

## **Seller Beware**

*By Richard Laubenstein*

As is so often the case, the little things you learn from your mom and dad turn out to be right. When you were growing up, how many times did you hear "honesty is the best policy?" That is especially true if you are selling residential real estate.

In Illinois, the seller of residential property, which includes everything from a single family house to a four-flat, is required to furnish the prospective buyer with a written disclosure of any defects that the seller is aware of regarding the building and land. If a seller is aware of a problem and fails to disclose it to the buyer and the sales transaction is completed, the buyer has the right to sue the seller and recover the repair costs, court costs and, depending on the circumstances, other expenses including attorneys fees.

Even if the seller specifically makes the sales contract "AS IS" and the buyer knows that the seller is not making any representations concerning whether the building is in good condition, if the seller is aware of a defect and fails to disclose it, the seller will wind up paying the consequences. Consider what happened to these unfortunate sellers:

The sellers owned a home with a fully finished basement. The home was on one of the lower lots in their subdivision. After a particularly heavy rain, they found the basement flooded and the drywall and carpeting soaked. The sellers repaired the home and hired a contractor to fix the problem. The contractor built a berm (a low, earthen mound) along the lowest spot of the yard and added new drainage tile around the perimeter of the building. However, the contractor wasn't certain if this fully would protect the property, and in fact, told the sellers personally and in writing that he could not guarantee that the basement would not flood if there was another heavy rain. The sellers put the home on the market and sold it "AS IS" and did not disclose that there was a flooding problem at the home.

After the sales transaction was completed, there was another heavy rain and the basement flooded again. The buyers sued the sellers for misrepresentation. The sellers claimed that since the transaction was "AS IS" the buyers bought the home knowing that there might be problems and therefore, the buyers had agreed to assume the risks. The Appellate Court of Illinois disagreed. A seller must disclose all defects of which the seller is aware. Once the seller has made the defects known to the buyer, the parties can still choose to negotiate a contract which provides that the sale is "AS IS" - meaning the seller has pointed out the problems and made it clear to the buyer that the seller will not pay for any repairs, and the buyer has agreed to take the building in its present condition. If only these

sellers had listened to their parents.

The real property disclosure report that is used on all residential transactions only requires the seller to disclose problems that the seller knows currently exist. If, for example, there was a leak from the roof, and the homeowner



Richard Laubenstein

Continued on page 3

## **Who Owns The Software Program You Paid That Consultant To Develop?**

*By Margherita M. Albarello*

Companies frequently contract with a variety of software consultants, computer programmers and other independent contractors to write software programs based entirely on the company's specifications. The company oversees the program's development, tests the product, indicates changes which need to be made, and pays the contractor in full for the program. Who owns the finished product?

If you think the company does, you're wrong. In fact, even if the company discovered that the contractor was licensing the program to the company's competitors, there is little the company could do about it. This can have a devastating impact on the value of your company when you try to sell it. This seemingly counter-intuitive answer is based on U.S. copyright law. Copyright protects an author's right to the economic exploitation of the tangible expression of ideas. It is the author's expression that is protected, not the idea. In the scenario described above, the company came up with the idea and specifications for the software program, but the contractor authored the expression of the ideas and specifications. Therefore, the contractor is the author and the copyright owner of the software program. Absent a contract to the contrary, the company only has the right to use the copyrighted program. It cannot sell or license the program to others; it may not be able to revise the program.

What should the company have done to avoid this problem? Among other things, during the creation of the relationship, the company should have obtained a writing signed by the contractor stating that the contractor is transferring exclusive copyright ownership rights to the company. If you are engaging an independent contractor to provide services to your company, allow us to work with you to guide you through the process, ascertain your ownership and usage rights, and negotiate an appropriate contract. This is an example of the planning and discipline one should do in getting a business ready for sale.

## Selling Your Company Requires Planning and Discipline

By Lin Hanson

Selling your company is a huge step. You have spent your life creating it. It may be the most valuable asset you own, and your future depends on how successful you are in selling it. Key is planning and preparation. Failure to do so can wreck havoc on your best-intentioned plan. A recent case, *Annecca, Inc. et al. v. Lexent, Inc.* (November 16, 2004), gives us some insight.

We all have seen the term "GAAP" (Generally Accepted Accounting Principles). It means, roughly, that the financial records are properly prepared and accurately reflect the results of operations on a consistently applied basis. But do you really know what GAAP means? Did you know that there is more than one kind of GAAP? Did you know that a cash method of accounting can never be GAAP?

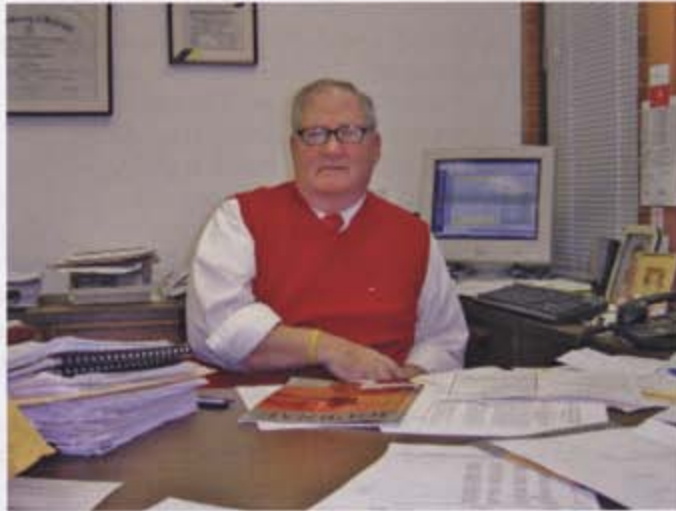
What you really need to know is that you probably shouldn't assume you know what is or isn't GAAP. You probably employ an accounting firm in addition to your law firm. You need them to tell you, in no uncertain terms, whether your financial statements are or are not prepared in accordance with GAAP. And, by the way, they either are or aren't, no almost, no maybe.

If your financial statements aren't prepared in accordance with GAAP, it doesn't mean you can't sell your company. It's just an item to be disclosed, and negotiated in the contract. Evidently in our example case, *Annecca v. Lexent*, it was known early on that the financial statements were not prepared in accordance with GAAP, but **the contract required GAAP statements**. When the "wheels fell off" the deal, and the buyer decided to walk away, the seller pointed out that the buyer knew early on the statements weren't GAAP, but nevertheless continued with its due diligence and preparations to close for months. The court said, though, that the buyer's early knowledge made no difference.

In the process of preparing for the buyer's takeover, the buyer requested the installation of new computers which it felt would be essential to its operations after the takeover. The buyer purchased the equipment

and the seller had it installed. The old equipment was discarded.

Not all engagements end in marriages, and not all sale contracts end in sales. In our subject case, at some point, the buyer concluded not to close. It pointed out that the seller's representation as to its net worth was not met, and the financial records and financial statements were so incomplete



Lin Hanson

and in some instances inaccurate that they could not provide the buyer with an understanding of the seller's financial condition.

Subsequently, buyer asked the seller to reimburse it for the computer equipment installed at the seller's company. The seller refused, stating that equipment was installed, was critical to its ongoing operations, and that the old equipment had been disposed of at the time of the installation, at buyer's request.

Cancellation of the transaction was a disaster. The seller's dreams of retirement in relative security and comfort were dashed. Now the seller had to resume operations, after having disclosed every intimate detail of operations to the buyer. Employees might have been upset by the pending sale, customers might have been "scared off" and all sorts of things might have happened.

The seller sued the buyer for wrongful termination of the contract and the buyer counterclaimed for reimbursement of its costs, including accountant's and attorney's fees and the computer equipment. Ultimately the court awarded more than \$250,000 in attorney's and accountant's fees to the buyer, as well as the cost of the computer equipment.

The point of this article is to stress the importance of carefully reading and understanding the "boilerplate" language in the contract. This includes conferring with your accountants with regard to the accounting aspects of the transaction. Secondly, during the pre-closing process the niceties and formalities of separateness should be observed. None of us would allow a home buyer to move into the house without closing. Similarly, you need to be careful about changing your business methods and practices before the closing occurs. This would include installation of new equipment, hiring and firing decisions, changes in employee benefit plans, etc. Always be aware of the need of an "escape route" or mode of survival if the transaction does not close.

Ideally you will have the opportunity to prepare to sell your company. With your attorneys and accountants, conduct your own mini due diligence. Keep the corporate books and records up to date. Make sure stock transfer records

are in order and complete. Develop an outsider's understanding of your business, including its accounting practices, its strengths and weaknesses. Investigate potential liabilities that may crop up, and deal with them. Determine that employment practices stand scrutiny. Are necessary confidentiality and non-compete agreements in place? Try to cast a "critical eye" on the operation just as you would if you were the buyer. Don't assume you can cover up or gloss over deficiencies in you operation - they almost certainly will come up in the due diligence investigation. Even if they don't, your sale contract will most likely require you to make pages of "representations and warranties" which the buyer can enforce against you even years after the closing. Your preparation will assist you in negotiating the contract, and closing gaps before the buyer's counsel finds them in the due diligence period.

Preparation is the key to success in selling your business, just as it is in operating your business.

hired a roofer to repair it, and the roofer gave his guarantee that the problem was corrected, then unless the homeowner had any reason to dispute the contractor, the problem no longer existed for purposes of making the disclosure. Obviously, if the roof leaked again after the work, or if the roofer would not guarantee the work, then the homeowner could not truthfully state that he was not aware of a possible problem with the roof. In the situation we just considered with the flooded basement, the seller could not honestly tell the prospective buyer that the seller was not aware of possible flooding problems, since the contractor who put in the berm and drainage tile specifically said he could not guarantee the property would remain free from flood problems in the future.

However, in situations where the repair work has been done and the owner is not aware that the problem is still ongoing, the seller can honestly state that he is not aware of any problems. I recently had a situation like this on a transaction where I represented the seller.

Many years ago, the seller put an addition on her home. She hired a builder to pour a new foundation, concrete slab floor and frame out the room to attach it to her existing house. Several years later, she put in new carpeting and the carpeting contractor noticed a crack that ran from side to side in about the middle of the room. It was a very narrow crack, and the client never noticed it because it was always covered with carpeting. The contractor told her it was a minor crack and that he could easily repair it. She had the crack repaired and put in the new carpet and thought nothing further about it.

A few years later, she listed the property for sale. She filed out the disclosure form and stated that she was not aware of any problem with the floor. The buyer completed the sales transaction and shortly after he moved in, he decided to redecorate and put in new carpet. When the carpet was removed, he noticed that the floor had cracked again at the same spot where the contractor had patched it. The buyer sued my client and claimed that she made a false statement.

During the trial, I had the seller show the court the repair receipt she had received from the contractor, in which he agreed to patch the crack and guaranteed his work.

The seller testified that she had experienced no trouble with the floor and had no reason to believe that the problem had reoccurred. The trial judge concluded that there was no way (short of destroying the house by tearing up the carpet) that my client would have known the crack came back and there was no reason for my client to have doubted the contractor. The judge ruled against the buyer and determined that the buyer was not entitled to recover any money from the seller.

The disclosure document does not require the seller to conduct any type of invasive testing or to hire an expert to see if there are any conceivable problems with the home - it merely asks the seller to truthfully disclose any problems that the seller actually knows about. If you know a problem hasn't been fixed, then listen to your mom and dad - just tell the truth.



Chet Lizak & Justice McMorrow

### In The News

On February 28, the Advocates Society of Polish American Attorneys presented its highest award, the Award of Merit, to our partner Chester A. Lizak at its 75th anniversary installation dinner at the Hotel Allegro in Chicago.

A 1963 DePaul Law School graduate, and former President of the Advocates Society, Chet received the award in recognition of his lifetime of community service. For the first 10 years of his practice, Chet practiced primarily criminal law. During that time, while Chairman of the Chicago Bar Association Defense of Prisoners Committee, he obtained not-guilty dispositions for indigent defendants in eight consecutive non-capital murder cases.

After turning his attention to civil practice, he continued his involvement in pro bono activities. He provided free representation to the Copernicus Foundation for more than 20 years, and acted as a volunteer at the Amicus Poloniae legal clinic.

At the award ceremony, Chet was lauded not only by leaders of the Advocates Society, but by Cook County State's Attorney Richard A. Devine, and Supreme Court Justice Mary Ann G. McMorrow.

# Di Monte & Lizak, LLC

216 Higgins Road  
Park Ridge, IL 60068

# Di Monte & Lizak, LLC

216 Higgins Road  
Park Ridge, IL 60068

(847) 698-9600  
(847) 698-9623 (Fax)  
(847) 698-9624 (Fax)

[www.dimonteandlizak.com](http://www.dimonteandlizak.com)

To order additional copies of this publication, please contact MaryLeslie Naker at (847) 698-9600 or [mnaver@dimonteandlizak.com](mailto:mnaver@dimonteandlizak.com).



While the Newsletter is intended only to provide information of general interest to our clients and their advisors, under the Rules of the Supreme Court of Illinois, or the rules of other jurisdictions, this publication may be regarded as advertising. Information contained herein should not be considered as individual legal advice or legal opinion. You are urged to consult your D&L attorney regarding your own legal situation and any specific legal questions you may have.