# Business Update

The Legal Newsletter For Maine's Small Business Community Fall 1999

PUBLISHED BY PERKINS OLSON & PRATT, P.A. WITH OFFICES AT 30 MILK ST., PORTLAND, ME • 871-7159 & 21 ELM ST • CAMDEN, MAINE • 236-7070


## *Closing the Deal with a Handshake:*
# The Enforceability of Oral Agreements in Maine

*By Neal F. Pratt, Esq.*

Your house needs painting so you contact an acquaintance that operates a small home repair business. You casually mention to him that you need this work done and ask for a referral. He offers to do it himself at a cut rate of $2,000. Silently congratulating yourself on your obvious business acumen and financial windfall, you quickly accept his offer. You confirm your agreement with a hearty handshake. You arrive home on the evening he completes the job and find a bill for $4,000 in labor and $1,200 in materials. After inspecting his work it also becomes clear that he applied only a single coat of paint, and that the overall job quality is far below your expectations. He responds to your inquiry by stating that he quoted you $4,000, not the $2,000 you remember, that his quote did not include materials, and that it is his standard practice to apply only one coat of paint.

Is this simple hypothetical a clear-cut case of breach of contract? The precise answer under Maine law is: Maybe, maybe not.

In this age of increasing commercial sophistication and mounting lawsuits over contractual relations gone bad, I have often heard people wonder aloud: "What happened to the good old days when you could do business with nothing more than a handshake?" Given that there has been little change in the law of oral contracts in decades, this sentiment apparently laments the passing of a simpler time when people were truer to their word. Setting aside for now the issue of whether society has fundamentally changed over the years, most oral contracts continue to be a legally valid way to conduct business and are in many cases entirely enforceable. Practical considerations, however, dictate that we undertake them at our own risk.

### *What Constitutes a Contract?*

A contract is legally defined as "a promise or set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." Generally speaking, a contract must meet certain requirements to be legally binding.

First, there must be an offer made by one party, which is legally defined as "a manifestation of willingness to enter into a bargain."

Second, there must be acceptance of that offer by the other party, legally defined as "a manifestation of assent to the terms thereof… in a manner invited or required by the offer."

Finally, there must be consideration, which is legally defined as "a performance or a return promise [which] must be bargained for."

Maine's highest court described in the case of Roy v. Danis what is necessary to form a contract:

To establish a legally binding agreement the parties must have mutually assented to be bound by all its material terms; the assent must be manifested in the contract, either expressly or impliedly; and the contract must be sufficiently definite to enable the court to determine its exact meaning and fix exactly the legal liabilities of the parties.

These requirements must be met whether the contract is verbal or written. Obviously, demonstrating that a contract was formed between two parties is much simpler when there is evidence in writing. The primary down side to reliance on an oral contract is that its terms, let alone its very existence, are much more difficult to prove. Subject to some specific exceptions (see below), the law will enforce an oral contract only when the party seeking to enforce it can prove that a contract was indeed made, and that its terms were sufficiently clear. In those instances where a dispute ends up in court, it frequently boils down to a battle of credibility, i.e., one party's word against the other's. Although the ability to establish the existence of an oral contract and/or its terms can be enhanced by a witness to the discussion in which the agreement was reached, or partial performance of the contract terms by one or both of the parties, proceeding without a written contract in conducting important matters is a risky proposition.

### *Are Oral Promises Binding?*

Despite the relative advantages to having an agreement in writing, there are circumstances where courts have enforced oral promises which technically fall short of meeting the requirements of a contract. Under the theory of "promissory estoppel," a promise made by a person to another can be binding if the promisor should reasonably expect it to induce action or forbearance on the part of the promisee and such action or forbearance by the promisee actually occurs to his or her detriment. In other words, if a promisee relies on a promise to his or her detriment, and does so reasonably under the circumstances, the promisor may legally be required to keep that promise even though no formal contract was ever reached.

A particularly ripe field for potential application of the promissory estoppel doctrine is employer-employee relations. For example, if a company represents to an employee that she will be promoted to supervisor upon the retirement of the current supervisor in six months, and based on this representation the employee turns down a supervisory position with a competitor, and after six months the company gives the supervisory position to someone else, the employee may have a cause of action for damages against the company under the theory of promissory estoppel. Even though there was no "bargained for" contract reached, and even though the company received no consideration for stating that the employee would be promoted, the employee will nevertheless have a compelling argument that she relied to her detriment (by rejecting a similar position with a competing business) on the company's promise that she was next in line for the supervisory position, and that the company should reasonably have expected its promise to induce the employee to forego looking elsewhere for a supervisory position. While such cases are either settled or decided in court, advance knowledge of the potential enforceability of such oral promises can avoid unforeseen and unwanted trouble down the road for both employers and their workers.

*continued on page 4*

As your business law counselors, we want to help you avoid liability/expenses from your business dealings. For that reason, this edition of our newsletter focuses on liability issues for business owners. Our hope is that these articles will prompt you to consult us *in advance* of problems.

# Escaping or Saving Close Corporations

*by David J. Perkins, Esq.*

Most Maine corporations are closely held, which means that 5 or fewer shareholders hold the shares. Great care should be taken during the formation of close corporations to ensure that a procedure is in place to break up the ownership of the corporation, in the event of antagonism between shareholders.

Without shareholder agreements covering dissolution or buyout provisions, both minority shareholders and majority shareholders face substantial risks.

The problem is that dissolving a corporation, through litigation, is expensive, time consuming, and the results are highly uncertain and difficult to predict.

The Maine Business Corporation Act, 13-A MRSA Section 1115 sets forth grounds upon which shareholders can seek involuntary dissolution of a corporation. These grounds include:

Deadlock: If the directors or shareholders (where no board of directors is used) are so divided concerning management of the corporation's business that votes cannot be ob tained to direct corporate governance, with the consequence that the corporation will suffer irreparable harm, or the business cannot be conducted to the advantage of the shareholders generally;

Fraud: If the acts of directors or controlling shareholders are illegal or fraudulent;

Waste of Assets: If corporate assets are being misapplied or wasted;

Abandonment of Business: If the corporation has abandoned its business and has failed to liquidate its affairs within a reasonable time.

Significantly, the dissolution provisions states that dissolution will not be denied solely because the corporation's business can be conducted at a profit.

A common dissolution scenario involves a falling out between shareholders. With the stress of business, shareholders are always prone to disagree sharply over the conduct of business.

If the shareholders own equal amounts of stock, then there will be acorporate deadlock. Neither shareholder will have the ability to prevail on votes of the board of directors or the shareholders. This situation will clearly authorize a court to dissolve the corporation, due to deadlock.

If the stock is issued so that there is a majority shareholder, or a body of shareholders who vote together to form a majority vote, the dissolution scenario becomes much more complex and cumbersome.

The minority shareholder will have to complain of illegal or fraudulent conduct by the directors or shareholders in control of the corporation, or that corporate assets are being misapplied or wasted.

Unless the actions of the majority shareholders are egregious, the minority shareholder will often have a difficult case to prove. The directors do have a duty of loyalty owed to the corporation. This duty requires each director to act in good faith, with the diligence and skill of an ordinarily prudent person, and to not use his/her position to gain any special privilege or advantage. However, a well advised or savvy majority shareholder will often be able to freeze the minority shareholder out of the operations of the corporation, without triggering a basis for dissolution based on fraud or illegality.

Regardless of whether you are a majority or minority shareholder, you want to structure your corporation to protect against protracted and unpredictable dissolution lawsuits. These protective agreements should be established at the time of the formation of the corporation. Mandatory arbitration, with an agreed upon arbitrator who has relevant business experience, is one good device. Clear provisions for buying out unhappy shareholders, with precise valuation rules, though, is the most critical component.

---

# Hosting a Party?

## Maine's Liquor Liability Law Applies to You

*By Neal F. Pratt, Esq.*

There are a number of laws on the books intended to protect the public from the potential harms attributable to excessive alcohol consumption. The most notable is Maine's tough drunk driving law. Less conspicuous, but potentially as formidable, is Maine's Liquor Liability Act. Contrary to what many believe, you do not have to be a professional server of liquor, such as a bar or restaurant, to be held liable for serving someone who gets involved in an automobile accident.

Maine's Liquor Liability Act defines a "server" as "any person who sells, gives or otherwise provides liquor to an individual." If you host a party, and you make liquor available to your guests, you would be considered a server under that law. This means that you need to take some precautions.

First, you should make sure that you do not serve liquor to anyone who you even suspect of being underage. You can be held accountable for injuries or damages caused by a minor driver who leaves your party intoxicated if you "negligently" serve liquor. The law considers you negligent if you serve liquor to the minor in circumstances where a reasonable person should know that the drinker is underage. If you know the person drinking the liquor is a minor and you intentionally served him drinks, then your conduct is considered "reckless." That also makes you liable if an accident happens.

Second, whatever the age of your guests, you need to be on the lookout to see whether any of your guests appear to be under the influence. If you serve liquor to someone who is "visibly intoxicated," the law assumes you are disregarding the harm that person might cause, and that is also considered "reckless" and exposes you to liability.

Do the circumstances change if you didn't supply the liquor to the person involved in the accident? Perhaps they do. Let's say someone leaves a party at your home and causes an accident and you get sued. If you could establish that the person was intoxicated before your party and that he did not drink anything at your home, you should be successful in the lawsuit. But, if you were serving liquor to any of your other guests, you may have a difficult time proving who did or did not drink while at your house.

The issue of designated drivers is not addressed in the law. Certainly, it is a good idea for hosts to make them available. However, even though providing access to a designated driver is an act of responsibility, the law does not recognize it as a defense to liability. The law makes you liable for serving liquor. If an intoxicated guest drives home from your party and causes an accident, the fact that you made a designated driver available to him and he chose not to use it does not relieve you from liability.

There are limitations on who is entitled to bring a lawsuit under the Liquor Liability Act. If your intoxicated guest was under 18 years old, he can sue for his own injuries. If, however, he was an adult, he is not permitted to bring suit against you. While other persons can sue for injuries or damages they incur due to the accident, they cannot sue for claims arising out of the injury or death of the intoxicated individual if he was an adult. Of course, to win a lawsuit, the injured party would also need to show that his injuries were legally caused by the server's negligent or reckless service of alcohol. If you were found liable, the law limits a damage award to no more than $250,000.00, exclusive of medical care and treatment.

As a host, the safest course of action to avoid the risk of liability associated with serving liquor in your home is to make sure that you do not serve any minors at all, and that you do not serve or continue to serve anyone who appears even remotely affected by alcohol. While this may seem to place a heavy burden on a party host, the Maine Legislature has taken the position that this burden pales in comparison to the tragic results that have often occurred on our streets as a consequence of drinking and driving.

# Personal Liability of Officers, Directors & Shareholders

*By Richard P. Olson, Esq.*

We often hear people tell us that they have set up a corporation or limited liability company to avoid liability. Both the corporation and the limited liability company (and the now little used limited partnership) offer passive equity holders substantial protection from the torts of their business organizations; however, the officers and directors of corporations, as well as managers and member managers of limited liability companies, face a number of potential liabilities. Additionally, shareholders of corporations or members of LLCs that fail to conform to applicable law and formalities also face exposure.

### Background

Corporations and LLCs are creatures of state statutes. Before their existence, business was done in the form of sole proprietorships and partnerships. The sole proprietor was liable for his debts, as well as those incurred by his agents and servants/employees in the course of their duties. All of the partners were similarly liable for all of the debts of the partnerships.

As businesses expand to require ever larger amounts of capital, states developed the notion that people could invest in an enterprise but would not be personally liable for the debts of those enterprises so long as the investors paid in capital for their shares and remained passive investors.

In theory, a corporation is owned by its shareholders, managed by its directors and operated by its officers. That is the typical structure of public companies. In practice, with smaller companies, the shareholders are often the directors and the officers. They play each role interchangeably.

### Corporate Formalities

Corporate law requires that the fiction of separate ownership and management be maintained in the records and actions of the corporation. Each year we send our clients annual reports required by the Secretary of State, as well as annual resolutions where the shareholders ratify the actions of the officers and directors during the past year, and re-elect directors where necessary.

Each time a corporation wants to open a bank account, lease equipment or borrow money, we prepare resolutions for the directors to execute authorizing the president or other officer to take the desired action. We do it because the failure to respect the fictions of the corporation, failure to "follow corporate formalities" is one of the grounds for a court to "pierce the corporate veil." When a corporate officer enters into contracts on behalf of the corporation, it is important to make it clear that the officer is signing in his or her corporate capacity—"Jane Smith, as President of XYZ Corp."

### Shareholder Liability

In closely held companies, the shareholders are often the officers and directors. Even passive shareholders face liability if the creditor pierces the corporate veil. If the corporate veil is pierced, the shareholders can be deemed to be the legal equivalent of general partners–liable for all of the debts of the enterprise. Courts are reluctant to pierce the veil, but under Maine law a creditor can pierce the corporate veil if: (1) the claimant can demonstrate some misuse of the privilege of the corporate form and (2) an inequitable result. Johnson v. Exclusive Properties, 1998 Me. 244, 720 A.2d 568 (1998).

The Exclusive Properties decision cites twelve factors to be considered in determining whether or not a shareholder has misused the corporate form: (1) common ownership—of multiple corporations; (2) pervasive control; (3) confused intermingling of business activity, assets or management; (4) thin capitalization; (5) nonobservance of corporate formalities; (6) absence of corporate records; (7) no payment of dividends; (8) insolvency at the time of the litigated transaction; (9) siphoning away of corporate assets by the dominant shareholders; (10) nonfunction of officers and directors; (11) use of the corporation for transactions of the dominant shareholders; and (12) use of the corporation in promoting fraud. See The George Human Constr. Co. v. Gateman, 16 F. Supp. 2d, 129, 149-50 (D. Mass. 1998).

Although the law of LLCs is still developing, we expect similar principles will apply regarding the liability of members for LLC liabilities.

### Liabilities of Officers & Directors

Officers and directors of businesses face additional exposure to liability. One often overlooked area of liability lies in the area of tort law. Even though an officer or director is not personally liable as a general matter for the liabilities of the corporation, an officer or director is liable for the torts (such as fraud, negligence or intentional misrepresentation) that person commits or participates in–even if such torts occur in connection with the officer's or director's corporate duties. This principle is obvious in the case where the corporate president punches a customer in the nose. It is less obvious where a corporate officer is individually accused of negligent misrepresentation in connection with making a major sale. See In re Baietti, 189 B.R. 348 (Banrk. D. Me. 1995). Criminal acts done "for the corporation" likewise are not shielded. State v. Placzek, 380 A.2d 1010 (Me. 1977)

Directors and officers are more commonly involved in litigation involving their fiduciary duties to the corporation and the shareholders. The concept of fiduciary duties can be amorphous and the breach of those duties, beyond the obvious, is often determined on a case by case basis. Under Maine law those fiduciary duties can extend to each other in the case of a closely held family business. Rosenthal v. Rosenthal, 543 A.2d 348 (Me. 1988).

An officer is charged with "exercising all due care and vigilance to safeguard property and protect the rights of the corporation." Automatic Accoustical v. Moreira, 348 A.2d 263 (Me. 1975). Furthermore the officer and director has a duty of loyalty and disclosure to the corporation. See Thompson's Point v. Safe Harbor Devel. Corp., 862 F.2d 594 (D. Me. 1994).

In practical terms, this means that officers and directors cannot ignore dangers to the property and rights of the corporation. Directors cannot simply put their heads in the sand. They have an affirmative duty of inquiry to actively manage and protect the interests of the corporation. Directors and officers cannot "usurp corporate opportunities." Under this principle a director who engages in a competing business or starts or participates in a business that acts in an area where the first corporation might be able to participate, without appropriate disclosure, may end up as a defendant in a lawsuit. See Northeast Harbor Golf Club v. Harris, 661 A.2d 1146 (Me. 1995).

Even though directors and officers have substantial duties to the shareholders, they have powerful defenses to certain shareholder claims. The business judgment rule protects officers and directors from lawsuits by shareholders over bad management decisions unless those decisions result from fraud or bad faith. Rosenthal v. Rosenthal, 543 A.2d 348 (Me. 1988).

In stark terms, officers and directors who act in good faith will not be liable to shareholders no matter how stupidly they act with the corporate assets–so long as they are merely stupid and not acting fraudulently or in bad faith.

### Criminal and Tax Liability

The corporation or LLC does not protect individuals from liability for their individual acts. Individuals who participate in the planning, discussion or cover-up of criminal corporate acts may face criminal charges even where their involvement seemed, at the time, to be minor. Remember that criminal investigations of illegal business activities tend to cast a wide net and charges may be brought to pressure relatively unimportant individuals to implicate the central actors.

One type of tax liability that we frequently deal with is liability for so-called "trust fund taxes" such as withholding taxes for payroll taxes, FICA, and the like. Officers of financially troubled companies often decide not to pay these taxes to keep their companies alive. This strategy almost never works and the responsible parties face personal liability for the unpaid taxes which are not discharged by bankruptcy.

### Conclusion

Corporations and LLCs provide valuable opportunities to avoid certain liabilities; however, it is important that you recognize their limitations and take appropriate action to maximize their protection.

Oral Contracts, continued from page 1

***Are Any Contracts Required To Be In Writing?***

Although many oral agreements have the potential to be legally binding, there are instances where they will not be enforced, regardless of how much proof exists as to their existence and terms. Under Maine's so-called "statute of frauds," the following eight types of agreements must be memorialized in writing in order to be legally enforceable:

1. to charge an executor or administrator for any special promise to answer damages out of his or her own estate;
2. to charge any person for the debt, default or misdoings of another;
3. an agreement of marriage;
4. a contract for sale of land;
5. any agreement that cannot be performed within one year;
6. a contract to pay a debt discharged in bankruptcy;
7. an agreement to give property by will; and
8. an agreement to refrain from carrying on any business.

The purpose of the statute of frauds is to prevent fraud, and these eight types of agreements have been legislatively identified as being of sufficient importance and magnitude to impose a writing requirement as a prerequisite to validity. Unless the absence of a written agreement in one of these areas is itself due to fraud, the courts will strictly enforce the statute.

Other than the statute of frauds, there is one other type of contract that must be written to be enforced. A "home construction contract" for more than $1,400.00 in materials and labor must be in writing and signed by both the contractor and homeowner.

Although what constitutes a home construction contract is not exhaustively described in the statute, the example presented in this article assumes that house painting does not fall within its scope.

***And The Bill For Painting The House Is…***

Because the statute of frauds does not preclude the enforceability of the oral agreement to paint your house for $2000, you could legitimately sue for breach of contract. When analyzing the pros and cons of bringing a lawsuit, however, it becomes painfully clear why you should have reduced the agreement to writing, even if it had taken the form of nothing more than a confirmation letter. Although it is doubtful that you would have any difficulty proving the existence of the contract in light of the other party's partial performance of its terms, (i.e., actually painting your house), you would have difficulty trying to establish that the agreed-upon fee was limited to $2000.
It would be your word against his, and you would have to admit that your discussion did not contemplate whether the quoted price included materials. Given the uncertainty of such a claim, you would probably question the wisdom of a legal challenge to his bill. Even if you sued successfully, legal fees alone would most likely exceed the difference.

Alas, you too would be counted among those endless financial disasters caused by misplaced reliance on oral agreements, and would join the growing legion of victims lamenting the passage of the good old days when business could be done with a handshake.

The moral of this oral agreement story: GET IT IN WRITING!

**Perkins Olson & Pratt, P.A.**
P.O. Box 449
Portland, ME 04112