

UNIVERSITY OF ILLINOIS  
AT URBANA-CHAMPAIGN

# Startups: Incorporation, Funding, Contracts, and Intellectual Property

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Class 6



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# Today

- Review Exam #1
- Continue learning about contracts



# Contract Summary -1

- What is a legally binding contract?
  - (1) An agreement, (2) Between at least two parties, (3) That is actually enforced by a court
  - Based on objective reasonableness
    - Honor expectations of the parties and practice in industry
  - Lack of clarity is construed against the drafter
  - Contract is often a living document defining the operating relationship between parties
    - Focus on establishing a clear relationship



# Contract Summary -2

- Get it in writing
  - Forces parties to clearly define expectations and obligations
  - Minimizes drift by making a solid record of agreement that parties can refer to later
  - Enforcement, but only as last resort



# Contract Summary - 3

- Historic Case Law
  - Individual states have varying interpretations
- Restatement of Contracts (“Restatement”)
  - High-level law
  - Often persuasive, but not legally binding
- Uniform Commercial Code (“UCC”)
  - Very specific
  - Codified in all 50 states
  - Goods only – not real estate, services, or IP



# Needed For Contract

- Parties
- Offer
- Acceptance
- Consideration
- Performance



# Parties -1

- Note: There are exceptions to almost every rule
  - this is a simplified framework
- First thing needed to form an enforceable contract – parties!
  - Parties must have the ability at law to enter into the contract – the “capacity to contract”
  - Can be any legal entity – person, corporation, government, trust
    - Non-people act through “agents” like CEO
  - Must not be legally “incompetent”
    - Not allowed to enter contract



# Who is Incompetent?

- Who is legally incompetent?
  - Infants – those younger than 18
  - “*Non compos mentis*” – not competent mind
    - Insane – can be temporary, long-term, partial
    - Sometimes drunk
- Those legally prevented from entering agreement
  - Bankrupt entities
  - Under court order



# Joint and Several Liability

- Parties can bind themselves jointly and severally ( joint or several liability)
  - Example – Bob and Tom own adjacent parcels of land and both sign a contract with SpeedyFence, Inc. (SFI) to build a fence between them for \$5,000. Bob later refuses to pay.
  - If contract signed severally, then Tom’s liability is limited to \$2,500 and SFI must sue Bob for the other \$2,500
  - If contract signed jointly, then SFI can sue Tom and collect the whole \$5,000 from Tom – and Tom will have to sue Bob to get Bob’s \$2,500
  - What if Bob is broke? If “Several” – SFI takes the loss. If “Joint” – Tom takes the loss.



# Agreement - 1

- “Meeting Of The Minds”
  - Both sides substantially understood all of the terms of the contract to mean the same thing
- Typically, “offeror” proposes a contract
  - “You cut grass, I pay you \$10.”
- “Offeree” receives the offer and either
  - Declines
  - Counter-offers
  - Accepts



# Agreement - 2

- Bilateral contract
  - The typical contract – two sides
  - Can also be multi-lateral
  - Terms are often negotiated by parties
  - “Bob, will you cut my grass for \$10?”
- Unilateral contract
  - One side sets all the terms
  - Craigslist: “Whoever cuts my grass I will pay \$10.” If someone cuts your grass, you have to pay them



# Agreement - 3

- Express Contract – asking you to cut grass
- Implied Contract -
  - Bob asks you to cut his grass for \$10 one week. Calls you every subsequent week for 10 weeks. The next week you get up early and cut his grass without asking him and claim \$10 as an implied contract
  - It is reasonable to assume that Bob would agree to be bound to pay you \$10 under the circumstances
- Quasi Contract/*Quantum Meruit*
  - Bob didn't call you because he died. (A party to the contract is no more, so no contract can be created.) His estate probably owes you \$10 as a quasi-contract
  - However, recovery is “*in quantum meruit*” – as much as deserved, not necessarily \$10



# *Quantum Meruit*

- *Quantum Meruit* can be very powerful
  - Courts generally don't want people to be unjustly enriched, especially those who appear to be using the law to obtain an unfair advantage
- **But! Don't rely on implied or quasi-contract**
  - It is always better to CONFIRM before doing
  - Preferably using a medium that records
    - Paper
    - Text/E-mail
    - Video
    - Voicemail message



# Legal Enforceability

- Valid contract
  - One that is enforced by the Courts
- Unenforceable
  - Good parties, offer, and acceptance, but something prevents enforcement
- Voidable
  - One or both of the parties may avoid the contract
  - Example – contract with minor is voidable by minor
- Void (void “*ab initio*” –from the beginning)
  - No good from the beginning
  - Example, contract to commit a crime or illegal act



# Voidable Contract Example - 1

- Ann is 16 years old and goes to a car dealership. Dealer knows age, but gives her a car in exchange for her agreement to pay \$500/month for 20 years (\$120K in total payments)
- Voidable – Ann’s mom makes her give the car back – Dealer must take it and Ann does not have to continue paying for car
  - Some states – Ann should pay reasonable value of use of car (compare to rental)
  - Some states – Ann should pay decrease in value of car (drive off lot, car not “new”)



# Voidable Contract Example - 2

- What if Ann misrepresented herself as 21?
  - She gets less sympathy
  - Contract still voidable, but maybe go for larger value for rental or decrease in value to Dealer
- Really based on reasonableness
  - It is not reasonable to think that a court is going to enforce a contract on an infant
  - If Dealer acts reasonably, Dealer is going to get a lot of sympathy - “be made whole”
  - The actual contract itself is voidable, but there may be some sort of *quantum meruit* enrichment that Courts will likely address



# Co-Signer

- Usually Jointly liable with signer
- Include an adult on contract with minor
  - What if Ann's Mom co-signs Ann's loan papers and Ann stops paying?
  - Dealer can't sue Ann – she's a minor so the contract is voidable at her option
  - Dealer CAN sue Ann's Mom – and will likely be able to collect
  - The contract is not voidable as to Mom



# Ratification

- Ann starts paying at 16, then turns 18 and keeps paying for several months
  - Ann is now an adult and has ratified the contract through her behavior
  - Ratified contract is no longer voidable by Ann
- Example – person is insane but recovers
  - Contracts made while insane are voidable, but could be ratified by action made once sane and become binding
  - “Insanity” can be by rage, addiction, intoxication, depression, delirium, etc.



# What is an Offer?

- Once we have parties, what is an offer?
- Restatement
  - Manifestation of willingness to enter into a bargain so made as to justify another in understanding that their assent to the bargain is invited and will “lock-in” the bargain
  - “Bargain” must be clear - meeting of minds
  - “Understanding” must be reasonable



# Offer - 1

- Intent to offer
  - Intent is reviewed objectively (what would someone perceiving the offer think) rather than subjectively (whether the offeror thought she was joking)
  - If a reasonable observer would think that an offer has been made, then it has been
- Solicitation of an offer is not an offer itself
  - “I would like to sell my car for \$1,500.”
  - “Would you give me \$1,500 for this car?”
  - “I would think that \$1,500 would be a fair price for this car.”



# Soliciting an Offer

- The line between soliciting an offer and making an offer can be unclear
- Lack of clarity generally is not desirable
  - Other party may legitimately get the wrong idea – could lead to litigation or loss of working relationship
  - Other party may attempt to use lack of clarity to “improve” their position
  - Suggestion – if you are only soliciting offers, be very clear that you are doing so
  - Also, if you are unsure if the other party is making an offer, ask “Is that an offer?”



# Offer - 2

- Termination of an offer
  - Acceptance
  - Revocation/withdrawal
    - Wait I changed my mind!
  - Rejection
  - Counteroffer – actually a rejection + offer
  - Lapse of party – death, insanity
  - Passage of time - not reasonable to cut grass 2 months later
  - Material change in bargain – grass destroyed



# Revocation

- Generally, an Offeror can revoke an offer at any time for any reason or no reason
- Except when an offeree has paid to keep an offer open – a separate agreement called an “option”
  - “Pay me \$500 and I will keep the offer to sell you my house for \$100K open for a year”
- An option is a contract to make an offer to form another contract unrevocable for a time
  - The contract to make the offer to form another contract unrevocable is binding when the \$500 is paid
  - The underlying contract is unalterable
  - Just an offer - still can be rejected and need not be renewed



# Counteroffers

- Technically a simultaneous rejection of the previous offer and the making of a new offer
  - The original offeror may now accept counteroffer to make a binding contract
  - Prior offer is gone, but may optionally be renewed
  - What about “I accept, if you do X?”
  - Restatement – Must have agreement for all material terms - any proposal for material change in terms cancels original offer
  - UCC – If change in terms is modest, then it will likely be treated as an acceptance.
    - Example “OK, I’ll buy 100 bottles at your price, time, and delivery, but I want 50 red, 30 blue, and 20 white, not 30-30-40.” (all costing the same)



# Lapse of Party/Passage of Time

- Offeror gives an offer, but keels over before you accept – No Contract
- Offeror gives an offer, but offeror is insane – No contract
- Offeror (In June) offers to pay \$10 if you cut their lawn. You wait until December to cut it and then demand payment – No contract



# Material Change in Bargain

- Offeror offers you \$5,000 to level their land.
  - Landslide does it overnight. You see it in the morning and immediately rush to Offeror screaming “I accept!”
    - Likely no contract
  - You accept and then landslide does it overnight – likely a valid contract because the bargain has already been accepted – at the time the contract was formed, there was no change in the bargain.
  - You put a letter in the mail accepting offer, then landslide – likely valid contract under “mailbox rule”



# Method of Acceptance

- Typically, offeror can set the method for acceptance
  - “If you agree, then please stand on one foot.”
  - Silence is generally not sufficient, but could be reasonable under circumstances
    - Example – Sent letter, but hear nothing – likely no contract, especially under Restatement
    - Face-to-face – “indicate you agree by saying nothing for 10 minutes” – likely contract
    - UCC Merchants engaging in typical transaction that they have engaged in before – likely contract



# Battle of the Forms - 1

- Buyers and Sellers often use pre-printed forms, especially merchants
  - Purchase Order (From Buyer to Seller)
    - “I want these goods under my (Buyer’s) terms”
  - Invoice (From Seller to Buyer)
    - “Goods are provided under my (Seller’s) terms”
- Terms in PO and Invoice rarely are identical and are typically in favor of the party sending it – so which terms trump?



# Battle of the Forms - 2

- UCC 2-207 Additional Terms in Acceptance
- Don't need exact agreement for contract, unless contract is expressly made dependent on exact agreement
  - Buyer says, I will buy 1000 Xs, but my purchase is contingent on you accepting the terms of this PO



# Battle of the Forms - 3

- Between merchants, if acceptance is not made conditional on assent to buyer's terms, then seller's terms are part of contract (displacing buyer's) unless:
  - New terms materially alter contract
  - Notification of objection has already been given or is given in a reasonable time after they are received.
- However! - Most buyers POs are made conditional on assent to terms, so based on the written agreement, the PO usually wins



# Battle of the Forms - 4

- Even if the terms are a material change, the offer was contingent, or notification of objection was received-
  - Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract, even if the writings are insufficient
- Often, even if the seller provides the goods in a way other than that specified in the contract, but the buyer accepts it – and by accepting typically adopts the new terms



# *Ultra Vires*

- *Ultra Vires* – beyond the powers
  - Corporations used to be organized for very specific purposes and any agreement beyond those purposes could not be enforced
  - Example: “To operate railroad”- could not acquire new land to expand railroad, only operate current railroad
  - Now, most corporations are organized for “any legal purpose”
  - Can still have UV in some situations
    - Corporation violates state regulations
    - State entity operating beyond charter
    - Non-profit running like a for-profit



# The Corporate Veil - 1

- Usually, an agreement with a corporation is only binding on the corporation, not the corporation's agent
- Example – CEO signs contract that calls for A corp to pay \$2M to B corp for computers, typically only the A corp's assets are at risk, not CEO's
- However, a court may choose to “pierce the corporate veil” to hold the CEO personally accountable for contract in some situations
  - The typical liability limitation of the corporate form is removed



# The Corporate Veil - 2

- The decision to pierce the corporate veil is made by the court under the “totality of the circumstances”
- Typically arises when corporation is not being treated like a separate legal entity:
  - Corp is dominated by one or small group of shareholders that treat it as a personal bank
  - Corp formalities are not observed – yearly board meetings, minutes, etc.
  - Agent seeks to avoid consequences of bad acts by hiding behind corporate form
  - Harder to find that a LLC failed to observe corporate proprieties, but comingling funds or using the corporate form to further fraud or bad acts may still cause piercing



# Non-Binding (Voidable) Contract

- A contract is not binding (voidable) when there is no “meeting of the minds”
  - Mistake
  - Fraud
  - Misrepresentation
- Or when the agreement is not voluntary
  - Duress
  - Undue Influence
- Voidable at the option of aggrieved party only



# Mistake

- Unilateral mistake (by 1 party only)
  - Reasonable mistake? Likely not bound
  - Unreasonable mistake? Probably bound
  - Ex – A thinks there is oil under B's farm, so A contracts to buy B's farm at a fair price for a farm – but there is no oil. A remains bound.
- Mutual mistake
  - C is typically voidable by either party
  - Ex – A agrees to sell land he believes that he owns to B. A makes no representations or warranties. Land turns out to have passed to A's sister by will. C is  likely voidable by either party.

# Misrepresentation

- Misrepresentation is a false statement of fact transmitted from the seller to the buyer that induces the buyer to buy
  - Example – Seller is told by art appraiser that his painting is a Picasso. Seller tells Buyer it is a Picasso. However, it is not. Misrepresentation!
- Misrepresentation can be an honest mistake - Fraud is a “knowing” misrepresentation
- Misrepresentation makes the contract voidable by the Buyer (party misrepresented-to)



# Fraud - 1

- Seller makes a false statement of fact (that the Seller knows or should have known is false) to the Buyer to get them to buy
- Fraud is harder to prove than misrepresentation
  - Misrepresentation - just getting out of the contract
  - Fraud - getting out of the contract, but also often going after the seller for damages
- Most of the time, you just want out of the contract, so you will often go with misrepresentation rather than fraud



# Fraud - 2

- Most states require the following:
  - Misrepresentation of existing fact
    - Representations about the future are typically not fraud (may be warranty – to be discussed later)
  - Materiality of fact
    - Not “Mere Puffing” – misrepresentation of non-material fact. “This car was only driven by a little old lady on Sundays.”
    - But wait? Why would the seller say it if they didn’t intend for it to be persuasive? And if it is persuasive, why isn’t it fraud?
  - Actual Falsity



# Fraud - 3

- Seller's knows or should know of its falsity
- Seller's intent that statement is acted upon
- Buyer's ignorance of falsity
  - If you know they are lying, it's not fraud
- Buyer's reliance on the truth of the representation
  - If they lie about something but it does not persuade you, it's not fraud
- Buyer's right to rely upon it
  - No requirement at law for individual investigation
- Consequent damages suffered by Buyer



# Duress - 1

- Improper pressure placed on the other party that deprives them of their free will
  - Gun to your head
  - “Sell me your painting or I will destroy it!” – likely duress – painting is owned by other party, so destruction would be illegal
  - “Buy my painting or I will destroy it!” – likely not duress – he owns the painting and can do what he wants with his property
  - Most improper attempts to force someone are usually illegal, so it may be better to call the police at the start than have to argue uphill that a contract that you signed should not be enforced against you



# Duress - 2

- Threat must typically be reasonable
  - Threat typically must be accompanied by apparent means of carrying it out
- Threat can be physical or economic
  - Sell me your website or I will subject it to constant DOS attack – likely improper
  - Sell me your store or I will open a competing one right next door and drive you out of business – likely not improper, not duress
  - Pay up or I will report you to the credit bureau - OK
- Contract is voidable by party placed under duress only – not the one placing the duress



# Undue Influence

- One party improperly exploits a position of power over another
  - Especially when there is a disproportionate benefit to the person in power
  - “Power people” – parents (sometimes), boss, priest, lawyer, doctor, psychologist
  - Example – Lawyer persuades client to sign agreement giving lawyer half of the client’s estate
  - Example – Cult leader makes member sign  contract to give cult leader their house

# Consideration - 1

- In order for a contract to be enforceable, there must be an exchange of consideration
  - Something of value
  - Money, goods, services
  - Agreement to do or not do something
- Generally, consideration need not be equal, but must not be grossly unfair
  - Courts are reluctant to second-guess
  - But! it's tough to enforce very one-sided contracts



# Consideration - 2

- Consideration
  - Must have value
  - Must be legal
    - “Give me \$10 and I will not beat you.” Beating is illegal - declining to do illegal act does not constitute consideration. Contract not enforceable
  - Must be possible at the time agreement is made
  - Must be present or future
    - Past acts can't be consideration



# Consideration - 3

- Situations lacking consideration
  - Prior obligation
    - Zoning board rules shop must build a fence. Unbeknown to him, neighbor approaches shop about building a fence. Shop “contracts” to have fence built and split cost with neighbor. Neighbor finds out about zoning board and refuses to pay.
    - No consideration, no contract
    - But what if shop installs an upgraded fence at neighbor’s behest?
    - Likely consideration and enforceable contract
    - If you are the shop, it is better to disclose prior obligation



# Consideration - 4

- Gift
  - A gift is something given without getting anything in return
  - Can't be a gift if consideration is exchanged
    - A agrees to give B a statue as a gift, then decides not to – probably not enforceable
  - But! Watch out for promissory estoppel
    - Same as above, but B spends \$10,000 making a pedestal for the statute
    - A may have to compensate B for B's reasonable reliance on the word of A.



# Acts, Not Words

- It's not the words used when forming the agreement that matter – it's the actual deal – the underlying economic reality
- Example - “If you move to Las Vegas, I will give you \$10,000 as a gift.” Person moves, but offeror refuses to pay – what is the outcome?
  - Unenforceable gift (\$0 to mover?)
  - Gift with promissory estoppel (reasonable value of moving out and back, say \$2,000?)
  - Contract (\$10,000 to mover)?



# Negotiation Process - 1

- The negotiation process may vary widely depending e.g., on industry and complexity
- Timing - Usually several meetings
  - Example - Introduction, Term sheet, Full contract, Closing
  - Term sheet – parties agree on general terms and then turn it over to a lawyer to “paper”
  - Thoroughly review the final contract to make sure it is what you want
  - More meetings/effort when: larger company, bigger deal, more complex, new to other party, any risks



# Negotiation Process - 2

- The process itself may be used to wring concessions.
  - If one side really wants the deal done, they give better terms
  - Don't give the appearance of desperation
    - Don't rush it
    - Work with multiple parties at the same time
  - Do not allow the other party to string you along and delay your development



# Negotiation Process - 3

- Balancing fear/uncertainty and greed/profitability
- Keep BATNA in mind
  - Best Alternative to a Negotiated Agreement
- Negotiation may be influenced by the status of your company, product, the market, and the other party
  - Just because one other party can't make a deal with you right now, doesn't mean that you won't make a deal if things change somewhat



# Practical Contract Terms

- Term Sheet - Make it clear
- Make a fallback/cure if something doesn't go right
- Include milestones
  - Include remedy if milestone is not met



# Time Element Terms -1

- “Reasonably Promptly”
    - Within a reasonable time in light of all the circumstances
    - Objective determination of reasonableness, not your determination
      - Example, you want them to pay on Tuesday, but their cash flow makes it more convenient for them to pay on Friday – Friday is likely reasonably promptly
  - “Immediately”
    - “We will immediately notify”
    - Really? No time lapse at all? Not even to think?
-  Insert time for notification, even if short

# Time Element Terms -2

- “As soon as possible”
  - Still interpreted under objective reasonableness as to whether it was possible to do without causing considerable damage to self
- “Time is of the essence”
  - Performance must be completed by a certain date or time or else the party is in breach
  - Removes “reasonableness” from interpretation and turns it into a hard deadline
- Overall, why not include specific dates/  
milestones?
  - Alternatively, specify effort to be made and/or number of attempts



# Quality Element Terms

- “Best Efforts”
  - Dedicated and sustained efforts, but failure may be excused
  - Not an absolute commitment
- “Reasonable Efforts”
  - Objectively reasonable – not what you personally think is reasonable
  - Without specifying the efforts, this is very unclear and would be difficult to enforce
- “Commercially Reasonable Efforts”
  - They may only have to make reasonable efforts if it makes commercial sense to them



Questions?

See you next week!

