

Consequences of Bad Fundamentals

Each month I encounter a new instance where someone failed to properly record or document an event that otherwise should be recorded or documented. This month was no different than the last or the one before that. This month I saw an attorney (not me, thankfully) have his entire case dismissed because of a lack of standing and no written documentation to verify his client's claims. Please consider this month's installment as a public service announcement to avoid the type of activities that I am about to unfold.

Let me set the scene for you. Company A allegedly had an employment contract, which included a non-competition and non-solicitation agreement, with a former employee. Later on, Company A sued its former employee for violating the non-competition and non-solicitation agreement. The former employee defended by stating that the contract was unenforceable.

A valid contract has several requirements, and one of those is that the parties are competent to enter into a contract. At the time the employment contract was signed Company A did not exist as a legal entity under the laws of the State of Michigan; i.e. it was not a de jure corporation. In other words, Company A failed to file its Articles of Organization (used for LLCs) with the State of Michigan prior to entering into the contract. In Michigan, an LLC can enter into a contract after it has filed its Articles of Organization. The caveat to this rule is if the LLC qualifies as a de facto corporation; which Company A did not qualify. Under Michigan law, a contract entered into under these circumstances cannot later be ratified. For these reasons, Company A was not competent to enter into the contract; and therefore, Company A could not enforce the contract against the employee.

Company A then changed their legal argument. Company A alleged that they previously purchased all assets and contracts from Company Z, and it was Company Z that had entered into the contract with the former employee. Therefore, they could enforce the contract. Unfortunately, Company A had no documentation to prove that a purchase of Company Z's assets ever occurred. Without a proper purchase agreement to verify the terms of the sale, Company A failed to prove a sale occurred. The lawsuit was ultimately dismissed.

Company A made several fundamental mistakes. Make sure that your company has filed all necessary incorporation documents with the State of Michigan prior to conducting business. Make sure that all purchases or sales are evidenced by a written agreement. Otherwise, you might meet the same fate as Company A.

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