PROTECT YOUR BARGAINS

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What to do when your partner won't honor a contract

Every day in the business world, companies sign contracts, honor their part of the bargain and then discover that the other side isn't living up to its end of the deal. Most businesspeople enter into agreements assuming that the other party has the same intention and ability to honor the contract. All too often, you learn the hard way that integrity and performance is a one-way street. But you can protect your bargains.

Due diligence

You should know with whom you're doing business. Long-standing relationships can help, but they are not foolproof. One client just discovered that he had been doing business for a few years with someone who was recently indicted for serious crimes. Even though our client had nothing to do with the alleged felonies, the mere association with a potential felon threatened to taint our client's business and reputation. Further, the alleged crimes jeopardized our client's ability to obtain financing, attract investors and operate his company at the same level of profitability.

Of course, finding out you're in business with alleged crooks usually, happens only in Grisham novels. Still, plenty of entrepreneurs learn all too late that they are doing business with people who don't honor deals or would rather fight than deliver on a bargain.

But conducting due diligence can weed out potential problems. Consider conducting background checks and obtaining financial statements and references for the other party. Sometimes, we have checked court records and found lawsuits that demonstrated the other side either can't or won't fulfill their bargains. Likewise, if you talk with people who have dealt with certain companies, you may discover that the other side enters into deals easily enough, but then spends all of their time "retrading." That is, once they've locked you into a deal, they attempt to renegotiate the terms, instead of living up to the bargain.

Spell out your protections

Draft a contract that not only captures the business terms but also protects you if the other side does not deliver. The protections can vary. You need provisions that cover the "what ifs" and provide meaningful remedies if the other side defaults. Often, you will want to establish whether you will go to court or engage in arbitration each has its pros and cons.

You should also draft a clause entitling you to reimbursement of your attorneys' fees if you prevail. Contrary to popular misconception, you are not automatically entitled to payment of your legal fees if you win. You should also have remedies tailored to your particular situation. If the other side defaults, your damages may be unpredictable and hard to prove. So you might want liquidated damages: that is, the other side pays you a predetermined estimate of your losses if it breaches the agreement. But don't try this on your own because technical rules can affect the outcome. A skilled attorney should guide you through this process.

Establish collateral

Collateral can provide you with extra protection when even the best contract fails you. In one case, our side performed its obligations under the contract, but the other side reneged on payment. We chased the other company and the guy who owned it for a couple of years, and he kept dodging collection. But we had an ace up our sleeve because we had put a mortgage on the owner's vacation home as collateral for his company's payment obligations under the contract. When he went to sell the property, we collected the amount owed plus years of interest and attorneys fees. Hail collateral!

There are a variety of types of collateral that may apply to your situation:

Deposits: If you are leasing a property to someone, a deposit can provide a great source of protection in the event the tenant fails to pay. However, there are limits on this protection. If the tenant files for bankruptcy, the deposit might be considered the property of the tenant-debtor and you may have to turn the deposit over to the bankruptcy court.

Mortgages and deeds of trust: In many deals, you can make sure the other side has sufficient "skin in the game" to ensure that they will perform by collateralizing their obligations with a mortgage or deed of trust on their property. Knowing that they could lose their house or other property can be a powerful incentive to performance. Still, there are pitfalls. Even now, the Supreme Court is presently considering a case that may affect the value of a mortgage or deed of trust if the other side files for bankruptcy.

Personal guarantees: Making the other side personally liable for the performance of his or her business can provide a lot of protection. However, you need to confirm that the guarantor has assets or has not transferred property to another party. In one recent case, a guaranty was worthless because years before the guarantor had signed the guaranty he transferred all of his assets to his spouse.

One of the common problems with many types of collateral is their diminished value when the other side goes broke or bankrupt. But there is protection against this risk, too.

Third-party protection

Consider protection provided by third parties. For example, you might require the other side to provide a letter of credit from an established bank. Using a properly drafted letter of credit, you can require payment from a deep-pocketed bank if and when the other side breaches your contract.

Similarly, you can require the other side to provide you with bonds that require a third party, called a surety, to pay or perform when the other side defaults on your deal. For example, "payment and performance" bonds are frequently used in the construction industry to ensure that a credit-worthy financial institution will perform the job and pay subcontractors and suppliers if the contractor does not. There are technicalities that can trip you up. For example, if you pay the contractor when it has not earned the payment, you might release the surety from its obligations under the bonds. Make sure to obtain knowledgeable guidance in preparing and managing bonds, or you may lose vital protection.

Prepare for the fight

Prepare for the fight that you hope will never happen. Save evidence, such as emails between the parties. Send the proper notices when the other side breaches the agreement. Fulfill your end of the bargain so that the other side can't cloud the issues or argue that both sides abandoned the deal. Too many honest and hard-working businesspeople have good cases but struggle to prove them.

One bad deal can wipe out the profit from ten good ones. Even though you may not want to go to the trouble of obtaining protection or preparing for a fight, these measures may make the difference in preserving the benefit of your bargains.

ABOUT JACK GARSON

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Jack Garson's practice focuses on Real Estate, Construction and Business law. He serves as a legal advisor for numerous local, regional and national companies. In his role as legal counsel, Jack also serves as a strategic advisor and lead negotiator. Further, Jack provides guidance on the structure of complex transactions, the resolution of business disputes, the growth and sale of companies, and the management of issues such as liability and risk reduction, employment practices, and enhancing profitability.

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In the past two years, we've grown by 50% through expansions in New York City and, most recently, Charlotte, North Carolina. This growth has provided immense value to our clients and attorneys.

Wherever your industry, Offit Kurman is the better way to protect your business, preserve your family's wealth and resolve your most challenging legal conflicts. At Offit Kurman, we distinguish ourselves by our quality and breadth of legal services—as well as our unique operational structure, which encourages a culture of collaboration and entrepreneurialism. The same approach that makes our firm attractive to legal practitioners also gives clients access to experienced counsel in every area of the law.

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