

# Detroit Good Food Enterprise Legal Handbook

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# Introduction to the Detroit Good Food Enterprise Legal Handbook

Around the country, communities are reimagining how food is produced, processed, distributed, marketed, and sold. In Detroit, a diverse array of actors are working together to create a food system that produces “good food.” The premise of “good food” is a food system that operates with a higher degree of local accountability and local control than our current food system, which currently leaves many of Michigan’s communities food insecure. Specifically, a food system focused on “good food” produces healthy and affordable food in a manner that is environmentally sustainable and fair to all involved in its production, distribution, and sale.

At the heart of these efforts are good food entrepreneurs: people that have come together to form enterprises that promote “good food.” These people are engaged in a wide array of activities and include local farmers, distributors, grocers, caterers, and restaurants, just to name a few. Their enterprises also take many forms, including for-profit businesses, cooperatives, nonprofit organizations, and unincorporated associations. While the activities and the types of enterprises vary, their common link is food and their dedication to making a strong, local food system premised on the creation and consumption of “good food.”

Whether one is just starting a good food enterprise or is already operating one, the time, energy, and other resources required of such a venture can be immense. Sometimes, the last thing people want to think of is whether what they’re doing is legal or not. While the legal system can present a challenge to good food enterprises, it can also be a source of power. The more an enterprise knows about basic legal rules and principles regarding a few key areas of law, the easier it will be to ensure that what they are creating is within those legal rules and principles. This will allow the stakeholders to focus on the work they love and will help it avoid headaches and legal liability.

This handbook has been prepared by the Great Lakes Environmental Law Center and Keep Growing Detroit as an educational tool to help the law be a source of power for Detroit’s burgeoning and existing good food enterprises. In this handbook are four legal guides that cover employment law, real estate law, entity formation law, and contract law, which are relevant to many good food enterprises. The legal guides are relatively short and are meant to provide those associated with good food enterprises with a base of knowledge regarding the legal rules that are commonly encountered.

This handbook is not to be taken as legal advice. Laws, and interpretation of laws, change. The best way to resolve a particular question regarding your enterprise is to contact a lawyer.

Lastly, it is also important to remember that the law only states what one must do to avoid legal liability. What is legal and what is permissible based on the values of a good food enterprise may not always be identical. Therefore, it is important for each entity to distinctly consider what the values of the enterprise will be.

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# **FORMING A GOOD FOOD ENTERPRISE: THE LAW OF ORGANIZATIONS AND BUSINESSES**

The laws that govern organizations and businesses involve a lot of non-legal questions such what do you want to do and who do you want to reach. Unlike many areas of the law, the question is not how can you conform your activities to the law, but instead how can you conform the law to your organization or business. That is because there is generally a lot of flexibility in the laws that govern organizations and businesses that allow people to be creative in forming and structuring their enterprise. However, like in many areas of the law, there are unique factors that good food enterprises must consider. Considering that different entities come with different legal requirements and benefits, choosing the right one is important to ensure the long-term success of your enterprise.

This document is meant to provide a survey of the basic options you have when choosing what entity you want to use to structure your enterprise. It also provides the basic pros and cons that you and the other members of your enterprise should consider when contemplating what entity is right for you.

## **I.) Entity Choice Laws**

Entity choice is largely governed by three state laws: the Michigan Nonprofit Corporations Act, the Michigan Business Corporation Act, and the Michigan Limited Liability Company Act. The laws describe what is required to form various types of entities in the state of Michigan and specific legal requirements that the different entities must comply with. The good news is that the legal requirements are fairly basic and each is fairly flexible. However, choosing to create a legal entity or deciding to change legal entity forms is often procedurally difficult and therefore this is a decision that should be given a lot of consideration.

## **II.) Deciding Whether to Form a Distinct Entity**

One of the first questions that many people involved in social enterprises have is what legal entity is most appropriate for their enterprise. While forming a legal entity often does provide many advantages, it also comes with specific costs. Many legal entities have corresponding laws that restrict how an entity can be operated and require the entity to file specific financial information with the state and federal government on a regular basis. These requirements can be burdensome and restrictive on a young organization or enterprise that is still figuring out its role in the community. Therefore, it is important to specifically identify why you want to formalize your enterprise or organization by choosing a legal entity.

People choose a legal entity for a variety of reasons. Some of the most common are to limit their personal legal liability, to facilitate grants, to receive investments from outside sources, or to receive favorable tax treatment.

*A. What happens if you do not form a distinct, legal entity*

If you choose to not form a distinct legal entity, your enterprise will not be an entity separate from the people involved. While it will still be given a label, as will be described below, all enterprises that aren't embodied by a distinct, legally formed entity share many common characteristics. The most prevalent of those common characteristics is that the founder(s) are personally liable for the obligations of their enterprise. The two most common types of liabilities to be aware of are tort liability and contract liability.

*i. Tort Liability*

Tort liability arises from personal injury lawsuits. For example, if Party A punches Party B in the nose, Party A has committed the tort of battery. Party B may then file a lawsuit against Party A and recover any damages that resulted from Party A's tort, such as medical costs. There are both intentional and unintentional torts. The battery example described above is an example of an intentional tort. There are also unintentional torts. Unintentional torts generally arise because of one person's negligence or recklessness that results in another person being injured.

Good food enterprises that have not formed a distinct, legal entity should be wary of their potential exposure to unintentional tort liability. Unintentional torts typically arise from situations where a person acts negligently and harm to another person results.

People who start an urban farm or garden should be aware of potential unintentional torts that may arise from their farm or garden. In a situation where the individuals involved in operating an urban farm or garden have not formed a distinct, legal entity, each person involved in operating the urban farm or garden may be held liable for injuries that occur on the property. For urban farms and gardens that regularly utilize volunteers, there may be a sizable risk that one of the volunteers may be injured by a defective tool or by some hazard on the property that the owner was unaware of. In such a situation, the injured individual may allege that the operator(s) of the urban farm or garden committed an unintentional tort and file a lawsuit seeking to collect damages. If the operator(s) of the urban farm or garden are found liable, their personal assets may be reached to pay the assessed damages.

*ii. Contract Liability*

Contract liability arises when an individual fails to perform their duties under a legally enforceable contract. For those individuals or groups who do not form a

distinct, legal entity for their good food enterprise, the individuals themselves are personally liable for any and all contracts entered on behalf of the enterprise.

For example, if an individual or group of individuals take out a loan to pay the start-up costs associated with an urban farm or garden without forming a distinct entity, then the individual or group of individuals may be personally liable for failing to repay the loan.

In short, the personal risk for those involved with an urban farm or garden is higher for those involved in managing a good food enterprise. However, as will be discussed later, forming a distinct entity comes with its own disadvantages. It is important to weigh the costs and benefits when deciding whether forming a distinct entity to house your good food enterprise makes sense for you.

### *B.) Types of Presumed Enterprises*

Below are the labels given to enterprises that are not embodied by a distinct, legal entity. The common characteristic for all of the presumed enterprises is that the owners and managers of the enterprise are indistinguishable from the enterprise itself.

#### *i.) Unincorporated Association*

An unincorporated association is essentially a public benefit enterprise that has not incorporated under the Michigan Nonprofit Incorporation Act. Typically, an unincorporated association exists when 2 or more people decide to organize their efforts and work together towards an outcome that they desire, but do not decide to file Articles of Incorporation as is required to incorporate a nonprofit in Michigan.

There are no formal requirements to creating an unincorporated association and control of the organization and the law does not impose a requirement on how they can be structured.

Lastly, there are tax implications for individuals involved with unincorporated associations. Since an unincorporated association cannot hold assets, the individuals must accept donations on behalf of the organization. Those donations must be reported to the Internal Revenue Service as personal income, regardless of how the funds are used.

#### *ii.) Sole Proprietorship*

A sole proprietorship is a simple type of business structure. It exists when any individual decides to go into business as the sole owner, but does not form a distinct entity to embody their business. Once again, there are no formal requirements for the formation or operation of a sole proprietorship. However,

just as with unincorporated associations, the sole proprietor is personally liable for the obligations of the business.

Since a sole proprietorship is indistinguishable from the individual, the sole proprietorship has simple tax requirements. As a general rule, sole proprietors must use Schedule C (Form 1040) to report income or loss from a business operated as a sole proprietor and pay self-employment tax. An activity qualifies as a “business” if the individual’s primary purpose for engaging in the activity is for income or profit and the individual is involved in the activity with continuity and regularity.

There are additional filing requirements for urban farmers who operate sole proprietorships. If a sole proprietor operates a farm as a business, income that a person receives related to the operation of a farm must be reported by using Schedule F (Form 1040). However, if operated as a hobby the farmer need only report income on Form 1040, line 21.

### *iii.) Partnership*

As the name suggests, a partnership is comprised of 2 or more people. The group of people that make up a partnership operate a business for shared profits. Once again, no formal action is required to form a partnership; instead, its existence is implied as long as two or more individuals who have started a business have not formed any type of corporation or limited liability company (LLC). Lastly, as above, the partners are personally liable for the obligations of their partnership. Note that this means each partner is liable for the actions and debts of the other partner.

Similar to a sole proprietorship, a partnership is indistinguishable from the individual owners of the partnership. A partnership must file an informational return with the IRS (Form 1065) and each partner must use Schedule E (Form 1040) to report income or loss from the partnership and pay a self-employment tax.

## **III.) Entity Options**

### *a.) Business Organizations*

Just because someone is interested in starting a for-profit good food enterprise does not mean that enterprise’s activities and ideology are all that different from a nonprofit organization. Many for-profit good food enterprises in Detroit want to provide Detroiters with a source of local, fresh, healthy, and well-grown produce or value-added products. As our food system is reimaged, these types of enterprises are essential and their social purpose is often just as strong as a nonprofit organization.

However, mission-driven, for-profit businesses have traditionally faced a dilemma in balancing its need to generate profits with its mission to create some social benefit. Notably, this dilemma has implications that go beyond the ideology of the business, as the law imposes a duty to further the financial well-being of a business on those that manage it. Some entities allow this issue to be addressed more adequately than others, as will be discussed below.

*i.) Limited Liability Company (LLC)*

A limited liability company is popular amongst many for-profit businesses that nonetheless act as a nonprofit in certain ways. Essentially a LLC is a cross between a corporation and a partnership. It is a flexible entity that limits the personal liability of the owners of the LLC (similar to a corporation), but also allows for profits to pass through to the owners (similar to a partnership). By allowing profits to pass through to its owners, the LLC is not taxed as a separate business entity. Instead, the profits and losses “pass through” to each owner of the LLC who then report profits and losses on their personal tax returns. This means that the profits of most LLCs receive more favorable tax treatment than the profits of a corporation, as the profits of a corporation are subject to taxation both at the corporate level and, if profits are distributed to the shareholders, at the individual taxpayer level as well. The burdens of managing a LLC are also less significant than the burdens of managing a corporation. A LLC does not need to elect a board of directors, appoint officers, or hold regular meetings.

Creation

An LLC is legally created by filing executed Articles of Organization (Form BCS/ CD 700) with the Michigan Department of Licensing and Regulation. An LLC’s Articles of Organization are similar to the Articles of Incorporation filed by nonprofit corporations; it sets forth the basic structure of the LLC and must be filed with the State to effectively create the entity. An LLC is functionally created by having individuals or businesses make some form of contribution, either financial or otherwise, to help get the business started. In return for their contribution, the individual or business may be regarded as an “owner” of the LLC. An LLC’s owners are referred to as members; an LLC can have any number of members.

Governance Options

An LLC has two basic governance models it can choose from: “member-managed” or “manager-managed.” A member-managed LLC is operated on a day-to-day basis by all of its members. Under this governance model, the members are responsible for running the business. Alternatively, a manager-managed LLC is operated on a day-to-day basis by its manager or managers. This governance model is useful when one or more members does not want to be actively involved in the operations and decision-making of the business and only wants to serve as a passive investor. Instead of saddling each member with

the duties of running the business, a manager-managed LLC allows the owners to delegate management responsibilities.

Regardless of which governance model is selected, an LLC should draft an operating agreement to structure the financial and working relationships that exist amongst the members. While not legally required, it is highly recommended. The best operating agreements are the ones that reflect the unique nature of your business and all of its members. By carefully crafting your operating agreement, you can create a governance structure that reflects the values of your business and that effectively manages conflict.

### Overall Pros/Cons

The LLC is favored for four primary reasons: it limits the liability of its owners, it is the easiest of all of the entities to set up, it receives beneficial tax treatment, and it provides for the greatest amount of operational flexibility.

The negatives are that the LLC places a higher tax burden on the individual. Since LLC income is not reported and taxed at the business level, it must be reported on the personal tax returns of all of the members. That income is then subject to the self-employment tax, which is currently 15.3%. This is true whether the profits are distributed to members or kept in the organization. On top of the self-employment tax, individual owners of an LLC must also pay federal, state, and local income tax. Once combined, the owners of an LLC may be taxed at a rate around 35% for all LLC-derived income. The flexibility of the LLC can also be a pitfall, particularly for single-member LLCs. The member in a single-member LLC should be particularly careful to follow the formalities of an operating agreement to ensure that the LLC is regarded as an entity distinct from the individual for liability purposes. Otherwise, the benefit of limited liability may not exist.

#### *ii.) Low-Profit Limited Liability Company (L3C)*

In 2009, Michigan amended the Limited Liability Company Act to allow for the formation of low-profit limited liability companies. Similar to how an LLC is a combination of a partnership and a corporation, an L3C is a combination of an LLC and a non-profit organization. An L3C is set up and governed in a similar manner as an LLC.

As with an LLC, the owners of an L3C can freely receive distributions of profits, which is something that is tightly regulated for nonprofits. Those profits pass-through the entity for tax purposes, and the liability of the owners is limited. However, similar to a nonprofit, an L3C must be formed for some charitable or educational purpose. Specifically, the Michigan Limited Liability Company Act requires an L3C to put the following language in its Articles of Organization:

- \* Must conduct activities in conformance with a purpose that significantly furthers the accomplishment of one or more charitable or educational purposes described in IRC 170(c)(2)(B)
- \* Must not include, as a significant purpose, the production of income or appreciation of property, and;
- \* Does not include accomplishing one or more political or legislative purposes described in IRC 170(c)(2)(D)

The above requirements, which are contained in section 450.2102(2)(m) of the Limited Liability Company Act are important because they mirror IRS regulations that govern how foundations can make program related investments (PRI) in for-profit businesses. In short, PRIs are below-market loans with a low interest rate made by private foundations, typically to mission-driven, for-profit businesses. Historically, making a PRI has presented obstacles for private foundations as the foundation traditionally has had to conduct extensive up-front analysis and expenditure monitoring to ensure that the PRI complies with IRS regulations. In mirroring the IRS language that governs how foundations make PRIs, it was hoped that the L3C would simplify the complicated process by which a foundation makes a PRI in a for-profit business.

### Overall Pros/Cons

Unfortunately, the IRS has yet to acknowledge the L3C which has led to criticisms that the L3C does not actually facilitate PRIs in any way. Others have also noted that since the L3C is so new, few courts have considered just what the above operational restrictions entail, specifically in regards to what it means to not have significant income producing purpose.

Despite these criticisms, the L3C does have one key advantage. It can be very valuable for branding as it signals potential customers and the general public that your business is focused on something more than just generating profit. This kind of branding can be very difficult for other for-profit entities to create.

### *iii.) Corporations*

Corporations are business structures that, like all other business structures, limit the owners' personal liability. Unlike the other business structures described above, it is subject to double taxation. This means that income generated by the activities of the corporation are taxed as corporate income. Further, if the corporation distributes any income to shareholders, it is taxed as personal income of each of the shareholders. A key benefit of the corporation is its flexibility in raising capital. However, as described below, the corporation has typically not been a well-suited entity choice for mission-driven businesses. Regardless, certain corporations are utilizing the corporate form in unique ways that accentuate the positives of the corporate form while limiting the negatives.

### Creation

A corporation is legally created by filing Articles of Incorporation with the Michigan Department of Licensing and Regulatory Affairs. This is effectively done by filing BCS/CD Form 500. An corporation is functionally created when it prepares and issues stock to shareholders. Shareholders are essentially the owners of the corporation and are similar to the “members” of an LLC. A corporation can have an unlimited amount of shareholders and shares can either be offered privately or publicly. Shareholders are generally entitled to two things: a share of the corporate profits when the profits are distributed and a right to vote for who serves as a director on the corporation’s board of directors. In many ways, the shareholders are similar to the members in a membership-based nonprofit organization. The shareholders vote for the directors, who then operate the day-to-day business of the corporation.

### Governance

A corporation is governed in accordance with its corporate bylaws. A corporation’s bylaws are an incredibly important document for any mission-driven corporation. A corporation is free to place restrictions on the voting power of certain shareholders, who can be elected to the board of directors, and how shares are transferred and sold. All of these things are important ways for mission-driven corporations to ensure that the corporation stays dedicated to something more than its pursuit of profits.

### Overall Pros/Cons

As mentioned above, one of the most powerful benefits of the corporation is its flexibility in raising capital. However, with that flexibility comes risks. First, the tension between a business’s profit-generation mission and its social mission are strongest in corporations. Courts have stated that each director has a duty to enhance the financial value of the corporation for its shareholders. While the board of directors of a corporation is accorded a high degree of deference regarding corporate decisions that reduce profits while promoting a socially beneficial mission, a shareholder can nonetheless subject the corporation to a lawsuit if it feels slighted by the fact that the corporation is sacrificing profits for a social benefit. Second, corporations often are at high risk of mission drift. Founders of a corporation may drift from the original mission or a corporation may be subject to a hostile takeover by another person or entity that seeks to change the operations of the corporation. Since the corporate form is highly flexible, a corporate charter can be changed fairly easily.

However, just as the flexibility of a corporation can be the downfall of a mission-driven corporation, it can also be its saving grace. A corporation can creatively draft its corporate bylaws in a way that makes sure the corporation stays dedicated to its mission.

If you have considered the risks and benefits above and believe the corporate form is right for you, the next step is to consider the two basic types of corporate entities: the S Corporation and the C Corporation.

The C Corporation is the standard corporate form, while the S Corporation is a specific form that must be elected by filing Form 2553 with the IRS. Listed below are the two key characteristics of the C Corporation:

- ✦ Double Taxation: A C Corporation is regarded as a separately taxable entity that must file its own tax return with the IRS (Form 1120). This means that the corporation's profits are taxed at two levels by the IRS; profits are taxed both as corporate income as well as personal income when the profits are distributed to shareholders. This is commonly referred to as double taxation.
- ✦ Structural Flexibility: C Corporations are given a great amount of flexibility in structuring the corporate form. A C Corporation is not limited in its number of shareholders and it can also divide its stock offerings into different classes.

The other corporate form option is the S Corporation. Its key characteristics are as follows:

- ✦ Pass-Through Taxation: Similar to an LLC, a S Corporation does not pay income tax at the corporate level. Profits and losses pass through the corporation and are reported on the shareholder's personal tax return, but not by the corporation. However, the corporation must still file an informational federal tax return (Form 1120S).
- ✦ Structural Restrictions: The tax benefit described above comes with two key structural restrictions
  - S Corporations cannot have more than 100 shareholders
  - S Corporations can only have one class of stock

All of this boils down to a basic tradeoff. While the C Corporation form is highly flexible, the S Corporation is more restricted in its structure but receives more beneficial tax treatment in return.

#### *iv.) B-Corporation*

First, it is important to note what a B Corporation (B Corp) is not. It is not to be confused with a benefit corporation, which is a corporate form that has not yet been adopted in Michigan. A B corp is also not a statutory business form like all of the others discussed above, meaning it is not governed and regulated by any Michigan law.

Instead, a "B Corp" is a certification that is given by B Lab, a nonprofit organization. Any type of business models previously discussed are eligible for B Corp certification, but the business must comply with specific, socially

responsible business practices to be eligible for certification. It is somewhat similar to being certified organic in that it is a voluntary program to signal to others that your business follows a certain set of practices. However, unlike the National Organics Program, the B Corp program is run by a private nonprofit and not the federal government. As of the beginning of 2015, there were more than 780 B Corporations in the United States.

To determine eligibility, B Lab requires businesses to complete a questionnaire about its business practices regarding the environment, public service, community support, treatment of employees, and diversity. If a business achieves the required minimum score on the questionnaire, it must then adopt specific language in its organizational documents, such as its Articles of Incorporation or Membership Agreement. Further, every B Corp must reapply for certification by completing the questionnaire every 2 years. There is an annual certification fee; the amount of the fee is dependent on the business's profits. For good food enterprises that have less than \$1 million in annual sales, the annual fee is \$500.

For more information on B Corps, visit B Labs website: [www.bcorporation.net/](http://www.bcorporation.net/)

## B.) Nonprofit Organizations

Many associate nonprofit organizations with being exempt from taxes, but that is not necessarily true. Filing for tax-exemption often accompanies the incorporation of a nonprofit organization, but filing for tax-exempt status involves different laws and different decisions. Incorporating a nonprofit organization is governed by the Michigan Nonprofit Corporation Act and requires the organization to file Articles of Incorporation (Form 502) with the Michigan Department of Energy, Labor, & Economic Growth Department, Corporation Division. Filing for tax-exemption is governed by the Internal Revenue Code and, as will be discussed more below, requires an organization to file with the Internal Revenue Service.

While they are relatively few, some nonprofit organizations do function without tax-exemption because they do not want to be subject to the IRS regulations that may restrict their operations but also don't want to function as a for-profit business for varying reasons.

However, the great majority of nonprofit organizations do file for tax-exemption, and by doing so subject themselves to strict IRS regulations.

### i.) Types of Tax Exemptions

In total, there are 28 federal tax exemption categories that are available to nonprofit organizations. All of these are listed in Section 501(c) of the Internal Revenue Code. Section 501(c)(3) is by far the most commonly used exemption. The primary reason for this is because an organization that obtains tax-exemption under section 501(c)(3) is eligible to receive tax-deductible donations.

Further, many large foundation donors are restricted to donating most of their money to 501(c)(3) organizations.

Since the 501(c)(3) exemption is the most commonly utilized and the most legally complex, this guide will start with that tax-exempt status. However, there are several other categories of tax-exemption that may be relevant for good food enterprises that are also described below.

### 501(c)(3)—Charitable, Educational, and Religious Organizations

According to the Internal Revenue Code, a 501(c)(3) organization must be organized and operated exclusively for a religious, charitable, scientific, testing for public safety, literary or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.

Out of that legal language comes two tests and an organization that is seeking tax-exempt status under Section 501(c)(3) must meet both tests. First, there is the organizational test. The Articles of Incorporation must limit the organizations purposes to one or more of the exempt purposes that are listed above. Second, there is the operational test. An organization must be operated primarily for an exempt purpose. This means that an organization can engage in an activity that is devoted to a nonexempt purpose, but it must be an insubstantial part of that organization's activities.

#### *The Organizational Test*

First, it is important to note that **producing food, in itself, is not a tax-exempt purpose under section 501(c)(3).**

According to IRS regulations, the following things are considered “charitable”:

- ✦ Relief of the poor
- ✦ Lessening the burdens of government
- ✦ Promoting social welfare by lessening neighborhood tensions, eliminating prejudice and discrimination, or combatting community deterioration and juvenile delinquency

Many good food enterprises in Detroit can likely point to at least a few charitable purposes that are a part of their organization as well as some educational purposes. However, applying for 501(c)(3) status can be a lengthy process. To get an idea as to whether the IRS views the purpose of your organization as exempt, you should look to IRS opinions and court decisions.

## *The Operational Test*

Even if your organization's purpose qualifies as an exempt purpose, you must also be sure that the operations of your organization actually work to further your organization's exempt purpose. This is particularly true for nonprofits that generate income. As discussed below, income that comes from activities that are substantially related to the tax-exempt purpose of an organization will not be taxed. Overall, you should be wary of the following operational restrictions imposed on 501(c)(3) nonprofit organizations:

- ✦ Cannot have more than an insubstantial part of its activities be devoted to a nonexempt purpose
- ✦ May not use its assets to benefit a private individual or entity
- ✦ May not support or oppose political candidates
- ✦ May not engage in substantial lobbying

## *Overall Pros and Cons*

As you can see, attempting to obtain 501(c)(3) status and operating within regulations governing 501(c)(3) organizations can be a headache. The benefit of being granted tax-exemption is that it will enable easier fundraising from donors, especially foundations. Further, most 501(c)(3) organizations will be able to claim property tax exemption for all property that they own and occupy under Michigan law. The downside is that such organizations are limited in their activities, their use of funds, and have heavy reporting and recordkeeping requirements.

## *501(c)(4)—Civic Leagues and Social Welfare Organizations*

Typically, organizations that are exempt under 501(c)(4) are known as social welfare organizations. The IRS has described the purpose of the 501(c)(4) as “embodying the ideas of citizens of a community cooperating to promote the common good and general welfare of the community.” The only key restriction on the purpose of 501(c)(4) is that they must operate for the benefit of the community as a whole and not just for the benefit of a limited group. Donations to a 501(c)(4) organizations are also not tax-deductible for donors.

A key difference between a 501(c)(4) organization and a 501(c)(3) organization is that a 501(c)(4) organization can engage in political activity and lobbying as long as it is not its primary focus. Further, a 501(c)(4) organization can involve providing private benefits to people, as long as those benefits are provided to the community as a whole and not a limited group within a community. While it is permissible for a 501(c)(4) organization to target its services to a particular community, it may not limit its services within that community.

## Overall Pros and Cons

In general, 501(c)(4) organizations are allowed to engage in a broader array of activities than 501(c)(3) organizations. Perhaps most importantly, a 501(c)(4) is allowed to engage in a greater amount of political activity. However, the key cost is that contributions to 501(c)(4) organizations are not tax deductible. This may limit the organization's ability to fundraise with third parties.

### 501(c)(5)—Labor, Agricultural, and Horticultural Organizations

An organization that works to better the conditions of agriculture may be eligible for tax-exemption under 501(c)(5). In order to be eligible, the primary purpose of the organization must be to better the conditions of those engaged in agriculture, develop more efficiency in agriculture, or improve the products. The IRS has provided a list of some examples of activities that show an agricultural or horticultural purpose:

- ✦ Promoting various cooperative agricultural, horticultural, and civic activities among residents by a state, farm, or home bureau
- ✦ Testing soil for members and nonmembers of the farm bureau on a cost basis, the results of the tests and other recommendations being furnished to the community members to educate them in soil treatment
- ✦ Encouraging improvements in the production of fish on privately owned fish farms
- ✦ Negotiating with processors for the price to be paid to members for their crops

## Overall Pros and Cons

As an agricultural or horticultural organization, a 501(c)(5) does not need to be organized and operated for a charitable purpose and therefore the range of activities is wider for 501(c)(5) organization when compared with a 501(c)(3) organization.

However, the downside is that contributions to a 501(c)(5) organization are not tax deductible. Therefore, fundraising from third parties is likely to be more difficult. Instead, 501(c)(5) organizations typically get their income from fees provided for a service.

### 501(c)(7)—Social and Recreation Clubs

This tax-exemption is designed for social, recreational, and other not profitable purposes. The key distinction of the 501(c)(7) tax-exemption is that it is for organizations that exist for their own benefit as opposed to a social benefit. For example, a group of people that organize a community garden or farm may qualify for 501(c)(7) tax-exemption even if it does not qualify for 501(c)(3) or

501(c)(4) tax-exemption. The following are the three main characteristics that an enterprise must possess in order to be regarded as a 501(c)(7) organization:

- ✦ Enterprise must be comprised of members that have personal contact and commingle. Members must be bound together by a common objective of pleasure, recreation, or other not profitable purpose
- ✦ There must be limits on member admission so that the membership body remains consistent with the character of the club
- ✦ Organization must derive most of its income from members. Also, any income received from nonmember sources is taxed as unrelated business income.

An example of an enterprise that may be granted 501(c)(7) tax exemption is a garden that is run by a group of community members solely for the benefit of that group.

### Overall Pros and Cons

Applying for tax exemption under 501(c)(7) allows a group of individuals doing common work to pool their money in pursuit of their common interests without being subject to an additional tax. Further, the purpose of a 501(c)(7) organization need not be charitable as with a 501(c)(3) organization. The purpose need only be social or recreational.

However, 501(c)(7) organizations are limited in a couple of ways. First, they must limit their membership based on the character of the club. This means that there must be some application process for members and that non-members must not be allowed to access the organization's resources. Secondly, since most funds for the organization must come from the members, the fundraising capacity for the organization is limited.

### 521/501(c)(16)—Farmer Cooperative

Section 521 provides farmer cooperatives with favorable tax treatment as long as they meet the following requirements:

- ✦ Primary activity is to market the products of members and other producers and/or purchase supplies and other equipment for members and other persons
- ✦ Must pay patronage refunds to all patrons on the same basis

### *ii. Revenue Generating Restrictions Regarding Tax-Exempt, Nonprofits*

A key restriction that applies to all tax-exempt organizations is how they generate profits. Tax-exempt organizations can operate two basic types of income-generating businesses: related and unrelated businesses.

A related business is one in which the activities are substantially related to the tax-exempt purpose of the organization. In other words, the primary purpose of the money making activity must be to further the exempt purpose of the organization, and it must have a substantial causal relationship to achieving that tax-exempt purpose. If the profits are generated by a related business, the income is not taxed. The IRS uses a three-step test to determine whether an activity is an unrelated business:

- \* Activity is a trade or business
- \* Activity is regularly carried on, and;
- \* Activity is not substantially related to furthering the exempt purpose of the organization

What will be considered a related business by the IRS depends on the organization's tax-exempt purpose. For example, an urban farm that operates to provide job opportunities to youth and which serves as an educational forum to teach children how to operate an urban farm could, in theory, obtain tax exemption under section 501(c)(3) as an educational organization. That organization could then sell their produce and it would likely be regarded as a related business, but the organization should not operate the related business on a scale larger than necessary to achieve its educational purpose.

If a money-making activity does not qualify as a related business, it will be regarded as an unrelated business. While a tax-exempt organization can conduct unrelated business activities, any income generated from the unrelated business will be subject to Unrelated Business Income Tax (UBIT) and must be reported on the organization's 990. Further, there is a limit as to just how much unrelated business income a tax-exempt organization can generate. The general rule is that the unrelated business of a tax-exempt organization should not become substantial in relation to the nonprofit's total activities.

If you are concerned about whether the business activity of your tax-exempt, nonprofit organization would be regarded as unrelated business or if you are concerned that your unrelated business is becoming a large part of your tax-exempt, nonprofit, it will be important to talk with an attorney to decide what the best way forward for your organization is.

### C.) Cooperatives

A cooperative is a collaborative entity that is owned, governed, and operated by and for the benefits of the members of the cooperative. Its main benefit is that it allows people and organizations to use resources more efficiently and collaborate effectively.

Cooperatives are a very unique entity option that requires more space to discuss. **However, it is important to realize that the terms "cooperative," "co-op," or**

**any other variation may not be used in the name of an enterprise unless that cooperative has been organized under the Michigan Nonprofit Act or the Michigan General Corporation Act.**

# REAL PROPERTY LAW BASICS

Ask any good food entrepreneur in Detroit, particularly urban farmers, and most will tell you that obtaining a secure interest in real property is one of the biggest challenges they face. Many entrepreneurs are concerned about the possibility of losing a lease or being kicked off land despite all of the time and energy they have invested. As a result, it is extremely important for good food enterprises to understand the different types of interests in property that are recognized by law, what degree of security they afford, and things to look out for during real property agreement negotiations.

## I.) Traditional Interests in Land

Not all interests in land and property are created equal; there are a broad array of legal interests in property and each has its own unique characteristics. It is important for good food enterprise stakeholders to understand the basic differences between the various interests in property, particularly since different types of interests often provide dramatically different levels of security. Below is a short list of basic interests in real property. They are listed in descending order, with the first interest providing the most secure interest in real property.

- + Freehold Estate (Ownership)
  - o Fee Simple Absolute Estate
  - o Defeasible Fee Simple Estate
  - o Concurrent Estate
- + Non-Freehold Estate (Lease)
- + Non-Possessory Interest
  - o Easement
  - o License

### A.) Freehold Estates

The defining characteristic of a freehold estate is ownership. It is the largest interest in real property recognized by our legal system and provides the most security. However, with the security comes responsibility. Owners of a freehold estate are generally responsible for paying property taxes (although nonprofit organizations may be exempt) and for maintaining the property. In general, the owner of real property is exposed to more potential legal liability than a renter. Among other things, owners may be liable for injuries that occur on their property and may be liable for zoning ordinance violations.

Also, a freehold estate is not always without limits. A person's interest in a freehold estate may be subject to other interests as well. Those other interests may take the form of a security interest of a mortgage lender, a condition upon the grant of the freehold estate from the seller, or the interests of another party to

the freehold estate. Therefore, determining what kind of freehold estate one has is very important.

*i.) Fee Simple Absolute*

The fee simple absolute is the largest possible estate in property that a person can have. A person or business that holds a fee simple absolute in property is the owner of that property and they may do with it as they wish, within the bounds of the law. They may, amongst many other things, occupy and use the property for themselves, they may occupy and use part of the property and lease part of the property to another, or they may sell it to another. In short, the holder of a fee simple absolute has a lot of power.

However, it is important to note one interest that often accompanies a fee simple absolute. Many people purchase a property with a structure with the assistance of a mortgage or finance the purchase of a vacant lot by taking out a loan. In that case, the lender (often a bank) usually obtains a security interest in the property. This means that if the person taking out the mortgage or loan fails to repay the mortgage in accordance with the agreed upon terms, the lender may foreclose on the property. At that point, the lender obtains the interest in land that was previously held by the purchaser of the property.

So what does this mean for good food enterprises? It means that if you want the greatest amount of security in your land, you should be attempting to obtain a fee simple absolute in the property you're interested in. However, since the holder of a fee simple absolute has so much power, it may be expensive. It also comes with a high amount of responsibility. The holder of a fee simple absolute generally must pay property taxes and must maintain the property in accordance with local laws and regulations. There are also potential liability issues as holders of a fee simple absolute may be liable for injuries that occur on their property.

*ii.) Defeasible Fee Simple*

A defeasible fee simple is closely related to a fee simple absolute, with one key difference; a defeasible fee simple is an interest in property that comes with a condition. The condition can take many forms, and must be specified in the deed. For example, the seller of a parcel of property may condition the sale on the property being used exclusively for farming by the purchaser. In such a case, the seller has not transferred their full interest in the property. Instead, the seller has retained an interest in the property because if the buyer violates the condition of sale, the freehold estate transferred from the buyer to the seller may revert back to the buyer.

Good food enterprises should be mindful of any transfer of property that comes with conditions. Whether or not the interest conveyed automatically reverts to the seller depends on the language of the conveyance. Further, some conditions are

unenforceable by law. For example, a condition that the purchasing party not sell the property would be unenforceable as it is against public policy. Having a lawyer review a conditional conveyance of property is important.

### *iii.) Concurrent Estate*

If a person sells an interest in property to more than one person, it creates a concurrent estate. Generally, all parties to a concurrent estate own a partial interest in the estate. For example, if a holder of a fee simple absolute conveyed her interest to two people, they would likely each have a ½ interest in the fee simple absolute rather than a full interest. Each party's ½ interest can be sold freely and can be passed by will or inheritance.

Being one party to a concurrent estate comes with specific rights and duties. Generally, each party to a concurrent estate has the right to non-exclusive possession of all portions of the property. This means that no single co-owner can keep another co-owner off part of the property. Further, each co-owner is required to contribute equally to necessary repairs, mortgage payments, and taxes.

### *B.) Non-Freehold Estates – Leases*

Essentially, non-freehold estates are what we all enter into when we lease property. While a non-freehold estate is an interest in property that gives the buyer the exclusive right to possess the property, it is only for a specific time period. Further, the lessor, or landlord, retains the right to sell the property. Obviously, a non-freehold estate is less secure than any of the freehold estates described above because it has a definitive end point whereas most of the interests described above have a potentially infinite duration. However, long-term leases may provide ample protections for good food enterprises based on the legal protections that protect a tenant's right to possession under a lease.

### *i.) Creating a Lease*

While the act of negotiating with a third party for a lease is described below, it is important to mention that Michigan courts have required a valid lease to contain a few terms.

- \* Must name the parties
- \* Must adequately describe leased premises
- \* Must state the length of the lease
- \* Must state the amount of rent

If a lease is missing one of the above elements, it will generally be regarded as a license by a court (licenses are addressed at the end of this section).

## *ii.) General Duties of Tenant*

Under a typical lease agreement, the tenant agrees to pay rent in exchange for the exclusive right to possess the property at issue. However, that is not the extent of the tenant's duties. There is also an implied duty for the tenant to not commit waste on the property. This is an old legal doctrine that essentially requires the tenant to keep the property in the same condition as it was when the lease began. It is important to realize the doctrine against waste applies both to actions by a tenant that reduces the value of the property as well as actions by a tenant that increase the value of the property. Therefore, it is important to negotiate with a landlord at the start of the lease any material changes you wish to make to the property to make it more suitable for your operations.

## *iii.) General Duties of Landlord*

Just as the tenant has duties, so does the landlord. The most significant of the landlord's duties is the duty to ensure that neither the landlord nor any other person interferes with the tenant's quiet enjoyment and possession of the property. Michigan law also contains strong protections for tenants in various forms of leases. Generally, a landlord must give at least a one month notice to terminate any lease. There are also strong eviction protections for tenants.

So, once again, what does all of this mean for you? A lease is good for most good food enterprises, but there are things to watch out for. A lease does provide a great deal of security, at least for the term of the agreement, and generally doesn't require the tenant to pay property taxes. However, you should be wary of the doctrine of waste. There is a presumption with a non-freehold estate that it is being maintained in the same condition as the landlord left it. Therefore, any permanent changes that you may desire to make should be discussed with the landlord up front and incorporated into your lease agreement, such as soil amendments or fruit trees. Temporary changes to leased property, such as installing a hoop house or appliances, are allowed as long as the property is not permanently altered. However, anything installed must be removed by the end of the lease term, or it becomes the property of the landlord.

Another thing to watch out for are the terms of the lease. Like with all contracts, the more time and thought parties put into a lease agreement, the smoother the landlord-tenant relationship usually runs. At the very least, you should consider having a lawyer or real estate agent review a lease to make sure it adequately protects your interests.

## *C.) Non-Possessory Interest*

### *i.) Easement*

While an easement is an interest in real estate, it is not a possessory interest but instead only involves a right of use. Essentially, an easement is a carve-out that

allows the grantee to utilize the specified area of property that the grantor owns for the use(s) agreed upon. A common example is a driveway easement in which the grantee is permitted to build and use a driveway on the grantor's land. Another example is a utility easement in which an energy company, such as DTE, is permitted to building and maintain power lines on land owned by another.

### *Creating an Easement*

Since an easement is an interest in real estate, the conveyance generally must meet certain statutory requirements to be valid. There are two general requirements:

- \* Must be memorialized in a writing
- \* Must be signed by the holder

An easement may also be created by reservation. This occurs when a grantor conveys title to land to another, but reserves the right to continue using the tract for a specified purpose. However, this reservation can only be reserved for the grantor and an attempt to reserve an easement for anyone else is void.

Lastly, an easement can be created by prescription. Similar to adverse possession, which is discussed below, an easement by prescription results when a person has been using the property of another for a long period of time. There are three legal requirements:

- \* Use must be open and notorious or the owner must have knowledge of the use
- \* Use of the property must be adverse to the owner
- \* Use must be continuous and uninterrupted for 15 years

### *Scope of Use*

When entering an easement, it is important to negotiate with the grantor what the scope of the use will be and for how long the easement will be. Doing so will help avoid conflicts regarding how the property is utilized down the road and sets clear expectations for the duration of the easement. However, absent express terms, there are two legal presumptions regarding the scope and length of easements.

- \* Absent express terms, easements are presumed to be perpetual
- \* Absent express terms, grantee may reasonably develop their easement

An easement does not give the grantee exclusive rights to possession and therefore the grantee may not limit the grantor's access to the property subject to the easement. Further, easements do not create a landlord-tenant relationship and thus do not subject the grantor to rigorous landlord-tenant laws. However, an

easement cannot be terminated at-will by either party and it does allow the parties flexibility in dictating the terms of the agreement.

Additionally, good food enterprises should know that easements can be enforced by specific performance. This means that if the grantor violates the terms of the easement, the holder of the easement can file a lawsuit and have the court enforce the terms of the easement.

*ii.) License*

A license may be called several different things. It is sometimes referred to as a permit or a shared use agreement. Regardless of the name, the defining characteristic of these agreements is that the possessor does not have an interest in the property itself, but instead non-possessory interests that only involves a right of use.

Because a license agreement does not involve a conveyance of an interest in property, they can be revoked at any time. Therefore, license involves almost no security; instead, all it does is provide an assurance that the licensee is allowed to operate on the owner's property as long as the agreement is not terminated. Even if a license agreement specifies the duration of the agreement, it can be terminated at any time and the licensee will have no right to the property.

Lastly, since a license agreement does not involve an interest in property, it is not subject to the formal requirements that all other interests in land must comply with. A license agreement does not have to be in writing and does not have to contain any specific terms.

## **II.) Acquiring a Traditional Interest in Land**

**A.) Freehold Estates**

*i.) Conveyance by Deed*

For all freehold estates, there are essentially two ways to acquire an interest in property. The first, and most obvious, is through a conveyance by deed.

To purchase private property, only the landowner needs to approve the sale unless a third party (i.e. a mortgage company) has a financing interest. Purchasing land from the city of Detroit is different than purchasing land from a private landowner. If a property is zoned residential, it will be owned and sold by the Detroit Land Bank Authority. If a property is zoned commercial or industrial, it will be sold by the Detroit Building Authority. To purchase property owned by either the Detroit Land Bank Authority or the Detroit Building Authority, the applicant for purchase must be paid up on all of their property taxes.

Below is the process that is generally followed to purchase land from a private landowner:

### 1.) Enter a contract of sale

A contract of sale is the preliminary agreement that a seller and buyer enter into for the sale of property. Essentially, a contract of sale is meant to give the buyer some time to line up financing and inspect the property and give the seller time to make sure their title to the property is marketable. Please note that one is not required to enter a contract of sale; it is just meant to provide some protection for both the seller and the buyer as both prepare for the closing date, which is discussed below. The contract has four basic requirements:

- ✦ Must be in writing
- ✦ Must contain a description of the property
- ✦ Must include the names of the parties and be signed by the parties
- ✦ Must include the price to be paid

Once a contract of sale is entered into, it generally binds the parties to some legal obligations. Generally, the seller is obligated to produce marketable title within a reasonable time. This means that the seller must have a valid interest in the property that is not subject to another's interest that may give rise to a lawsuit. Conversely, the buyer is required to produce the purchase price agreed to within a reasonable time as well. During the time between when the contract for sale is entered into by the parties and the closing date, the parties can continue to negotiate the sale before the closing documents are drafted. However, any amendments to the initial contract of sale should be in writing and attached to the original agreement.

### 2.) Inspect the Property

Generally, it is important for all purchasers of property to consider inspecting a property before the closing date. Your inspection should encompass three things:

- ✦ Inspection of title
- ✦ Inspection of building for defects
- ✦ Inspection of property for environmental contamination

#### *Inspection of Title*

Generally, when one obtains an interest in property, either by purchasing the property at issue or foreclosing on delinquent taxes or a debt that is secured by the property at issue, they record that interest with the county. This is commonly referred to as deed recording, and it is important for the reasons described below. However, before you even purchase property it is important to search the chain of title, which is essentially all the interests that have been recorded regarding that property in the past. This is important because it could alert the

purchaser to a defect in the title, such as outstanding tax liability, that remains with the property even after it is sold to another purchaser. For purchasers that are receiving a quitclaim deed, searching the title carefully is incredibly important. As discussed below, quitclaim deeds come with less protection for purchasers regarding title defects.

The chain of title for all properties in Detroit can be searched at the Wayne County Register of Deeds. However, you may want to consider paying a title company to search the chain of title for you and issue title insurance for the property. Title insurance provides you with financial protection if someone later claims an interest in a property that you purchased. Some local title insurance companies include Title One and First American Title Company.

### *Inspection of Building for Defects*

For the most part, the purchaser has the duty of making sure that any buildings on the property being purchased are structurally sound. This is generally done by hiring a private inspector to inspect the structures on the property and including a provision in the contract for sale that the purchase of the property is conditioned upon a satisfactory inspection.

### *Inspection of Property for Environmental Contamination*

The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) is one of the strictest federal environmental laws. Essentially, it makes current landowners liable for the cleanup costs for hazardous substances that have been disposed of on their property whether or not they were responsible for their disposal. This means that if it is discovered that one owns property contaminated by a hazardous substance, the Environmental Protection Agency may hold the landowner liable for its cleanup.

There is a defense known as the “innocent landowner defense.” While the general rule is that the current landowner is liable for the cleanup of the contaminated property that they own, regardless of whether they are responsible for the contamination or not, there is an exception for certain landowners. To be eligible for the exception that is the innocent landowner defense, a prospective purchaser of real property must hire an environmental professional to assess the contamination of the property. If the environmental assessment shows no signs of environmental contamination, then the landowner will not be found liable for contamination that is later discovered.

### 3.) Deed at Closing

At closing, both parties must be ready to perform the obligations described above. It should be noted that even if a closing date is specified in the contract of sale, courts are hesitant to strictly adhere to such dates. Only if the contract of sale expressly states that time is “of the essence” will a court enforce a listed

closing date. If a party fails to perform on a closing date and time is expressly described as “of the essence” in the contract of sale, then the party who fails to perform cannot enforce the contract.

Assuming both are ready and willing, the seller will convey the deed to the buyer. In order for the conveyance to be valid, two requirements must be met:

- \* Deed must be in writing, signed by the seller, and identify the parties and the land
- \* Buyer must accept the deed

There are two basic types of deeds that a seller may convey: a quitclaim deed and a general warranty deed. They both convey the same interest, yet they provide different assurances for the buyer. With a quitclaim deed, the seller makes no promise regarding the validity of their interest in land. Therefore, if a third-party later challenges the buyer’s interest in the property, the seller will not be liable. On the other hand, a general warranty deed involves numerous implied promises. These include promises that the seller will protect the buyer against anyone who may later claim an interest in the property as well as a promise to do whatever is necessary to clean any defects to the title.

Beyond the implied promises that accompany a warranty deed, a purchaser may also obtain title insurance. While a warranty deed provides legal protection to the purchaser by ensuring that the seller will legally defend the purchaser if someone challenges their claim to the property, a title insurance policy provides financial protection. Generally, title insurance policies are important for title defects that are very difficult to discover, such as forged signatures.

#### 4.) Recording Deed & Filing Property Transfer Affidavit

While not required to make the transfer of property effective, recording a newly transferred deed is very important. Recording your deed protects your interest in the property in case another claims that they have acquired an interest in the same property. If you have not recorded your interest and the other party has, they may be regarded as the rightful owner of the property even if you purchased the property first. You can record your deed at the Wayne County Register of Deeds.

Every purchaser of property in Wayne County is also required to file a Property Transfer Affidavit (Form 2766) with the Wayne County Finance Department, Assessment Division. The Property Transfer Affidavit must be filed within 45 days of the transfer or you may be subject to fees.

#### *ii.) Adverse Possession*

Acquiring property by adverse possession is commonly referred to as squatting. Adverse possession has four legal requirements

- \* Actual entry giving exclusive possession
- \* Possession must be open and notorious
- \* Possession must be adverse to the owner
- \* Possession must be continuous for a period of 15 years

Notably, all of the above elements must be present for at least 15 years. If the landowner returns after 14 years of you being on their land and seeks to kick you off, they may do so. Michigan law also has a presumption in favor of the record owners, and a person claiming adverse possession bears a heavy burden in proving all of the above elements.

Further, Michigan amended its squatting laws in 2014. These amendments reduce legal protections for squatters and criminalize squatting in a residential home. Specifically, the Michigan legislature amended the Judicature Act. Prior to the amendments, a landowner could not unlawfully interfere with the possessory interest of a squatter. This often prohibited a landowner from taking measures such as changing the locks or erecting a fence to restrict the squatter from re-entering the property. The amendments enable a landowner to eject a squatter and restrict them from the property without the threat of legal liability. The Michigan Penal Code was also amended to make squatting in a person's home a crime.

Overall, adverse possession takes a long time and is risky. However, there are instances in which vacant, structureless property has been acquired by adverse possession in Michigan. However, proving all of the elements described above is difficult.

## B.) Non-Freehold Estates & Non-Possessory Interests

Both leases and licenses are contractual agreements. Therefore, like most contractual agreements, it is important for a good food enterprise and the landowner to extensively discuss up front what is important to either side. At the very least, good food enterprises should be considering the following issues when entering an agreement to use land. It is important to note that the points on this list are not legal requirements, and the relevant issues will vary from individual to individual.

- \* What is the property at issue?
- \* What is the duration of the agreement? Can it be renewed? Option to buy?
- \* What is the cost and over what time period?
- \* When can the agreement be revoked by the landowner as well as by the lessee?
- \* What happens if the agreement is terminated?
- \* Who is liable for accidents/mishaps? Is a certain level and/or type of insurance required by either party?
- \* Who is responsible for utilities (water, electric, trash, etc)?

- \* What equipment will be installed?
- \* Will any improvements be made to the property?
- \* Will any signs be erected?
- \* Who is responsible for property maintenance?

Remember, the key difference between a lease and a license is that a license can be terminated at-will by the landowner. However, if a licensor violates the terms of the license by terminating the license in a manner that contradicts the express terms of the agreement, they may be liable for violating the contract.

# COMING TO AN AGREEMENT

## CONTRACTING FOR GOOD FOOD ENTERPRISES

Many good food entrepreneurs work in highly collaborative environments and have already entered into and are conducting operations based on agreements formed with various partners. The degree of formality of these agreements varies widely from informal handshake agreements to formalized legal contracts.

Some people may find negotiating a contract to be uncomfortable. Additionally, some people believe that the introduction of formal rules to a relationship will negatively alter their interactions with their partners. However, running a business or a nonprofit often involves forming relationships with other people, businesses, and organizations. Out of those relationships come several agreements, whether formal or informal, which guide the relationship. A contract is simply an agreement that meets a few basic legal requirements and is enforceable by a court. However, an equally important component of creating a formalized contract is that it often makes the parties to an agreement think carefully about their relationship and how they can most effectively work together.

### I.) Contracting Basics

A contract is a legally binding agreement in which both parties promise to provide or actually do provide something of value. If an agreement is a contract, it is enforceable by a court, which provides an assurance to all that each party to the agreement will be bound to the agreed upon terms. With that said, contracts can serve purposes other than being a legally binding agreement.

Contracts can be helpful for setting expectations with your partners. By sitting down and discussing what each party expects of the others, the parties to a contract can generally avoid future conflicts by creating clear and thorough agreements that anticipate certain situations.

While not always legally required, it is recommended that you put most of your agreements, whether legally binding or not, in writing. Putting an agreement in writing generally prompts the parties to the agreement to be more deliberative regarding what their duties and obligations are under the agreement. Having an agreement in writing is also helpful for conflict management. For instances in which parties to an agreement disagree about their duties and obligations, it is very helpful to have a document to point to that describes what the parties agreed to.

## II.) Other Forms of Agreements

A party may wish to formalize an agreement without creating a legally enforceable contract. The reasons for doing this are several: the parties may wish to formalize an agreement to provide more clarity for their relationship or they may simply wish to avoid any prospect of legal expenses. Typically, documents that embody agreements that are not legally enforceable are referred to as memorandums of understanding (MOU).

The differences between a MOU and a contract are often very thin. If the parties have created a legally enforceable agreement and have expressed an intent that they be legally bound to that agreement, an enforceable contract will be found by a court regardless of whether the parties call it a MOU or a contract.

However, if the parties to an agreement express an intent that the agreement not be legally binding or if the agreement is one that is unenforceable because it lacks one of the essential elements of a contract described below, then it will most likely be found to be a MOU and will not be enforced by a court.

## III.) Creating a Legally Enforceable Contract

Generally, a contract has four requirements. First, some (but not all) contracts need to be in writing and signed by the parties. Second, the contract must contain enough terms so that it is enforceable by a court. Third, the contract must have consideration. Fourth, the contract must not violate the law and must not be against public policy.

### A.) *Writing Requirement*

Many people believe that in order for a contract to be enforceable, it must be in writing. This is not completely true as only certain types of contracts are required to be in writing. Below is a list of contracts that **must** be in writing, contain the essential terms described below in Section 3.B, and signed by the party against whom enforcement is sought:

- \* Contract involving real estate
- \* Contract involving the sale of goods priced at \$1,000 or more
- \* Contract involving services that cannot, by any possibility, be carried out within one year
  - o Examples of When a Writing Is Required
    - Employment contract for a defined period exceeding one year
  - o Example of When a Writing Is Not Required
    - Employment contract of indefinite duration

If a contract does not involve one of the above subjects, it is not legally required to be in writing to be enforceable by a court. This means that a verbal agreement may be enforceable. However, having a contract in writing is usually a good idea as it avoids confusion amongst the parties.

### *B.) Terms Requirement*

An offer to contract must have enough essential terms so that the agreement would be capable of being enforced by a court. Essential terms vary by the subject matter of the agreement, but generally include the price and a description of the transaction. Non-essential terms include timing of performance and timing of payment. Below are the required terms for various types of contracts.

#### *i.) Real Estate Contract*

- \* Must identify the land
- \* Must identify the price

#### *ii.) Sale of Goods Contract*

- \* Must identify a specific quantity
  - o *Exceptions*
    - Requirement Contract
      - \* A contract that measures the quantity by the varying requirements of the purchaser is valid, as long as the amount required is in good faith and not unreasonably disproportionate to estimates or prior requirements
    - Output Contract
      - \* A contract that measures quantity by the output of the seller is valid, as long as the output is in good faith and not unreasonably disproportionate to estimates or prior outputs

#### *iii.) Services Contract*

- \* Must clearly and accurately describe the service to be provided
- \* Must specify what the parties are exchanging

### *C.) Consideration Requirement*

All contracts require consideration, which is a fancy way of saying that all contracts require each party involved to give up something of legal value. This is often referred to as the two parties having a mutuality of obligations and it is the way the law distinguishes between what is a gift and what is a contract. While the recipient of a gift may have legal rights to that gift, those rights are governed by a different set of rules.

Courts will generally not attempt to police a bargain. What this means is that all the parties must do is give up something of legal value in return for something else of legal value to create a valid contract. The thing of legal value could be something as simple as \$1. For example, a private landowner may be a big believer in urban farming and want to give his or her land to an urban farmer for no cost. However, if the person gives away the land, the urban farmer has not given up anything of legal value and therefore no enforceable contract has been formed. On the other hand, if the landowner agrees to sell his or her land for \$1 both parties have agreed to give up something of legal value and the contract has valid consideration. While the land may be worth much more than \$1, courts will not ask whether \$1 was a fair price and instead will likely find the contract to be enforceable.

Consideration does not need to involve money; it can involve an exchange of services. For example, Party A may agree to till Party B's garden in exchange for Party B building a fence on Party A's land. Consideration can also involve a promise to *not* do something that one has a legal right to do. A common example is non-compete agreements, in which one party may agree to refrain from opening a restaurant in a defined area in exchange for money.

One notable example of invalid consideration is consideration for past services. For example, an agreement that is premised on Party A tilling Party B's garden because Party B built a fence for Party A several years ago is not enforceable because it lacks consideration. This agreement lacks the mutuality of obligation, as Party B has no obligation to do or refrain from doing anything in the present.

#### *D.) Legality & Public Policy Requirement*

While it may seem obvious, you cannot contract around the law. Just as you cannot create an enforceable contract for the sale of illegal drugs, you cannot create a contract in which an employee agrees to work for less than minimum wage.

However, there is an additional contracting limitation that good food enterprises should look out for. As a general rule, a contract cannot be regarded as against public policy.

Generally, if a contract has a legal purpose and involves legal consideration, it will be valid. However, if a contract "conflicts with the morals of the time, and contravenes any established interest of society" it will be regarded as void and be against public policy. Obviously, what conflicts with the morals of the time is hard to define, and it certainly does change over time. For example, in 1947 the Michigan Supreme Court held that real estate covenants that restricted African-Americans from purchasing housing were not clearly against public policy and were enforceable. That rule has obviously changed. However, there are a few solid examples of contracts that are against public policy:

- ✦ Restraints on sale of property
  - Example: A contract for the conveyance of real estate would likely be void if it conditioned the sale upon the buyer not selling the property
- ✦ Restraints on commerce
  - Example: A non-compete clause of an employment contract that is unreasonable in either its duration, geographic area, or type of employment may be found void or limited by the court in order to render the agreement reasonable

#### **IV.) Negotiating the Terms of an Agreement**

The best contracts are ones that are specifically crafted to guide an agreement and a relationship between two or more parties. Depending on how familiar the parties are with each other and how comfortable they are working with each other, the agreement may vary in length as parties that are more familiar with each other will be more comfortable leaving certain issues open with the faith that they can be resolved later.

However, there are a few points that should be considered in almost every contract. Please note that points below are not legal requirements nor are they meant to be exhaustive of the things that you may want to consider when entering an agreement. Nonetheless, they are a good starting point.

- ✦ Parties: Who are the parties to the agreement?
- ✦ Purpose: What is the purpose for the contract?
- ✦ Term: What is the length of the agreement?
- ✦ Duties: What are the responsibilities of each party?
- ✦ Reporting: What is the method of measurement regarding performance satisfaction?
- ✦ Breach: What amounts to a violation of the contract?
- ✦ Remedies: What happens if the contract is violated and what should be done by each party if the contract is violated?
- ✦ Termination: How should the agreement be terminated?
- ✦ Liability: What risks are involved and how should they be allocated?

If you and the party you are contracting with consider those nine points, you should be well on your way to creating a strong agreement.

#### **V.) The Steps to Create a Legally Enforceable Contract**

The process of creating a contract is usually a fairly simple two-step process of one party making an offer and another accepting that offer. However, there are some intricacies and it is important to know precisely when a contract is formed because, upon formation, a contract binds the parties.

## A. *The Offer*

As a general rule, the person making the offer is free to dictate how an agreement will be formed. The offer can state how long the other party has to accept, and can also dictate how the other party may accept.

### i.) *Making an Offer*

An offer is defined as a manifestation of willingness to enter into a bargain made in a way that would make another person feel that their assent to the bargain is invited and would create an agreement. To be valid, an offer must contain the essential terms discussed above. While what is and is not an offer will often be clear, in some situations it is not. Inquiries into the availability of a specific good are typically not regarded as offers, but rather as invitations to negotiate. For example, a restaurant asking an urban farmer if they have a certain amount of potatoes would likely not be considered an offer.

It is important to correctly identify what specific communication constitutes the offer and who has made it because it may impact the enforceability of your agreement.

### ii.) *Termination of an Offer*

Once an offer has been made, it can generally be accepted either in the time specified by the parties or, if no time is specified, within a reasonable time. However, the party making the offer is generally free to revoke their offer, and once the revocation becomes effective the power to accept ceases to exist. A party may revoke an offer by either method described below:

- + Express statement indicating an unwillingness to contract
  - o *Note:* Only becomes effective upon receipt of statement
- + Conduct that is inconsistent with an intention to make a contract

While the general rule is that the party making the offer is free to revoke it at any time prior to acceptance, there are a few exceptions.

First, the power to revoke will be limited if an option contract has been created. An option contract is a contract in which the person making the offer promises to leave the offer open and available for acceptance for a certain period of time. It is important to note that an option contract is distinct from an offer that sets a defined period during which an offer may be accepted. An option contract is regarded as a contract unto itself, and therefore must meet certain requirements in order to be enforceable. The formation requirements depend on the subject matter of the contract.

- + Contract for Goods

- If offer is given by a merchant and in a signed writing, it is irrevocable regardless of whether there is consideration
- *Example:* A restaurant offers to buy 50 bunches of collards from a farming business and promises to keep the offer open for the farmer to accept for 2 weeks, but the farmer provides nothing in exchange for the restaurant keeping the offer open for 2 weeks. The two parties have formed an enforceable option contract and the restaurant cannot revoke its offer until the 2 weeks is up.
- + All Other Contracts
  - Person receiving the offer must give something of legal value to the person making the offer in order to make the promise to keep the offer open for the defined period enforceable
  - *Example:* A farmer offers \$200 to a neighbor for the neighbor to paint the farmer's fence, and the farmer promises to keep the offer open for the neighbor's acceptance for 2 weeks, but the neighbor provides nothing in exchange for the farmer's promise to keep the offer open for 2 weeks. The two parties have not formed an enforceable option contract, and the farmer may revoke the offer made by the neighbor at any time.
  - *Note:* In order for the above option to be enforceable, the neighbor should have provided the farmer with something of legal value (E.g: Cash) to make the promise to hold the offer open enforceable.

Second, the power to revoke a contract may be limited if the offer is accepted by the start of performance. As will be discussed below, an offer generally may be accepted by a promise to perform or by actual performance. If a party starts the performance asked for in the offer, the offer is not legally deemed to be accepted until the performance is completed. However, once the party has started performing, the offer is irrevocable.

### *iii.) Rejecting an Offer*

The rejection of an offer terminates the power of acceptance. Once done, the original offer can no longer be accepted. Generally, a rejection takes two forms.

- + Express Rejection
  - *Note:* Effective upon receipt by party making the offer
- + Counteroffer
  - A counteroffer is generally an acceptance that adds terms or changes the offer in any way. A counteroffer serves as both a rejection and a new offer.
    - *Example:* Party A offers to construct a fence for party B for \$100. Party B accepts Party A's offer to build the fence for \$100, but states that he will only construct the fence if Party A pays for the materials. Party B has included an additional

term in its acceptance, and therefore has made a counteroffer. No enforceable contract has been formed.

There is one exception to the counteroffer rule that good faith enterprises should be aware of. For contracts involving goods, a written acceptance that includes additional or different terms often will not operate as a rejection. What happens with the additional terms, however, depends on who the parties are.

- ✦ If Both the Parties are “Merchants”
  - Additional terms are included in the contract unless they materially alter the contract, the offer expressly limits acceptance to terms of the offer, or the person making the original offer objects within a reasonable time
- ✦ If Any Party is not a “Merchant”
  - The terms of the original offer govern

A merchant is defined as a “person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction...” For example, the operator of a production farm and a restaurant would both likely be regarded as “merchants” for a contract involving the sale of produce.

Here’s an example: Party A, a commercial urban farm, offers to sell 20 bunches of collards to Party B, a local restaurant. Party B accepts by sending an order form that states Party B agrees to purchase 20 bunches of collards from Party A, and also states that Party A must deliver the collards in 2 weeks. Even though the order form sent by Party B states an additional term, the offer will nonetheless be deemed accepted and Party A will be bound to deliver the collards in 2 weeks *unless* the offer made by the farmer expressly limited acceptance to the terms of the offer or Party A objects to the additional term within a reasonable time.

### *B. Accepting the Offer*

As a general rule, an offer may be accepted in two basic ways: by promising to perform the duty described in the offer or by actually performing the duty described in the offer. For example, if Party A offers to purchase 20 bunches of collards from Party B, Party B can accept by either promising Party A that it will send 20 bunches of collards or by actually sending 20 bunches of collards to Party B.

However, as mentioned at the beginning of this section, the party making the offer is free to define how the offer may be accepted. For example, an offer can state how the offer may be accepted, when it must be accepted by, and when acceptance will be deemed valid. For example, Party A may offer to purchase 20 bunches of collards from Party B, and further state that Party B may only accept by promising to sell 20 bunches of collards by the next business day. In this

example, if Party B sent 20 bunches of collards to Party A, the performance would not serve as a valid acceptance of the offer. Party A would only be able to validly accept the offer and form a contract by promising to sell 20 bunches of collards by the next day.

## **VI.) Should a lawyer review my contract?**

It depends. People enter agreements all the time and often are able to get along just fine. However, having a lawyer draft or review a contract can be helpful to point out potential legal issues, to point out what your points of risk are, and to ensure that the contract is thorough enough to efficiently handle changed circumstances that may arise in the future.

As a general rule, you should try to have a lawyer review a contract if you are making a big commitment of resources or if you don't understand the agreement that is being presented.

## **VII.) Conclusion**

A contract can be a simple agreement that deals with a quick sale of goods, or it can involve a more complex, ongoing relationship that spans several years. The one common requirement for all contracts is that the parties must mutually agree on the essential terms. Beyond the essential terms, the parties have a lot of flexibility to determine what form it will take. It can be a very detailed agreement that is embodied within a lengthy document that takes weeks to negotiate, or it can be an oral agreement that is negotiated in a five-minute telephone conversation.

It may be helpful to think of agreement negotiation on a continuum. Some agreements will require a minimal amount of negotiation while others will require a large amount of negotiation. Below are a couple of points to consider when determining how extensive your agreement negotiations should be:

- \* How well do you know the other party to the agreement?
  - o As stated at the start, agreements are helpful in that they set expectations and help manage conflict. However, agreement negotiations aren't the only way to set expectations and create processes with which to manage conflict. Parties that are familiar with each other based on years of working together in different capacities may already know what each expects of the other and may have already developed a process for managing conflict. Therefore, shorter negotiations may be appropriate as the parties may have a greater degree of trust in each other. Conversely, parties that have no prior relationship may want to more fully negotiate their agreement because of the lack of a prior relationship.

- \* How complex is the agreement?
  - o While a one-time agreement to sell 20 bunches of collards is fairly simple, an agreement to sell 20 bunches of collards every 2 weeks over a 1 year period or an agreement to share a \$200,000 grant over the course of several years is much more complex. This is something the law has recognized, and it is the primary reason for the law requiring certain contracts to be in writing. By requiring a contract in writing, the hope is that the parties will realize the gravity of what is being agreed to. A good rule of thumb is that the more complex the agreement, the more time the parties should spend negotiating their agreement. A couple of common indicators of complexity include the length of the agreement as well as the amount of money involved.

# Employment Law and Good Food Enterprises

For nonprofit organizations and for-profit businesses working with limited resources in a highly collaborative environment, many laws can present unique problems. This is largely because most of our legal system has been set up to regulate traditional economic relationships under the presumption that both parties are working exclusively for their own benefit rather than a shared benefit. One area of law in which this is incredibly clear is employment law. Employment law is premised on a traditional employer-employee relationship in which the employer attempts to gain as much economic value as possible from the employee in the form of services while the employee seeks to do the same from the employer in the form of wages. In fact, the common law referred to this relationship as the “master-servant” relationship.

While American employment law is premised on this exploitative relationship between employer and employee, it has also recognized that, if left unregulated, the employer’s power would often greatly outweigh that of the employee. Therefore, a complex array of both federal and state laws and regulations exist to ensure a basic level of fairness regarding the employer-employee relationship. Such federal laws include the Fair Labor Standards Act, which sets minimum wage and overtime wage rates for employers, and the Occupational Safety and Health Act, which seeks to assure safe working environments for employees. State statutes include the Workforce Opportunity Act, which sets minimum wage rates for all Michigan employers.

## I.) Federal and State Employment Laws

There are both federal and state laws that govern the employer-employee relationship. Some of the federal and state laws address the same issues, such as the Fair Labor Standards Act (a federal law) and the Workforce Opportunity Act (a Michigan law), which both address the minimum wage employers are required to pay to employees. For instances in which there is both a federal and state law, the state law controls if it is more stringent than the federal law, as is the case with Michigan’s minimum wage law.

The most relevant laws are listed in descending order, with the most important at the top. There are also several additional laws that require employers to post notices related to employee rights. Please see the end of this document for that information.

### Federal Laws

Fair Labor Standards Act

Occupational Safety and Health Act  
Immigration and Nationality Act  
Federal Unemployment Tax Act  
Family and Medical Leave Act

### State Laws

Workforce Opportunity Act  
Michigan Occupational Safety and Health Act  
Payment of Wages and Fringe Benefits Act  
Employment Security Act  
Workers' Disability Compensation Act

## **II.) Determining when employment Laws Are Applicable**

As you can see above, there are a lot of laws that employer's need to be familiar with. Many of the laws described above also have a multiple purposes. Typically, employment laws provide some form of protection for employees by requiring an employer to give them a certain benefit, such as a minimum wage. Further, many of the laws described above also require the employer to share information with their employees, such as what their legal rights are under the law. For small, good food enterprises that employ only a small amount of individuals, figuring out what employment laws apply and what they require can be a difficult and expensive issue.

However, it is important to note that the employment laws described above do not apply to all workers. Instead, the protections provided by employment laws only apply if the employer is a covered employer and the worker is an employee.

### A.) The Legal Definition of "Employer"

As mentioned above, there are both federal and state employment laws. Fortunately many good food enterprises with a small number of employees will generally not be regarded as "covered employers" under federal employment laws. For example, the Federal Family and Medical Leave Act, which provides employees with the legally protected right to take unpaid, job-protected leave for specified family and medical reasons, only applies if the employee works for an employer that employs 50 or more employees. Most other federal employment laws have similarly high thresholds for determining which employers are "covered employers" and thus will not apply to many good food enterprises.

While federal employment laws are typically limited to large employers, this is not true for Michigan employment laws. Generally, a Michigan employer will be considered a "covered employer" if they employ 1 or more employees. This is not true for every Michigan employment law, and many Michigan employment laws

contain special rules for agricultural employers. Nonetheless, Michigan employment laws are generally more applicable than federal employment laws.

#### B.) The Legal Definition of “Employee”

Once an employer has determined that it is a “covered employer” under either a federal or state employment law, it then must determine whether the worker is protected by the law. Typically, both federal and Michigan employment laws apply only to “employees.” Throughout the many federal and state employment laws that exist, the term “employee” typically has been defined as either “a person permitted to work by an employer” or as “an individual employed by an employer.” On its face, the definitions of “employee” are very unhelpful and seem to apply to all individuals that work for another.

However, in interpreting the definitions above, courts have attempted to differentiate between workers who are “employees” and those who are “non-employees.” In differentiating between “employees” and “non-employees” the courts have developed numerous categories of workers that it regards as “non-employees.”

It is important to note that while the following categories of “non-employees” are a good starting point to help parse out which workers are protected by employment laws and which are not, each employment law has been enacted for a specific purpose and may be interpreted differently. **Do not assume that just because a worker is regarded as a non-employee for the purposes of one employment law that it will be so regarded by all employment laws.**

#### C.) Volunteers as Non-Employees

Many Good Food Enterprises rely heavily on dedicated volunteers who strongly believe in the social benefits that the enterprise provides. As a general rule, volunteers are not employees and therefore are not subject to legal requirements such as the payment of minimum wage. With that rule in mind, it is important to define just what a volunteer is.

##### i.) Legal Definition of Volunteers

The Supreme Court of the United States has defined a volunteer as “[a]n individual who, without promise or expectation of compensation, but solely for his personal purpose or pleasure, work[s] in activities carried on by other persons wither for their pleasure or profit.”

It is important to recognize that **even though a nonprofit organization and an individual may expressly agree that the work of the individual is on a volunteer basis with no expectation of compensation, the individual may nonetheless be found to be an employee by law.** In *Tony & Susan Alamo Foundation v. Secretary of Labor*, the individuals at issue told the Court they

considered themselves volunteers and expected no compensation. Nonetheless, the Court found that the “economic reality” of the relationship was more like an employee-employer relationship.

The Department of Labor has created a number of factors that it considers when deciding whether a worker should be classified as a volunteer. Nonprofit organizations that answer “yes” to the first four questions and “no” to the last two questions should be safely able to claim that the worker at issue is a volunteer.

- \* Is the entity that will benefit/receive services from the volunteer a nonprofit organization?
- \* Is the activity less than a full-time occupation?
- \* Are the services offered freely and without pressure or coercion?
- \* Are the services of the kind typically associated with volunteer work?
- \* Have regular employees been displaced to accommodate the volunteer?
- \* Does the worker receive or expect any benefit from the entity to which it is providing services?

#### *ii.) Compensating Volunteers*

While the traditional concept of volunteerism in American employment law has been premised on the lack of any compensation, the Department of Labor has permitted volunteers to be paid expenses, reasonable benefits, or a nominal fee for their service without jeopardizing volunteer status. The Michigan Supreme Court has similarly allowed employers to provide “accommodations” and “nominal gratuity” to volunteers.

According to Michigan law, to be considered “nominal gratuity” compensation must be of a nominal cost to the employer and of nominal value to the employee. For example, giving a volunteer a bunch of greens after a few hours of volunteer work would almost certainly be regarded as “nominal gratuity” rather than compensation. The Department of Labor has also more clearly defined what is considered nominal in regards to federal law. According to federal regulations, if an employer gives a volunteer less than 20% of what that employer would otherwise pay for the same service from an employee, then it is presumptively nominal.

Another important thing to consider when providing benefits to volunteers are taxes. Nonprofit employers must treat payments and reimbursements to volunteers the same as payments to employees and therefore must withhold income tax and FICA contributions. However, inexpensive items such as a t-shirt, light refreshments, or a small amount of vegetables will likely be considered de minimis fringe benefits under the Internal Revenue Code and thus do not need to be reported as taxable income.

#### *iii.) Legally Utilizing Volunteers*

### Nonprofit Organizations

For nonprofit volunteers that are not also employees of the organization that they volunteer their time to, volunteers may be freely used as long as there is no expectation of either formal or informal compensation as described above.

It is different for volunteers that are also employees of the organization for which they are volunteering. According to federal labor regulations, an employee of an organization can still donate their time and act as a volunteer for their nonprofit employer. In such situations, the employer is not required by law to pay minimum wage for the volunteer hours. However, it is the policy of the Department of Labor's Wage and Hour Division that the volunteer work of the employee be dissimilar from the activities that the employee is employed to perform. For example, an office employee of a nonprofit can volunteer in the field during off-time without their volunteer services being regarded as compensable work.

### For-Profit Businesses

While many for-profit Good Food Enterprises are very dedicated to a socially beneficial mission such as creating a more sustainable and local food system, employment laws nonetheless treat them much differently than nonprofit organizations.

This is most important in the area of volunteers. Similar to nonprofits, many for-profit businesses are working with limited resources and often depend on having some volunteer help. However, for-profit businesses should be especially careful that their volunteers are not regarded as employees by the law.

It is important to note that the law is somewhat vague on this topic due to the various sources of authority. The Department of Labor, which is a federal agency, has taken a strong position against for-profit businesses utilizing volunteers. Federal courts, while not taking as strong of a stance as the Department of Labor, have ruled against for-profit employers who claimed that the worker at issue was a volunteer. The Michigan Wage and Hour Division generally takes the view that a for-profit business should not use volunteers, but also requires a complaint to be filed before an investigation is initiated.

So how can a for-profit business use volunteers without violating employment laws? The short answer is that they typically should not because the situations in which a for-profit business can utilize volunteers are rare. However, the steps discussed below should help a for-profit business identify how it may utilize volunteers without exposing itself to probable legal liability.

As a first step, it is important to maintain a healthy, close relationship with your volunteers and to use only a small number of them. Generally, the Michigan Wage and Hour program will not investigate an employer unless a complaint has been filed.

Secondly, you should consider the following six factors, which have been utilized by the United States Supreme Court to distinguish between an employee and a volunteer:

- \* Does the worker expect to be compensated or are they working for their own personal purpose or pleasure?
- \* Who is receiving the immediate and primary benefit of the work?
- \* Is the work being performed integral to the business?
- \* Is there an expressed or implied coercion or pressure by the employer on the worker?
- \* Does the worker volunteer regularly or only every once in a while?
- \* How long does the volunteer work?

No matter what a for-profit business does, utilizing volunteers will always present a legal risk.

*D.) Interns/Trainees as Non-Employees*

*i.) Nonprofit Organizations*

In general, the Department of Labor regards individuals who volunteer their time, freely and without anticipation of compensation, for religious, charitable, civic, or humanitarian purposes to nonprofit organizations to be volunteers. The Department of Labor has also extended this to unpaid internships for nonprofit organizations.

If a nonprofit organization pays its interns/trainees, it is unclear how whether the intern/trainee would still be regarded as a “non-employee.”

*ii.) For-Profit Enterprises*

Interns and trainees at for-profit enterprises are subject to more scrutiny under employment laws. The Department of Labor has issued a six-factor test to determine when an intern/trainee will be regarded as a “non-employee”:

- \* The internship, even though it includes actual operation of the facilities of the employer, is similar to training which would be given in an educational environment
- \* The internship experience is for the benefit of the intern
- \* The intern does not displace regular employees, but works under close supervision of existing staff
- \* The employer that provides the training derives no immediate advantage from the activities of the intern and on occasion its operations may actually be impeded
- \* The intern is not necessarily entitled to a job at the conclusion of the internship, and;

- \* The employer and the intern understand that the intern is not entitled to wages for the time spent in the internship

It is important to note that these factors have not been uniformly adopted by the courts. Some federal courts have stated that while the above six-factor test are helpful, they are not determinative. Alternatively, some courts have instead chosen to utilize a primary benefit test. Under the primary benefit test, the court will analyze who is receiving the primary benefit of the work: the intern/trainee via their on-the-job education or the employer via the services provided by the intern/trainee. If the intern/trainee is receiving the primary benefit, then the intern/trainee will be regarded as a non-employee.

#### E.) *Independent Contractor as Non-Employees*

The independent contractor classification is one of the most helpful for employers and also one of the most risky. If an employer employs the services of an independent contractor as opposed to an employee, the employer is excused from a wide array of legal obligations imposed by employment laws. However, the test for determining whether an individual is an independent contractor as opposed to an employee is a very murky one and misclassifying a worker as an independent contractor can be subject an employer to very expensive legal liability.

Before getting to the legal test that has been utilized to determine who is and is not an independent contractor, it may be helpful to describe what an independent contractor is in non-legal terms. An independent contractor is best described as a skilled worker that performs discrete tasks on a contractual basis, typically for numerous employers, while retaining discretionary control over how the task will be performed.

In determining whether a worker is an independent contractor, an economic realities test is used. Essentially, the economic realities test looks to all the facts and circumstances regarding an employment relationship. In particular, courts have typically looked to the following factors:

- Permanency of the Relationship
  - \* The more temporary the working relationship, the more likely the worker will be regarded as an independent contractor
- Degree of Skill Required
  - \* Typically, an independent contractor engages in work that requires a relatively high degree of skill
- The Worker's Capital Investment
  - \* If a worker utilizes its own equipment to perform the work at issue, then the worker is more likely to be regarded as an independent contractor
- Opportunity for Profit or Loss

- ✦ An independent contractor typically has some discretion that will allow them to either increase their profits or suffer a loss based on their level of skill and how they manage their work.
- Worker’s Right to Control
  - ✦ An independent contractor typically has the discretion to determine how the work at issue will be done.

Notably, different courts have emphasized different factors of the above test. Federal courts have at times emphasized the “opportunity for profit or loss” factor and whether the worker can exercise some amount of entrepreneurial discretion in their work. Michigan courts have typically emphasized the “right to control” factor and have stated that if an employer maintains a right to control, even if that right goes unused, then the worker at issue will be presumed to be an employee.

This area of law is particularly unpredictable and misclassification of an employee as an independent contractor can subject a good food enterprise to expensive legal liability. Before making a self-determination that a worker is an independent contractor, it is highly recommended that an enterprise speak with an attorney.

#### *F.) Partners as Non-Employees*

In American employment law, the defining relationship is the one that exists between an employer and an employee with the employee often being protected by various laws and regulations. However, in many nonprofit organizations and for-profit businesses that line is blurred. Many people that work for an enterprise also manage the business and have input on the direction of the enterprise while also working as a traditional employee.

Unfortunately, the law on the distinction between “partners” and “employees” is not well developed. Michigan courts have found partners to be employees for the purpose of claiming worker’s compensation benefits from insurance companies with the reasoning being that the owner is the employee of “another” with the other being their own business. Michigan courts have also interpreted partners to be employees pursuant to the Michigan Occupational Health & Safety Act, reasoning that the broad definition of employee includes an employer who performs the work that an employee would normally perform. It is unclear how these decisions apply to other areas of employment law.

Despite the uncertainty at the state level, federal courts have attempted to distinguish between partners and employees in cases involving employment discrimination. In *Clackamas Gastroenterology Associates, P.C. v. Wells*, the Supreme Court of the United States found that one is not an “employee” when no master-servant relationship exists. It also adopted the Equal Employment Opportunity Commission’s guidelines for determining when a master-servant relationship does exist. The factors are:

- Whether the organization can hire or fire the individual or set the rules and regulations of the individual's work
- Whether and, if so, to what extent the organization supervises the individual's work
- Whether the individual reports to someone higher in the organization
- Whether and, if so, to what extent the individual is able to influence the organization
- Whether the parties intended that the individual be an employee, as expressed in written agreements or contracts
- Whether the individual shares in the profits, losses, and liabilities of the organization

The factors above govern federal employment laws regarding workplace discrimination. It is unclear whether it extends to other employment laws and whether it will be applied to state employment laws.

### **III.) Employees and Statutory Wage Requirements**

If an individual is determined to be an employee by law, then that individual is required to be paid at least the state minimum wage, which is currently \$8.15 per hour and is scheduled to increase in 2016, 2017, and 2018. An employee is also required to be paid overtime wages, which is 1.5 times their normal rate for every hour worked past 40 for the workweek.

As mentioned above, this is true regardless of whether you have expressly agreed with the individual that you do not consider them an employee but instead a volunteer or an independent contractor. Under the Michigan Workforce Opportunity Wage Act, employees can either file a civil action for recovery of unpaid minimum wages and overtime, or they may file a complaint with the Michigan Occupational Health and Safety Administration. Recovery under the Act can include all unpaid minimum wages and overtime wages, as well as additional liquidated damages and reasonable attorney fees.

There is one notable overtime wage exception. Under Michigan's Workforce Opportunity Wage Act, an "employee employed in agriculture" is exempt from overtime wage requirements. An employee is considered to be "employed in agriculture" if they are involved in cultivating, growing, and harvesting agricultural commodities as well as a practice that is performed in conjunction with farm operations such as delivering produce to market or other buyers.

### **IV.) Other Employer Responsibilities**

While paying your employees the minimum wage mandated by law is perhaps the most important legal requirement, it is definitely not the only one. Below is a

list of other basic responsibilities for employers. For more in-depth advice regarding the legal requirements described below, please contact an attorney.

*A.) Withhold Federal, State, & Municipal Taxes from Employees*

While nonprofit organizations are exempt from paying income taxes, they, along with for-profit enterprises, must withhold income taxes from the wages of their employees. This involves calculating how much to withhold, depositing the withholdings with the appropriate federal, state, or municipal governmental entity, and filing the appropriate monthly, quarterly, or yearly withholding tax returns. They also must pay employment taxes themselves.

The administrative burdens involved with withholding income taxes from employees can be burdensome. It is recommended that you contact an attorney for assistance when a good food enterprise hires a new employee.

*B.) Pay FICA Taxes*

The Federal Insurance Contributions Act (FICA) imposes a tax on all employers. The FICA tax includes a 6.2% Social Security tax and a 1.45% Medicare tax.

*C.) Verify Employee Eligibility*

The Immigration and Nationality Act requires employers to have each new-hire complete the Employment Eligibility Verification form (Form I-9) to ensure that the individual can legally work in the U.S. An employee should complete the form no later than their first day of employment, and the employer must retain the form for a period of 3 years.

*D.) Comply with Michigan Unemployment Insurance Program*

Michigan's Employment Security Act describes the state's unemployment insurance program. The program is administered by the Michigan unemployment insurance agency. The law requires all liable employers to either pay taxes to the unemployment insurance agency or to reimburse the unemployment insurance agency for benefits paid by unemployment insurance agency to an employer's former worker.

*i.) Determine whether you are a liable employer*

In general, a liable employer is defined by the Act as an employer that pays \$1,000 or more in wages or an employer that has at least 1 employee in covered employment in at least 20 weeks out of the year.

If an employer appears to satisfy any of the tests for becoming a liable employer, the employer can send Form UIA 518 to the Michigan Department of Treasury at the following address:

Registration Section  
Michigan Department of Treasury  
Lansing, MI 48922

*ii.) Pay Unemployment Insurance Agency*

If an enterprise is determined to be a liable employer, it is generally required to pay unemployment taxes for workers performing services in covered employment. The law specifically excludes certain workers from coverage. Below is a list of the most relevant exclusions. For the full list, please refer to MCL § 421.43.

- ✦ Agricultural workers if the farmer pays less than \$20,000, in cash, in a calendar quarter for agricultural labor, and employs fewer than 10 employees in each of 20 different weeks in a calendar year.
- ✦ Service by an AmeriCorps participant if performed for a guaranteed stipend opportunity and if the participant received the full stipend

A nonprofit organization that is a liable employer can choose to be a reimbursing employer rather than a contributing employer. A nonprofit making such a choice would not pay taxes to the state unemployment tax for workers performing covered services. Instead, a reimbursing employer only becomes liable to the Unemployment Insurance Agency once the Agency pays unemployment benefits to the nonprofit's former employee. In such a case, the reimbursing employer pays the Agency dollar-for-dollar the amount it paid in benefits to the former employee. In order to make this election, the nonprofit must file a request with the Unemployment Insurance Agency seeking to become a reimbursing employer within 30 days of being determined to be a liable employer. Once reimbursing status is granted, it must be retained for at least 2 calendar years.

**E.) Pay Federal Unemployment Tax**

In addition to the Michigan Employment Security Act, the Federal Unemployment Tax Act requires covered employers to pay a federal unemployment tax, commonly referred to as the FUTA tax.

In general, an employer will be subject to the FUTA tax if:

- ✦ It paid wages of \$1,500 or more in any calendar quarter, or;
- ✦ It had one or more employees for at least some part of the day in any 20 or more different weeks

The FUTA tax rate is 6% and it applies to the first \$7,000 the employer pays to each employee as wages during the year. However, employers that are also subject to the Michigan unemployment tax may receive a credit that will reduce its FUTA tax liability.

Generally, an employer must deposit its FUTA tax quarterly and must file Form 940 as its annual FUTA tax report.

It is important to note that there are special rules for farmworkers. An employer is only liable to pay FUTA tax for wages paid to a farmworker if:

- ✦ The employer paid wages of \$20,000 or more to farmworkers during any calendar quarter, or;
- ✦ The employer employed 10 or more farmworkers during at least some part of a day

#### *E.) Comply with Federal, State, and Local Anti-Discrimination Laws*

Under Michigan's Elliott-Larsen Civil Rights Act, it is unlawful for an employer to subject people to differential treatment on the basis of religion, race, color, national origin, sex, height, weight, familial status, or marital status. Specifically, an employer cannot discriminate against any member of the above classes in hiring, compensation, or the terms, conditions, and privileges of employment. The Elliott-Larsen Civil Rights Act also makes it unlawful for an employer to even ask an employees or potential-employees about their misdemeanor arrest record. Additionally, employers with 15 or more employees also may be liable under various federal anti-discrimination laws such as the Civil Rights Act, the Americans with Disabilities Act, and the Age Discrimination in Employment Act.

Absent from both federal and state law is sexual orientation as a protected class. However, Detroit, by ordinance, has prohibited all employers from discriminating against individuals based on sexual orientation.

#### *F.) Obtain Worker's Compensation*

As a general rule, Michigan employers are required to cover employees with workers' compensation insurance if they either regularly employ three or more workers at one time or if they have regularly employed at least one worker for 35 hours or more per week for 13 weeks or longer. There is *no exception* for nonprofit organizations. However, there is an exception for agricultural employers.

As a general rule, agricultural employers *do not* need to obtain workers' compensation insurance for their employees. An agricultural employer is defined by the Act as "one who hires a person performing services on a farm, in connection with cultivating the soil, or in connection with raising or harvesting an agricultural...commodity..."

However, an agricultural employer does need to obtain workers' compensation insurance if:

- \* The agricultural employer has 3 or more regular employees paid hourly wages or salaries, and;
- \* Those 3 or more regular employees are employed by the employer 35 or more hours per week for 13 consecutive weeks during the preceding 52 weeks.

If an employer is mandated to purchase workers' compensation insurance, they may satisfy their legal requirements in one of the following four ways.

- \* Purchase a policy from a licensed and approved insurance carrier
- \* Purchase a policy through the assigned risk pool
- \* Secure coverage through a self-insured group fund
- \* Receive authorization from the bureau director to be an individual self-insurer

#### *G.) Comply with Michigan Payment of Wages and Fringe Benefits Act*

The Michigan Payment of Wages and Fringe Benefits Act regulates the time and manner of payment of wages and fringe benefits to employees.

Generally, employers must pay employees in either money, check, or by direct deposit. If payment is by direct deposit, the employee must give their written consent. Employers are also required to keep records regarding paid wages and to provide such records to employees. The records should contain the following information:

- \* Employee's full name, address, birth date, and occupation or classification in which the employee is employed
- \* Total basic rate of pay (Hourly/Weekly/Piecemeal)
- \* Total hours worked in each pay period
- \* Total wages paid each pay period
- \* Itemization of deductions and an itemization of fringe benefits

#### *H.) Provide Safe Working Conditions and Comply With Safety Standards*

The Michigan Occupation Safety and Health Act mandates that all employers maintain a safe and healthy work environment for all workers. Below is a list of more specific requirements for employers under the Act.

- \* Display all relevant posters (See pg. 51 for information regarding workplace posters)
- \* Notify MIOSHA within 8 hours of a workplace incident in which there is a death or when 3 or more workers go to the hospital

- ✦ Log all occupational injuries and illnesses
  - Employers with 11 or more employees must log all occupational injuries and illnesses and post an annual summary (See MIOSHA Form #300A)
  - Employers with 10 or fewer employees may be requested to keep records of occupational injuries and illnesses by MIOSHA, the Bureau of Labor Statistics, or the U.S. Department of Labor. The request must be made in writing. If no written request is made, no injury and illness records are required to be kept.

In addition to the general employer requirements, there are additional requirements for agricultural employers. For an agricultural business operation that employs individuals engaged in the production of food or other materials, the employer must provide potable water, access to a toilet, and hand-washing facilities in locations readily accessible to all employees.

#### *I.) Comply with Federal Leave Laws*

The federal Family and Medical Leave Act (FMLA) requires liable employers to grant certain employees unpaid leave from their employment for specific events.

Most good food enterprises will likely fall below the employer threshold and thus not be liable under the FMLA. In order to be liable, an employer must have at least 50 employees for at least 20 weeks in the current or previous year. Further, not all employees are eligible. The employee must have worked for the company for at least a year, must have worked at least 1,250 hours during the previous year, and must have worked at a location with at least 50 employees within a 75-mile radius.

If an employer is liable, an eligible employee can take unpaid leave from their employment to recuperate from a serious health issue, to care for a family member with a serious health issue, or to bond with a new child. While FMLA leave is unpaid, when it ends the employee is entitled to be reinstated in the same or equivalent position.

#### *J.) Maintain Required Notices and Records*

The Michigan Occupational, Safety, and Health Act is not the only law that requires an employer to post workplace notices. Employers are required to post several notices relating to employee rights in accordance with several state and federal laws. Links to the notices required by law can be found here: <http://www.michiganbusiness.org/cm/Files/FactSheets/RequiredWorkplacePosters.pdf>

## **V.) Employment Contracts**

In addition to all of the above laws that provide some measure of substantive protection to employees, the law also grants legal protection to employees in employment contracting. An employment contract is an enforceable agreement between an employer and an employee. Like most contracts, an employment contract is important in that it describes the essential responsibilities of both the employer and the employee as well as the term of employment. However, in general an employment contract does not have to be written to be enforceable. An enforceable employment contract can be orally created and a court can even imply a contract.

Employment relationships generally fall into one of two categories: “at-will” or “for-cause.” Michigan, like most states, has a general rule that presumes an employment relationship is “at-will.” This means that either the employee or employer can terminate the employment relationship at any time, with or without cause. The alternative to an “at-will” employment relationship is a “just-cause” employment relationship. A “just-cause” employment relationship, as the name suggests, can only be terminated with cause. If an employee believes they were terminated without cause, or that the cause for their discharge was merely pretext, they can bring a wrongful termination lawsuit to collect damages. An “at-will” employee cannot bring a wrongful termination lawsuit. However, they still have the right to enforce the terms of their employment agreement. The general rule described above has three exceptions. They are listed below.

#### A.) Public Policy Exception

An employer may not fire an at-will employee for failing or refusing to violate the law during the course of employment or for exercising rights conferred by a well-established legislative enactment.

#### B.) Clear and Unequivocal Oral Promise Exception

This exception requires an employee to show that there were some negotiations for “just-cause” employment or a specific intent on the part of the employer for “just-cause” employment. Typically, this exception applies when an employer has made a statement to the employee that leads the employee to justifiably believe their employment may only be terminated for cause.

#### C.) Legitimate Expectations Exception

Under this exception, an employee can rely on an employer’s promise or statements to the workforce in general as evidence that there is a “just-cause” relationship. However, the employee’s reliance on the employer’s promise must be reasonable. Employers should be aware that an employer’s policy statement that employees may only be fired for cause may create an implied “just-cause” relationship.

An employer and an employee are also free to contract around the presumption for at-will employment. In general, this requires the employee to agree to a specific term of employment and the employer to agree to only fire the employee for cause prior to the termination of the specified term. The Michigan Supreme Court has also held that an employment contract that provides that an employee shall not be discharged except for cause creates a “just-cause” relationship regardless of whether the contract is for a definite or indefinite term.

Employment contract disputes, like most contract disputes, arise when employers and employees don’t discuss the specifics of the relationship they are entering and what each party’s respective expectations of the other are at the outset. As an employer or an employee, you should at the very least discuss with the other party whether the relationship will be “at-will” or “just-cause.” Ideally, you should also clearly delineate what the responsibilities of each party are. Doing these simple things will go a long way to limiting disagreements regarding the employment relationship. For enterprises focused on social justice, it can also limit the possibility of a lawsuit that claims the enterprise wrongfully terminated an employee, which can be incredibly harmful to their reputation in the community regardless of the outcome.