

# Understanding the Options in a Start-Up

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### The Plan and the Process

To help clients who are starting new businesses, it is essential to understand the type of business they are getting into and their goals in entering that business, so that we can advise them properly on how to legally protect themselves and other investors in the business as they go forward. The first steps of the process include an assessment of the clients and their hopes and desires. Based on this information, we recommend the proper business formation, proper accounting advice, and all other necessary advice to best protect the clients as they begin their new endeavor.

We advocate that everybody have a business plan. In our own business, we update our business plan and recommend this be done four times a year. For a new business, a business plan is particularly important. A business plan will lay out the actual projected fiscal costs, legal costs, and accounting costs. You must err on the conservative side. You must have sufficient assets to get you through the initial planning period for your business, so you can survive and be competitive.

The first items that should be included in the plan have to be the business goal, the nature of the business, realistic benchmarks for the first twelve months, and when you hope to achieve specific break points—the more detailed, the better. Production issues, location issues, goal issues, and all the basic factors central to the character and mission of the business should be considered in the plan. It is important to work with good advisers on that plan, be they technical business advisers or accountants and lawyers, so everyone understands what the business plan is and whether it is realistic and achievable.

The earlier clients think about a business structure, the better. There are all sorts of legal implications, as well as tax implications and basic business implications. The attorney's initial role is to assess business structures. There should also be an independent accountant advising them concerning tax consequences. It is best to have that all set up before beginning any actual activity for creating the business entity.

There are three different business structures as the tax code is currently designed: the C corporation, the S corporation, and the LLC, in a variety of

capacities. If one were considering a major business entity with significant venture capital, they would consider a C corporation. A negative of a C corporation, though, is the double taxation; the corporation itself is taxed, and the shareholders are taxed in their personal income taxes on dividend distributions. That would be a significant business undertaking, not the usual startup company.

The usual start-up is an S corporation or LLC, where essentially all the tax consequences pass from the business entity to the individual owners of the business. That is the preferred way as we initially look at creating a business. With regard to the S corporation, there are terrific legal protections you receive, and if you properly follow the corporate formalities, as an individual investor of the business, you are protected, which is very significant. S corporations combine some of the more attractive benefits of the other entity choices into one. In an S corporation, shareholders are afforded the same corporate veil protection as C corporation shareholders, leaving shareholders generally not responsible for the debts of the corporation in an amount greater than the shareholder's equity investment. Unlike C corporations, though, S corporations are not subject to the Alternative Minimum Tax (AMT).

### Filing, Taxes, and Financing

Registering the new business is critical. You would be surprised how many businesses we have represented that have not been properly registered. What is required in registering depends on the municipality, the state, and the countries in which you do business. There are all sorts of different requirements for registration, therefore you need a talented corporate attorney and accountant to advise you as to the proper forms of registration. In certain businesses, special or specific licenses or registrations are needed. For instance, hazardous products have additional requirements of registration that are necessary from federal, state, and local municipality standpoints.

We advocate avoiding registration problems at all costs; you do not want to be penny wise and pound foolish. You want to have good advisers around you. The most important time of any business is at the commencement of the business, and then maintaining the business properly as one goes

forward. We have represented businesses that let the corporate formalities lapse. Once you let lapse the corporate formalities, you are again individually exposed to liability for purposes of any particular lawsuit that may happen, or problems that may happen. You can open yourself up to state, federal, and local government tax liability.

Federal tax considerations need to be handled when starting a business. Look at the nature of the business. A C corporation essentially is a double form of corporation; the corporation pays, and the shareholders pay. With regard to an S corporation or LLC, the beauty of it is the investors and/or the shareholders or partnership members will pay taxes only off their individual tax returns, for instance, having a corporate tax return filed.

Continuing on the theme of money considerations, there are all sorts of financing arrangements. Traditional bank financing has been more difficult lately, but may be getting easier with the federal bailout legislation. There are venture options and self-funding options as one goes into the business. It is important to have financing lined up and deal with more of the accounting functions and how much money you need to have, so you are protected as you go forward and have sufficient assets as you go through the initial stages of incorporating and running a business.

### **Employment, Zoning, and Environmental Issues**

The next consideration is dealing with labor laws with regard to employing new hires. The laws are complex, and you need to understand the variety of labor laws that regulate the type of people you can hire, from an age standpoint, the hours that they work, and the control you have over them. There are talented legal folks you should be working with, as well as accountants, to help you get through the rather challenging list of laws that regulate the work force.

The classic tricky situation for a new business can be a restaurant-type setting or a bar-type setting, with stringent regulations on the age of folks who can work and perform certain functions. If you do not adhere to those issues, you can easily have a licensing violation filed against your specific establishment, which can challenge the ability to even go forward. You need to be aware of these things and make sure you employ folks who are legally

authorized to work in the United States. On that issue, employers are held strictly liable, so there are a series of laws on which you have to be specific. Also, there is a series of laws that regulate the way employees are paid, from a standpoint of commission to hourly, with stringent penalties if you do not pay properly. You have to be aware of all those things as you go forward.

The zoning laws of the municipality will control where a business can function. Depending on the type of business, there can be what we call super lay, which means overlay functions of the state and federal government. Certain businesses at the state and federal government will endure whatever business loans they are in, and the municipality has to agree to it. Otherwise, you have to look closely at the municipal regulations as to what types of businesses are permitted in what areas of the particular municipality.

The best time to research these different zoning requirements is at the beginning of the business. You have to deal with attorneys who know what they are talking about and accountants who know what they are talking about, and do good work so your business is protected properly and incorporated properly in whatever location you decide on.

Permitting is a big issue, and there have been some efforts to streamline the permitting process, but permitting is something you have to be well aware of from a municipal standpoint, and with some federal and state overlay input. You need to understand the permitting laws of the particular jurisdiction you are in, so you can be properly zoned to do business, be licensed to do business, and then do business in a particular location.

Disputes can occur when contracting to build the facility for the business. Those disagreements can be totally crippling, so you need to be aware of the possibilities and work to prevent them. Once you begin to have adverse rulings by a municipality concerning where they may be doing business, there is a very complex series of appeal processes that take you into the courts that can obviously destroy your business before it ever begins. It is best to have all of this worked out well in advance so there are no challenges, and you are adhering to all necessary regulations and are properly doing business in the specific location where you are working.

Additionally, all sorts of environmental laws affect the business, depending on the type of facility you have and the type of business you have. You must comply with these laws, from superfund to other issues that you need to be aware of, so you are not tied up with governmental authorities or superfund litigation or things that could be costly or problematic for you as a business owner. These situations could include toxic substances on the property, how one deals with trash removal, and how one deals with any environmental fluid issue. These are sensitive topics.

It is best to have attorneys or folks who know how to work with the environmental groups involved, running from the federal to the state authorities to local authorities. They all have joint jurisdiction over these issues, so you can be faced with three different challenges. You need to have people who understand how to work with these agencies to be protective of the business.

### IP and Other Legal Considerations

I think the establishment of a quality board of directors is essential in a new business—quality people who can assist in the business, who may have had experience with the type of business, and who bring value to the business. These are folks who are independent from the entrepreneur and looking at the business and making meaningful recommendations as they go forward. At the commencement of the business, it is important to not make decisions that are overly dramatic and costly from a business standpoint. Just try to do the best job you can with the essential nature of the business.

In preparing to work with an attorney, new business owners should be organized. You should have your basic business plan in order and a basic concept of what you would like to do with the business. Concisely and clearly, speak to the attorney regarding what you would like to do with the business, so the attorney can recommend to you the different business formation issues, the different possibilities from not only formation but also investment in the business. You can also check with the Small Business Association and different governmental agencies that recommend counsel who have dealt with the particular businesses in which you are involved.

The biggest mistake new business owners can make is to think they can do it on their own. They are usually bright, entrepreneurial people who want to try to regulate what they are paying on attorneys' fees and accountant fees, and who think they can do it alone. That is absolutely the wrong attitude to have when you form a business. You have to be in a much better situation to share information and to seek quality counsel from both an accounting standpoint and from a legal standpoint.

Business owners usually do not expect the variety of legal challenges you can have through labor issues, human resources (HR) issues (even in the hiring process), potential environmental claims, and claims by third parties that seem to come out of nowhere, which could challenge the entire business. We want to keep the entrepreneurial spirit alive. Attorneys who work in this area have to appreciate the nature of what that spirit is about, while helping clients protect themselves from challenges that could interfere with achieving their vision. It is a team effort as you go forward, protecting the corporation and protecting the (intellectual property) IP and doing the right thing by the client. In the end, that is also the right thing for the attorney and accountants because it will be a successful joint venture at that point.

For a business with a new product, IP issues are an important consideration. Those property interests need to be protected so they are not stolen by competing entities or folks in other countries. You need to have a good IP attorney who has taken the necessary steps to protect your concepts because if they are not protected, they become essentially worthless. You can lose your business and your idea to other folks who will simply take your IP. It is best to err on the conservative side and to properly protect every concept as best you can with the IP laws of this country.

The costs associated with IP protection, in terms of things to file and individuals with whom to work, are dependent on the type of IP we are talking about. The actual costs are not prohibitive. It is much more costly *not* to protect your particular IP rights because then basically it is a free-for-all to steal those concepts in the marketplace.

Overall, I would think the business formation issues require more legal assistance than the other start-up issues discussed here. I think the business

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formation/legal plan issues are the critical issues to look at, followed by the accounting issues. There are many challenges when one begins a business. Do not enter an area without considering the myriad of issues presented. If you do not seek the proper advice at the commencement of the business, you face so many challenges that the business is likely not to survive.

Keep in mind that you do not want to over-lawyer. Attorneys are often bad business people, and they need to appreciate the entrepreneurial spirit, encourage that spirit, and help their clients navigate through the challenges to help the business to become successful. That requires a strong relationship with attorneys and accountants.

Daniel R. Gibson is the managing director of Gibson & Behman P.C. Mr. Gibson has advised and represented clients on some of this country's most significant catastrophic loss cases, including the Malden Mills \$600 million fire loss and personal injury cases. Mr. Gibson has extensive international arbitration experience. He was lead counsel for an insurer involved in a \$1 billion oil rig collapse case. The incident occurred off the coast of Brazil and was mediated in Scotland.

Mr. Gibson has advised and represented clients in all aspects of civil litigation. He has participated in cases presented to the United States Supreme Court, the U.S. Court of Appeals, First and Second Circuits, and federal and state courts in eight states. He has received many awards of distinction and has authored a leading text on dram shop liability published by the American Bar Association.

Mr. Gibson, a 1982 graduate of Villanova University School of Law, is a member of the Board of Consultants for Villanova University School of Law and contributor to the Rensselaer Fund (Charter Member Fund), established in dedication to Dean Rensselaer, founding Dean of the Villanova School of Law Fund.