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Five Overlooked Legal Mistakes Entrepreneurs Make

Posted by Lisa Girard | August 31, 2011

URL: http://www.entrepreneur.com/article/220224

Starting a business can be fraught with potential legal issues that are often overlooked by first-time entrepreneurs. Many details that don't seem pressing at the start can mean the difference between success and failure later on. But many common pitfalls can be avoided with the right planning and execution. Here are five mistakes small-business owners make -- and how to avoid them.

Mistake No. 1: Making handshake deals with clients and vendors.
Always put your business dealings in writing. Don't naively assume that everything will go according to plan. "This is often not the case, and when things go wrong, the entrepreneur and the client or vendor may have different ideas about what is supposed to happen," says Rachel Rodgers, principal attorney with Rachel Rodgers Law Office in Phoenix, Ariz.

How to avoid it: Keep a written for every relationship your business enters into to protect yourself from loss of time, money, and potential lawsuits.

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Mistake No. 2: Choosing the wrong business structure.
Whether you choose sole proprietorship, S-Corp, or limited liability company (LLC), making a hasty choice can put your business at risk, and lead to painful tax bills at the end of the year. With a sole proprietorship you are not required to register your business with the state and it's often chosen by startups operating on a shoestring, but beware there's no wall between your business and personal assets. S-Corps and LLCs may cost more to set up and maintain but your business is kept legally separate from personal assets -- so it's less risky if your company goes under or is the target of a lawsuit.

How to avoid it: Rodgers recommends incorporation in most cases. Since it's a more complex structure, it shows customers, banks and investors that you're serious about being in business over the long haul. If you opt for the simpler route of sole proprietor, she suggests looking at business insurance to protect your personal assets in case your company is sued and loses. Of course, you'll want to consult with a lawyer or accountant to determine the best structure for your particular size and needs.

Mistake No. 3: Bringing on partners without a detailed agreement. Many entrepreneurs put this paperwork on the back burner in favor of "focusing on the business," but several problems can arise in the meantime. "One of the biggest boons to my startup practice has been the movie The Social Network, which revolves around the litigation surrounding the ownership of the ideas, code, et cetera, at the onset of Facebook," says Gregory Kratofil, an attorney and shareholder with the law firm Polsinelli Shughart in Kansas City, Missouri. No matter how much you like and trust your business partners, you need a legally binding agreement -- not just detailing operations and responsibilities, but also what happens if you have opposite views of where to take the company.

How to avoid it: Have the hard conversations now, when everybody's still in love, says lawyer William M. Moore, founder of the Moore Firm in San Diego, a law firm that serves entrepreneurs. That's when to put in writing important issues like who owns what shares, who has what power, as in the case of deciding a potential buyout.

Mistake No. 4: Establishing a 50-50 partnership. In theory, this sounds great, but ultimately when issues arise -- like whether to bring on new investors -- somebody has to be able to make an executive decision. If you deadlock on a major decision and nobody budges, the company is frozen in limbo unless one of you buys out the other. "It's very difficult for human beings to decide how to divide things up after there is something to divide up," Moore adds.

How to avoid it: Consider at least a 51-49 split instead, where one partner is at the helm with the power to make critical decisions in the event of a stalemate. "Remember, a business is not a democracy," Moore says.

Mistake No. 5: Filing a trademark without doing enough homework. If you think a quick Internet search or cursory look at the U.S. Patent and Trademark Office database is all you need before filing for a trademark, think again. You don't want to invest in a brand only to learn someone else came up with it first, says lawyer Frank A. Natoli, founder of New York-based law firm Natoli-Lapin LLC. For example, Natoli had a client who lost most of his $100,000 investment in branded inventory after another company with the same name shut him down.

How to avoid it: Do your research not only with the Patent and Trademark Office, but on the state level (each state has its own registry), in business directories like YellowPages.com, domain-name companies, and even the Canadian Intellectual Property Office.