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Ten Business Blunders That Small Businesses Make

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While representing small-business clients over the years, I have advised them on how to avoid making some common mistakes, and on how to fix some mistakes they already made. This is a top-ten list:

1. Choosing the wrong type of legal structure for your business.

This is an area where the do-it-yourself corporate kit can be dangerous. Too many business owners have launched their company as a C corp only to realize that they are needlessly taxed twice -- at the corporate level and the individual level. Other business owners have chosen the single-level taxation of an S corp, only to "blow the S election" inadvertently by issuing more than one class of stock or by allowing another corporation to become a shareholder. Your lawyer should work with you to choose an entity that gives you favorable tax treatment and proper legal protection.

2. Not choosing any business structure at all, let alone the wrong type.

Sometimes, an entrepreneur is so busy launching his business that he neglects to select a legal structure. Unfortunately, ignoring the issue invites the state to make decisions for the entrepreneur. For example, a person starting his own business is considered to be a sole proprietor if he does not form another type of business entity. While in many cases a sole proprietorship is a good choice of business entity, there are pitfalls. Sole proprietors are personally liable for their business debts. So if the business fails, creditors can take the sole proprietor's assets (like his house and savings). And the same problems can arise for two or more people who launch a business together. If business owners do not incorporate or take other steps to pick an entity that limits their liability, the law may decree them to be a general partnership, which places each owner's personal assets on the line if the business fails. Again, it is smart to enlist a lawyer to avoid these costly mistakes.

3. Not having an agreement among business owners.

When you set up shop with your business partner, you may think that you'll get along forever. Unfortunately, the courts are crowded with squabbling business owners who thought the same thing. An agreement among owners can lay down many of the rules which you and your partner agree to follow. Drafting the agreement educates each of you about what problems can arise, and the signed agreement gives you the procedure to solve them. For example, many owners' agreements have buy-sell provisions which give one shareholder the right to buy the other's shares if he dies, becomes disabled, or simply walks away from the business. Isn't it better to agree on those rights now, rather than having your deceased business partner's heir suddenly become your workmate and co-owner?

4. Owning a business 50/50.

If you have split ownership evenly with your business partner, you have laid the groundwork for business paralysis when you disagree with each other. Deadlocks often occur, resulting in costly litigation, and even the appointment of a receiver to dissolve your business. A good agreement among owners can provide solutions for this, including buyout provisions in the event of deadlock. But often the best solution is to avoid a 50/50 arrangement in the first place.

5. Having an accountant and a lawyer who do not talk to each other.

Many business decisions have legal and tax consequences. A lawyer will often draft an agreement that impacts the client's tax situation. For example, a lawyer may draft a buy-sell agreement that provides for the sale of a sole proprietor's business to his employee. If the lawyer does not consult with the sole proprietor's accountant, an incorrect method of valuing the business may be chosen. In this situation, the IRS may even step in to place a higher-than-necessary value on the business for estate tax purposes. Be sure that your accountant and lawyer work together to protect your interests.

6. Not having key employees sign a non-competition agreement.

Too many entrepreneurs struggle to grow their business, ultimately succeed, and then suffer the loss of key customers to a former employee who has decided to become a competitor. Non-competition agreements can help to minimize this risk, but they must be carefully crafted and implemented or a court may not enforce them. Non-competition agreements are a valuable way to ensure that former employees will not profit unfairly from your hard-won success.

7. Having an employee handbook you don't follow.

As your business grows, it is a good idea to create an employee handbook which contains your company's policies and procedures. Unfortunately, however, these handbooks are often created and then forgotten, only to be cited by a disgruntled employee -- and his lawyer. Employee handbooks are a useful resource, but one that must be updated and scrupulously followed by everyone, including the business owners who wrote them.

8. Failing to keep corporate minutes.

It is common for small businesses to ignore the need to create corporate minutes which reflect the various decisions that directors and shareholders made regarding the company. This is a big mistake, which is too often discovered only after the IRS or some other government authority subpoenas your minute book, or after a company buying your business starts its due diligence. Worse yet, if you fail to observe certain corporate formalities such as keeping minutes, a creditor may be able to argue that your business is not entitled to the limited liability which corporate shareholders enjoy -- a concept known as "piercing the veil." It is far better to make sure the veil is properly placed and impenetrable by keeping your minute book up to date.

9. Mixing your personal funds with your business funds.

If you open your wallet to fund your business, certain creditors of the business may use this as another reason to "pierce the veil," on grounds that you were not observing corporate formalities by keeping your money separate from your business's money. Avoid this liability exposure by documenting your contributions to capital and your loans to your business. If you decide to make a loan, prepare a promissory note with a specific interest rate and repayment schedule. This will help to ensure that the IRS does not consider your business's loan repayments to be something else, such as taxable income or a shareholder distribution.

10. Waiting until you've blundered to find a lawyer.

The worst time to look for a good lawyer is when you are in trouble and need legal guidance. The pressures imposed by an IRS audit, a complex business transaction, or a contentious lawsuit will not be lessened by having to interview a string of prospective attorneys to find one you feel you can work with productively. Establish this relationship now, and you can more effectively address your business blunders -- or better yet, avoid them entirely.

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