

Introduction to certain legal issues facing SMEs

The following materials do not constitute legal advice; they are provided for informational purposes only. Please consult your own advisors for the legal consequences of business formation specific to your jurisdiction and circumstances.

OVERVIEW

Part I **Contracts**

Part II **Issues in Commercial Real Estate Leasing**

Part III **Investment and Partnering Issues**

PART I - CONTRACTS

What is a contract?

- A contract is a legally enforceable agreement between two or more parties to do or not do particular things
 - The term "party" can mean an individual person or a company
- All parties must generally have a “meeting of the minds” on a specific subject

ORAL CONTRACTS

- Contracts need not be in writing to be enforceable
 - However, some types of agreements must be in writing to be enforceable
 - Different jurisdictions have different rules for contracts that must be in writing to be enforceable

WHEN DOES A CONTRACT EXIST?

- A contract arises when there is an offer, acceptance of that offer, and sufficient "consideration" to make the contract valid:
- An **offer** must be clear, definite and certain enough so that the offeree would reasonably expect that the offering party is willing to be bound by the offer on the terms proposed
 - An **acceptance** is a clear expression of the offeree's acceptance of the terms of the offer
 - **Consideration** is a legal term given to the bargained-for exchange between the parties to the contract
 - Consideration can include a promise to take action in the future or taking action in reliance of the other party's promise or performance

BREACHES AND DISPUTES

- A party's failure to fulfill an end of the bargain under a contract is known as "breaching" the contract
- When a breach of contract happens, one or both of the parties may wish to have the contract "enforced" on its terms, or may try to recover for any financial harm caused by the alleged breach
- If a dispute over a contract arises and informal attempts at resolution fail, the most common method used to resolve contract disputes and enforce contracts is legal action and the court system

REMEDIES

- If a party to a contract fails to perform, depending on the terms of the contract, the non-breaching party (in addition to bringing an action to enforce the contract) may have other remedies, including termination of the contract, suspending performance of the contract, dilution of ownership or monetary damages
- If you believe that the other party has failed to perform, consult with a lawyer to determine what remedies may be available to you

PART II - COMMERCIAL REAL ESTATE LEASING

KEY ISSUES

- Basic Terminology:
 - **Landlord:** the owner - the person responsible for providing the premises to the tenant
 - **Tenant:** the renter - the person responsible to the landlord for complying with the lease
 - **Premises:** the space the tenant is renting from the landlord
 - **Term:** the amount of time the landlord is obligated to lease the premises to the tenant (and typically the period for which the tenant is responsible to pay rent)

IMPORTANT LEASE PROVISIONS

- **Term:**
 - How long is the lease?
 - When does the lease term begin?
 - When does rent start to be payable?
 - Is there any “free rent period”?
 - Are there any options to extend the term?
 - Consider including a renewal right if there is a concern that business needs may change or the area’s economic situation may change
- **Premises:**
 - The space being rented should be clearly defined
 - If possible, a lease should attach a floorplan of the space to be rented
 - Rights to common space/basement/roof/storage should be spelled out in the lease
 - Is there any right to expand the premises rented (is there room to grow)?
 - Are there any limitations on what the space may be used for?

IMPORTANT LEASE PROVISIONS

- **Rent:**
 - How much is the rent and when must it be paid?
 - Are there any “concessions”?
 - Is the landlord required to perform any services or provide items to the tenant without charge?
 - Is there “additional rent”?
 - For example, is the tenant responsible for other costs such as repairs to the premises or to common areas?
 - Are other “services” provided by the landlord (parking spaces, utilities) that must be separately paid?
 - Is the rent the same over the term of the lease and any extension periods?
 - Rent may be subject to “escalation” clauses, requiring higher rent payments over the course of the term of the lease

IMPORTANT LEASE PROVISIONS

- **Alterations:**
 - Is the space suitable for its intended use?
 - Although most leases will not permit structural changes to the premises, tenant may negotiate for the ability to make non-structural changes without landlord's approval
 - If landlord requires some consent rights, consider negotiating a “ceiling” for alterations below which landlord’s consent is not necessary
 - To provide certainty, consider requiring landlord a maximum period in which to respond to requests for tenant alterations
 - Typically, leases will require that alterations be removed at the end of the lease term (if not extended)
- **Repairs:**
 - Generally, if a lease is for a portion of space in a larger building, the landlord will be responsible for maintenance and repairs to the building and systems
 - Tenant typically will be responsible for its proportionate share of the costs of the repairs as additional rent may be able to negotiate abatement of rent if unable to continue to use the premises for its intended use
 - Generally not in small leases (so it is important to obtain appropriate insurance)

IMPORTANT LEASE PROVISIONS

- **Assignment and Subletting:**

- Can a tenant transfer all or a portion of its obligations to a third party without the landlord's consent?
 - If a lease is assigned, the new tenant will have a direct relationship with the landlord, and the "old" tenant usually will not be involved in that relationship
 - If a portion of a premises is sublet, the tenant is the "Sublandlord" to the new "Subtenant", and the "old" tenant continues to be responsible to the landlord for all obligations under the lease
- Generally, landlords will not permit transfers without their consent, but
 - Landlords may agree not to unreasonably withhold their consent to a transfer
 - Landlords may agree to permit a transfer in connection with the sale of the business
- Remember, if any guarantees are given to the landlord in connection with any lease, the guarantor will continue to be responsible after any transfer unless the landlord specifically agrees to release them from their guarantee

IMPORTANT LEASE PROVISIONS

- **Default:** Generally means the failure of the tenant to comply with the terms of the lease
 - Because landlords have very few obligations under a lease, many commercial leases will not have a separate landlord default provisions
 - Defaults under a lease will permit the landlord to exercise remedies against the tenant, including instituting eviction proceedings against the tenant
 - Defaults generally include failure to pay rent when due (after an agreed cure period), failure to comply with the use or other obligations under the lease,
 - Defaults may also failure of the tenant to take possession of the premises within a period of time after the commencement of the lease term

PART III

INVESTMENT AND PARTNERING ISSUES

BUSINESS OWNERS FACES COMPLEX RELATIONSHIPS WITH “PARTNERS”

- In a business with more than one owner, the owners will need to address how the business will operate
- Who will run/control the business on a day-to-day basis?
- How will big decisions be made (e.g. hiring, opening a new store, selling the business)? Who will have the authority to make them?
- What happens if the owners disagree? Does it matter if the disagreement is so serious it hurts the business?

BUSINESS OWNERS FACE COMPLEX RELATIONSHIPS WITH “INVESTORS”

If a business has “investors” (i.e. people that are not involved in the day-to-day operations of the business), other issues may arise:

- How much of the business are investors entitled to own?
- Should investors get a different “return” if they are investing cash?
- How much control should investors have in the business?
 - Should they have the right to approve important decisions?
 - Should they have the right to fire employees (even if they are the principals/owners)?
 - Will company records and financial information have to be shared with them?

ISSUES FACING BUSINESS PARTNERS

- What role should each partner play in the business?
 - Will each of the partners be committing to equal effort?
 - Does one of the partners bring something else to the business?
 - e.g. ideas, inventions, skills, customers, money
- “We trust each other and want to be equal partners”
 - Nice words, but if it doesn’t work out . . .

ISSUES FACING BUSINESS PARTNERS

- Controlling a business
 - Partnerships of equals can work, but sometimes they don't and breaking up can destroy the business
 - If one partner has control (or 2 of 3 partners have control), the business has the best chance of surviving a disagreement
 - Is there a good solution to a “deadlocked” partnership of equals? Not always

ISSUES FACING BUSINESSES WITH INVESTORS

- When family, friends or “silent partners” invest in a business, several questions must be answered:
 - What form should the investment take?
 - A loan, which will be repaid over time or at a certain time?
 - Equity, entitling them to a continuing “piece” of the business?
 - How much of the business should these investors “own”?
 - How much control should these investors have?
 - What other protections do you need?

PARTNER/INVESTOR ISSUES

- Form of investments
 - The best form of investment is the same form as yours (e.g. if your business is a company, common shares)
 - Sophisticated investors often want a “better” investment (i.e. a “senior security”) than yours
 - This senior security might take the form of e.g. “preferred shares”

PARTNER/INVESTOR ISSUES

- How much of a business should you sell?
 - Valuation: an investor should receive an ownership interest in proportion to the value of his investment relative to the “pre-money” value of your business.
 - Example: if your business is worth \$90, and the new investor proposes to invest \$10, the total value of the business will be \$100
 - The investor’s \$10 investment is 10/100 or 10% of the total value of the business
 - Therefore it would be reasonable for the investor to receive a 10% ownership interest in the business
- How do you know what your business is worth? Essentially, it is a guess although it can become a very sophisticated guess
 - Financial techniques used:
 - discounting projected cash flow
 - multiples of current cash flow
 - comparison to similar business

PARTNER/INVESTOR ISSUES

- How much “control” should investors be given?
 - Fight hard to give them as little control as possible
 - But be respectful of the risks they are taking
- “Minority protections” (for large non-controlling investors)
 - Right to information, especially financial information
 - Maybe the right to approve certain major actions:
 - sale of business
 - change in business
 - major expenditures: new location, new equipment, etc.
 - liquidation
 - performance-based rights (i.e. maybe investors get greater control if you are not as successful with your business as you hoped)
 - Right to representation on the Board of Directors/Board of Managers
 - Co-sale (“tag-along”) rights
 - Right to make additional investments

PARTNER/INVESTOR ISSUES

- What minimal protections do you need if you have outside investors?
 - Operating control
 - Control of resale
 - You should keep control of any investor's sale of his or her ownership interest
 - As a practical matter, resale is unlikely but . . .
 - Control of sale of the business
 - Outright prohibition on sale
 - "Right of first refusal"