



# The Letter of the Law



## THE SHAFER LAW FIRM

LAWYERS WHOSE PRACTICES HAVE BEEN BUILT ONE REFERRAL AFTER ANOTHER

### AVOID PITFALLS IN BUSINESS STARTUPS



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Starting a new business is a major undertaking. Whether it is a sole proprietorship, a general partnership, a limited liability corporation (LLC), a limited liability partnership (LLP) or a traditional business corporation, getting started on the right foot is critical.

#### Early Involvement Of An Attorney And Accountant.

All too often, business entrepreneurs, in an attempt to save time and expense, minimize or avoid the use of an attorney and accountant when starting a business.

I am reminded of the Fram oil filter commercial of many years ago: "Pay me now or pay me later". The Fram commercial demonstrates that skipping regular oil and oil filter changes can result in total engine breakdown. This analogy can apply to startup business owners who fail to obtain good legal and accounting advice. These business owners can later discover that their business has legal, tax and accounting problems. The legal and accounting costs incurred resolving problems after startup are frequently much higher than doing it right in the beginning.

Working together, a business attorney and an accountant can help a startup business in many ways. These include:

(1) Making the proper choice of entity. Should it be a sole proprietorship? Should it be a general partnership; an LLP; an LLC or a traditional business corporation?

(2) Compiling a good business plan. If the startup business needs bank financing (which is almost always the case), how can the business owner best put together a business plan to maximize the chances of getting the loan or loans needed for

startup?

(3) Preparing comprehensive agreements among owners. If there are multiple owners in the new venture, what kind of agreements should be created among those owners to best protect each individual's interests as well as the ongoing business?

#### Entity Choice.

There are many factors involved in determining the best legal entity to own a new business. What will afford the business owners the best protection from personal liability? Which form will be best to minimize taxes? Which entity works best when there are multiple owners?

The simplest choice of the legal entity may be a sole proprietorship. This is where a single business owner operates under their own name, with the possible use of a fictitious name. While this is the simplest structure, if the business involves risk of tort liability, such as personal injuries resulting from the use a product or service provided by the new business, that cannot be adequately insured against, a separate entity such as an LLC or traditional business corporation may be advisable, despite additional complexity and cost.

If the business venture involves more than one person, the entity structure becomes even more important. Who among the owners will have controlling interest? How will the owners share profits and losses? How will the ownership of the business interest affect each of the owner's tax returns? Will the profits and losses be taken at the corporate level or will those profits and losses pass through to the individual owners' tax returns? Can the structure be designed to avoid double taxation at both the business and individual levels?

#### Preparation of a Business Plan.

Almost every new business needs some type of help from a professional lender such as a bank. These lenders won't consider lending any substantial sums without a comprehensive business plan. The business plan outlines not only what the new business plans to produce or what service it will perform, but also the details of how the business plans to turn a profit and pay the bills. This is where a business accountant can be very helpful. The process of putting together a business plan is also a helpful exercise for the new business owner. Costing out operational overhead and determining pricing on products and services are just two examples. The accountant may also accompany the new business owner when he or she calls on the lender.

#### Agreement Among Owners.

One of the most important documents needed at the outset of any new business is a signed agreement among all of the owners. Unfortunately, new business owners frequently think they can postpone this decision until after the business is established. With the pressure of getting a new business off the ground, this agreement can get pushed to the bottom of the priority list. This is a big mistake. The more successful the business becomes, the bigger the problems can be due to the lack of a comprehensive agreement among the owners. Ironically, the lack of a written agreement among business owners who know each other well, are good friends and/or relatives, can often result in the most troublesome situations. No one intentionally misleads the other business owner(s) but, because they have failed to openly and completely discuss the issues ahead of time, each of the multiple owners can unknowingly have a different idea of what their ownership means and what

their expectations are.

The mere process of writing out an agreement helps each owner understand what the others are thinking. At startup is the time to resolve problems; not months or years later after a lot of hard work and failed expectations among the owners.

Issues to be addressed in the inter owner agreement, should include the following:

(1) What happens if one of the business owners dies, becomes disabled, wants to leave the company or is terminated as an employee?

(2) If any of the above events occur, do the other owners have the first right or obligation to buy the share(s) of the departing owner?

(3) Does an owner have the right to sell the stock to outsiders or give it to other family members?

(4) In the event of the sale, how is the price of that interest determined?

These are all discussions that should occur with the business attorney and accountant in the process of preparing the owners' agreement.

#### Summary.

It is more economical in the long run to spend money on a business attorney and accountant before starting a new business rather than waiting until problems develop down the road. There are enough difficulties and risks involved in starting a new business without creating unnecessary ones.

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