, it is a generalization, but in my experience, it is an accurate one. Whether acquired through the advice of counsel, or self-taught through experience, general contractors usually understand contracts. The nature of the profession requires as much. Largely absent from this understanding, however, is a grasp of the distinctions that arise when dealing with suppliers.

And this makes sense. After all, for general contractors, the majority of construction contracts are for services. Contractors employ subcontractors to construct and install. Although goods are incorporated into the subcontractors' improvements, it is common for the subcontractors to purchase the goods from suppliers.

The objective of the article I discovered was to make general contractors aware of a critical distinction in contract formation when dealing with suppliers versus service-subcontractors. In the interest of keeping a level playing field, I thought it valuable to consider the same point, but from the vantage point of the supplier.

Contract Formation: Goods vs. Services

As between sale of goods contracts and service contracts, perhaps the greatest distinction in contract formation is what is commonly referred to as the "mirror image rule". Every contract requires an offer and an acceptance. To form a service contract, the acceptance must be on precisely the same terms as the offer. It is said that the acceptance must be the offer's "mirror image." If the acceptance varies in the slightest, it is not an acceptance, but rather a counter-offer.

With contracts for the sale of goods, such as contracts with suppliers, the mirror image rule does not apply. The Uniform Commercial Code ("UCC") permits an acceptance to include different or additional terms and nonetheless give rise to a binding contract. The only requirement is that the parties agree to certain key terms or so-called "dickered terms" – generally construed to include subject matter and quantity – and a contract is created.

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The complexity of this shift merits an example. Suppose a general contractor submits a purchase order to a supplier for 100 widgets. The purchase order includes payment terms of 2/10 net 60.

An important caveat is that either party can serve as offeror or offeree. The role of contractor as offeror is used in the examples because it is the more common; it is possible, however, for the supplier to function as offeror. In this context, the same legal principles apply.

Upon receipt of the order, the supplier generates an invoice, which includes its standard terms of 2/10 net 30 and adds that interest is calculated on past due balances at 1½ % per month. Despite the supplier's inclusion of both different and additional terms, the parties have formed a binding contract. Under the UCC, the supplier's variance in payment terms is not considered so fundamental as to avoid contract formation.

On the other hand, if the parties were contracting for services (for example, plumbing installation), the same varying acceptance would not constitute an acceptance at all. Under common law principles, the service-subcontractor's purported acceptance would give rise to a counter-offer that the general contractor could either accept or decline. Without some further action, neither party would be bound.

Avoiding the Other Party's Terms

Now that you know the key formation distinction, the obvious next question is whether the different or additional terms become part of the sale of goods contract. This answer is dependent upon a series of variables, making it a complex and context specific inquiry. But a simpler consideration, which is perhaps equally important – and from a practical standpoint, probably of greater utility – is understanding how to avoid the other party's terms.

Through careful drafting, parties can effectively invoke the application of the common law mirror image rule into their sale of goods contracts. If successfully done, the effect is to prevent a varying acceptance from establishing a contract. When a party extends a varying acceptance, it will merely constitute a counter-offer, which can then be either accepted or rejected.

If the counter-offer is neither accepted nor rejected, and the parties continue performance (i.e., supplier ships and contractor accepts goods), the contract will include only the terms on which the parties' forms agree. Any different or additional terms will fall from consideration. So, working with the facts of the previous example, if a general contractor desires to limit the terms of a potential contract with its supplier, it can do so by explicitly stating in its purchase order that its "offer to purchase is expressly limited to the stated terms." If the general contractor includes this language, a supplier's varying acceptance with different or additional terms will serve as nothing more than a counter-offer.

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If the parties then proceed with performance, the only terms given effect are those on which the parties' separate forms agree – most commonly, subject matter, price and quantity. Typical supplier terms such as heightened interest and attorneys' fees will be excluded.

But this is not the necessary conclusion. The supplier can similarly employ language to avoid the general contractor's terms. If the supplier includes in its invoice/acceptance that "acceptance is expressly conditional on assent to additional and different terms," the supplier's purported acceptance is not treated as an acceptance, but rather a counter-offer for the general contractor to accept or decline. If the parties then perform without any further exchange of documents, the contract, as before, will only include the terms on which the parties' forms agree.

There is one further tip here for the supplier. If you include the referenced language in your invoice/acceptance and then acquire a signature from an authorized representative of the general contractor – not a laborer, but someone with actual authority to enter contracts – before or at the time of the delivery of the goods, the general contractor will have expressed its assent to a contract on your terms. If this occurs, the contract will be to the exclusion of the terms contained in any previously exchanged forms.

So, what is the take away advice? Monitor the document exchange. Review the purchase orders you receive, and if an order includes more than a type and quantity of goods, make sure you obtain a signed invoice/acceptance. If you fail to do so, know that may be giving up valuable contract terms and potentially shifting control of the transaction.

Conclusion

The UCC is intended to facilitate commercial transactions. One way it does this is by favoring contract formation – a function accomplished by relaxing traditional contract principles. This modification of the law is in some ways a sacrifice of formality, and can pose a trap for general contractors who fail to distinguish their dealings with suppliers from owners and service-subcontractors.

Because suppliers deal almost, if not exclusively, in the sale of goods, the documents they use are most often tailored to the UCC. This, of course, puts them in the best position to control the terms of their transactions and benefit from the mistakes of the sometimes uninformed general contractor.

Using the correct documentation, however, is not always enough. When forms are exchanged on both sides, you can expect competing terms. An understanding of how the UCC treats this "battle of the forms", will help you to preserve the application of your terms and maintain control of your transactions.

Discovery- A Necessary Tool

- By Jim Beck

In the course of a lawsuit, the Plaintiff and Defendant have the opportunity to request information from each other regarding the case. The purpose of discovery is to encourage and allow each party to find out what evidence the other party has in support of its case. This process allows the parties to determine the strengths and weaknesses of their case and their opponent's case. Some of the mechanisms for obtaining information include Interrogatories, Requests for Production of Documents, and Depositions.

The parties are allowed by the Rules of Civil Procedure to ask questions and seek documentation covering a broad subject matter, as long as they can show it relates to the case in some way. As an illustration, the Defendant can ask the Plaintiff general questions about its business, who its officers are, and whether it has been involved in previous lawsuits. However, some questions are off limits, as the Rules allow for certain objections. A party can object to a question for several reasons. For example, a party does not have to provide information that is protected by the attorney-client privilege (which protects confidential communications between a party and its attorney).

Discovery is an important part of the litigation process, and can have a major impact on the ultimate outcome of the lawsuit.

The Rules provide a certain time limit for responding to discovery requests, which is generally thirty days and can be extended for an additional thirty days. If responses are not provided in that time, then any objections to the questions are waived. If a party has to file a Motion to Compel discovery because the other party will not respond, then the Court can order the non-responsive party to pay the attorneys' fees incurred in seeking the Order to Compel. Thus, it is important to respond timely to discovery to avoid these implications.

Discovery is an important part of the litigation process, and can have a major impact on the ultimate outcome of the lawsuit. In fact, we were able to exclude a Defendant's defense at a recent trial as a result of its faulty discovery responses. The discovery process can be tedious and time consuming, but can lead to a favorable outcome in the case if done properly and carefully. ◆◆◆

So, You Want To Start A Business?

- by Cody Loughridge

You've made the decision you want to start a business. Now you are asking yourselves, "Which type of business is right for us?"

In North Carolina, there are essentially three dominant business entity types: Corporations, General Partnerships and Limited Liability Companies (LLC). Each type of business has its own advantages and disadvantages that one should consider when choosing which form their business will take.

First, **Corporations**: A corporation is a separate legal entity from its owners, employees, and management. Corporations have lives of their own with certain specified powers and liabilities. A major advantage of the corporation form of business is the limited liability of its owners. The owners of the corporation are not responsible for the profits and losses of the corporation, but rather their liability is confined to their individual investment in the company. On the other hand, a disadvantage to consider is the taxation on corporations. When an owner of a corporation receives profits, the individual must report the profits as personal income. Additionally, the corporation is responsible or reporting the corporation's revenue as well. Essentially double taxation!

Second, **General Partnerships**: A general partnership is essentially two or more persons carrying on as co-owners of a business for profit. An advantage of a general partnership is the lack of formalities. A general partnership can be created without any official memoralization or filing with the State of North Carolina. A partnership can be created through an express agreement of the parties or may arise simply by the parties associating themselves as a partnership. Then again, the major disadvantage for conducting a business as a general partnership is the individual liability of the partners. In short, the partnership and the owners have the same legal identity, thus each partner is liable for the full debts and liabilities of the partnership. There is no limitation on liability to a particular partner's investment.

Finally, **Limited Liability Companies (LLC)**: Many states, including North Carolina, recognize the business form of Limited Liability Companies (LLC). An LLC is essentially a hybrid of a corporation and a general partnership. An advantage of an LLC is that, like a corporation, the liability of the owners (called "members") is limited to their individual investments. However, unlike a corporation but similar to a partnership, an LLC is not taxed as a separate taxable entity. Thus, a member of an LLC is only taxed for the personal income generated; the income of the LLC is not separately taxed on the same revenue. But there are some disadvantages to LLCs. LLCs are not necessarily the best option for businesses hoping to grow and accumulate new investors because investors are still wary of investing in a hybrid type of business. Furthermore, the transferability of a members' interest in an LLC requires unanimous consent of the existing members unless expressly provided for in the articles of organization; thus the transfer of ownership interests in an LLC can be more complicated than in a corporation.

When determining which business model may be the most effective for your particular situation, remember to consider both the advantages and disadvantages of each, including potential tax implications, liability exposure, risk aversion and level of complexity. If you have any questions about starting your new business or which form is best suited for you, please feel free to contact our firm. ◆◆◆

Electronic Signatures Gain Official Approval From North Carolina Court

- By James Vann

Digital signatures have finally been officially approved by the North Carolina Court of Appeals. In a recent decision by the North Carolina Court of Appeals in Powell vs. City of Newton, the Court enforced a settlement agreement even though no settlement agreement had actually been signed. As far as we know, this is the first reference to this statute by the North Carolina Court of Appeals.

The Court reached it's decision in part based upon emails which were sent between counsel for the parties which reflected the settlement terms and which circulated the necessary documents. The Court held that the emails and documents which were sent between attorneys for the parties actually satisfied the signature requirement of the statute and thereby bound the parties to the settlement agreement. The Court went on to say "The parties, by their conduct, impliedly agreed to conduct themselves via electronic means, subjecting themselves to the provisions of the Uniform Electronic Transactions Act".

How Can This Impact Your Communications With Others?

The Uniform Electronic Transactions Act ("UETA") does not apply to all transactions but it does apply to most. It applies only to electronic records and signatures that relate to a "*transaction*", which is defined as those interactions between people relating to business, commercial, or governmental affairs. UETA has the limited objective of ensuring that electronic records and electronic signatures are the equivalents of paper records and manual signatures. Thus, you now may enter into contracts with binding terms without ever actually physically signing a document as you have in the past. Simply agreeing to the terms and conditions of the agreement and responding via email to the other parties may be enough to create a binding agreement.

Agreement to use electronic means between the parties may be derived in several ways including express assent and from the context and surrounding circumstances, including the parties' intent. In some circumstances, the use of a business card that includes your email address may be an indication of asset to contract and bind yourself electronically.

The Court's recent decision to uphold the UETA law is a great start in enforcing the existing law. The primary aspect to remember now is that your electronic communications, including those with smart phones, etc. may create binding agreements with those you contract with.

Have You or Your Business Encountered Customers Filing for Bankruptcy?

- By James Vann

Bankruptcy filings by customers continue to be an issue which business owners must deal with. According to reports recently released, third quarter 2009 bankruptcy filings increased by 33% compared to 2008. However, the third quarter 2009 business bankruptcy filings were slightly lower than the second quarter for 2009.

If you or your business encounter customers and/or vendors filing for bankruptcy, it is wise to consult your attorney as to what actions you can take to protect your rights to payment and/or your rights in existing contracts with the business which filed bankruptcy. Please remember that if your customer or vendor files for bankruptcy, there are certain actions which you may not take due to the automatic stay of the bankruptcy code.

If you have received payment from your customer within 90 days of your customer filing for bankruptcy, you may receive a letter as much as two years later requesting the payments received in that 90 day window to be returned to the bankruptcy court! This is called a preference payment. If you receive such a letter, we suggest you contact an attorney who practices creditor's rights law. There are numerous defenses to the alleged preference payments which can be of advantage to you.

If you have questions concerning your customer or vendor's bankruptcy filing, please feel free to call us to inquire how we can help you.