Considerations for startups

How to avoid common legal pitfalls when starting a business

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When forming a business, there are many considerations that should be made to protect the company's legal and financial future. However, business owners often spend their time focused on what they are good at — making products or delivering services — and fail to assess many legal issues that create future liabilities.

Smart Business spoke with Louise M. Mazur, a partner at Brouse McDowell, about steps new business owners should take to protect their company.

What do new business owners need to know when forming the entity?

Incorporated businesses need a code of regulations that governs the organization of the business. Through this, the founders can create protections that will give them a strong position if they later take on investors for the business, such as delegating voting and nonvoting shares.

Similarly, limited liability companies need articles of organization, which enable the founders to designate themselves as the managing member and tax matter partner. These articles give them control of the day-to-day operations and oversight of the important financial decisions, legally establishing the founder's authority so it cannot be challenged by future investors.

New businesses should also have an established buy/sell agreement that controls how ownership interests are sold to new investors, which will help avoid disputes with future investors.

There are also ongoing legal responsibilities after a business is formed. For example, a company must regularly update the existence of its business, including updates to the designation of its statutory agent. A company can be cancelled if it fails to file articles of continued existence or does not update its statutory agent. If that occurs, the founders could be, unknowingly, personally liable for the debts and obligations of the business.

How do founders shield themselves from liability?

Founders need to establish a separate mailing address for the company — even if just a P.O. Box — a separate bank account, credit card and line of credit. They should also keep their business receipts separate from personal receipts.

Those who do not establish a clear line between their personal and business identities may have significant problems. For example, if an owner makes a personal purchase on a company credit card, the IRS will classify it as income to the individual, which means the person needs to either declare it as such on his or her taxes, or reimburse the company for the purchase. Failing to do so will lead to penalties.

What should a business do to protect its operations from the start?

An employee should be asked to sign a new hire agreement that contains three components: confidentiality, noncompete, and work-for-hire provisions.

Concerning confidentiality, the employee will acknowledge that certain proprietary information is the property of the business and that the employee is legally prohibited from using the confidential information or sharing confidential information with third parties during and after employment. Noncompete agreements are designed to restrict an employee's ability to compete directly with the company, either by setting up a competing business or working for a competitor, within a specified geography and amount of time.

In the employer/employee relationship, the employer owns all rights to the work created by the employee. Nonetheless, the new hire agreement should include a work-for-hire provision to clearly confirm that all of the employee's works or inventions become the sole property of the employer.

A new business should also develop terms and conditions of sale to outline the required due dates for payment and interest that accrues for late payments. Terms and conditions can also protect a business by placing limitations on liability to customers and minimizing customers' remedies against the business. Terms and conditions should address how problems will be handled if and when they occur.

Before forming a business, founders should talk with an accountant and an attorney to ensure the company will be on strong legal footing and positioned to optimize any tax advantages. A little foresight at the start goes a long way for a new business. ●