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Common Mistakes in Forming a Business . . . and How to Avoid Them

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We receive telephone calls almost every day from individuals looking for guidance on how to bring their business ideas to life. Of course, we also receive frequent calls from anxious business owners looking to resolve potentially damaging business disputes. With almost every such call, careful, knowledgeable business planning will provide the entrepreneur with a clear, defined path to opportunity – and likely would have saved the anxious business owner from unnecessary stress, damage and legal fees.

The most common mistake new business owners make is not investing the time to properly form their new business. Starting a healthy business requires careful planning, knowledge and foresight. Here are five simple ways you can avoid common – and costly – mistakes:

1. *Seek Professional Guidance:* Consult with a qualified attorney and business accountant to determine what kind of entity is best. While limited liability companies are all the rage, and often the default choice for small businesses, the limited liability company (LLC) structure is not right for every business.

Frequently, special tax, financial, growth or control considerations make the corporate structure a better choice. To help with this decision, your attorney will examine the type of business you intend to operate, the number of owners and their rights to participate in the business, assets the business will own, projected profits and the business' long-term plan. And that is just for starters. There are plenty of other things you will need to discuss.

2. *Know What Documents Are Required:* To limit personal liability, most business owners operate their business as a corporation, LLC or limited partnership. To form an entity, all local jurisdictions require business owners to file one or more documents with the Jurisdiction. Take note, however, since this probably is not where your filing obligations will end! For example, many businesses are required to apply for a Federal employer identification number (essentially a social security number for the business). Owners intending to operate as a "Subchapter S" or "S" corporation under Federal tax laws only have a small window of time to file the required election with the IRS. Many new businesses are required to obtain business licenses, occupancy permits, unemployment and workers' compensation insurance and tax account numbers before earning their first dollar or hiring their first employee. It is much more cost effective to take these steps up front to avoid unnecessary penalties and fees down the road.

3. *Define Your Relationship:* One of the most common, and costliest, mistakes business owners make is not entering into a written agreement memorializing the terms of the owners' relationship with one another. Corporations, LLC and partnerships all use such agreements, which commonly are referred to as shareholders' and buy-sell agreements, operating agreements and partnership agreements, respectively. These agreements typically answer three fundamental questions: a) how are decisions made, b) how is money split, and c) how can an owner withdraw from the business. A well-drafted relationship agreement may be the best investment a business can make.

4. *Protect Your Assets:* A business is only as valuable as its assets, whether those assets are widgets, formulas, business methods, trade names or client lists. Business owners must take affirmative steps to protect their assets from unscrupulous and would-be competitors. Courts generally will not step in to protect a business' assets if the owners did not take reasonable affirmative steps before the problem arose. Protecting assets can be as simple as having employees sign carefully drafted employment policies and restrictive covenants, but it can be as complicated as seeking Federal copyright, trademark or patent protection. Addressing these matters early can help avoid devastating problems from developing later.

5. *Don't Wait:* While nothing can replace the security of forming your business on carefully tailored advice, it generally is not too late to go back and "audit" your business and fill in any gaps unless a problem already has surfaced. The time to take action is now. Don't wait any longer.

David P. Shapiro is a business and commercial transactions attorney with Paley Rothman in Bethesda, a 40-attorney firm that provides legal services in more than 20 different practice areas. Its attorneys are at the forefront of representing professional, health care, biotechnology, government contracting, manufacturing, retail and real estate businesses and financial institutions from the incubator to IPO.

Paley Rothman, founded in 1972, provides legal counsel to corporate and individual clients in a wide range of practice areas. It maintains a business-orientation and handles tax, real estate, employment law, estate planning, litigation and a variety of other matters for businesses and professionals in Montgomery County and throughout the Washington, D.C. metropolitan area.

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