

COMMON MISTAKES WHEN STARTING A BUSINESS

By: [Craig Etem](#)

One of the many great things that have accompanied the recovery and rebirth of the economy in northern Nevada is the number of new companies that have opened their doors, including technology startups, service providers and those related to the larger players entering the market.

At [Fennemore Craig](#), we enjoy working with these new businesses sooner rather than later as, all too often, a new business will take a step that, somewhere down the road, either impairs their business plan or costs them a good deal of money to correct.

Although pitfalls abound for the new business, we find that most issues arise in the following areas:

- **Choice of Entity:** Often the new businessperson does not give a great deal of thought to the choice of entity. In fact, sometimes the business is started as a sole proprietorship. Given the low cost of creating an entity that will provide at least some level of liability protection, that is almost never a good idea. However, even if the businessperson does decide to use an entity form, careful consideration should be given as to whether the entity should be a corporation (and, if so, whether it be taxed as a Subchapter S or C corporation), a limited liability company or even a limited partnership. The former two are much more common as the LLC has, in most circumstances, supplanted the limited partnership. Nevertheless, the choice of entity is important for several reasons, including potential tax issues and the businesspersons ultimate goal with the company.
- **An Entity to (probably) Avoid:** One entity that we hear about from time to time that we seldom recommend is the Series LLC. The Series LLC is used to segregate assets into different pools that are, theoretically, safe from the liabilities of the businesses conducted in another of the pools. Businesspersons who have multiple irons in the fire will sometimes consider using a Series LLC to reduce the number of entities with which they must deal. The Series LLC is, however, relatively new and untested. At this point, no one knows if the courts of a state that does not have a statute authorizing Series LLC's will respect the segregation. Anyone who is considering using a Series LLC should consult with an attorney well-versed in this kind of entity (and, as they are new, there are not many attorneys well-versed in them).
- **Rights and Obligations of Owners:** Once the entity is formed, assuming the businessperson will have equity investors, it is extremely important that the rights and obligations of each equity holder be spelled out in (sometimes excruciating) detail. The LLC's operating agreement, the LP's partnership agreement or a shareholder agreement for a corporation should provide (among other things):

- the parties' intent on distributions of available cash,
 - management (especially when ownership is evenly divided),
 - exit strategies (that is, what do you do when the investors are sick of each other and there is no public market for the equity—this item is probably the biggest problem we see with new companies)
 - If these issues are not handled when everyone is friendly, they will be a great deal more expensive and time-consuming to handle once a dispute has arisen.
- **Convertible Notes:** New investors come in many forms. One of the more common forms is the convertible note investor. With a convertible note, the investor makes a loan to the company and has the right or obligation to convert the note to equity at specified times and at a specified conversion rate. From time to time we have seen convertible notes (and other forms of investment documentation) that do not make the parties' rights and obligations clear. As these documents effectively provide ownership to the investor, they should be carefully drafted by an attorney with experience in this area (fortunately, that attorney is not as rare as the attorney with experience with Series LLCs).
 - **Follow the Rules for your Entity Type:** After the business gets started, it is important to keep in mind that there are certain rules for how decisions are made. In the corporation, much of it is set forth in statute, as well as in the corporation's articles of incorporation or bylaws. In the limited liability company or limited partnership, more of the procedures are in the operating agreement or limited partnership agreement. But, whatever the type of entity, it is important that the owners follow the rules. Failure to do so increases the risk that a court would disregard the liability shield the company is supposed to provide and allow a plaintiff to sue the owners directly. Following the rules and keeping financial accounts separate is not terribly difficult, but the failure to do so can lead to a terrible result.

Although a new business is often short of cash, bringing an attorney on board at the early stages (perhaps limiting the representation to handling the most important items) is likely well worth the cost in light of the potential cost of not doing so. Think of it as insurance—it is a waste of money until something happens!

The author of this article is the managing director of Fennemore Craig's Reno office. He represents large and small companies and those that are both privately and publicly held. His practice involves a wide range of business matters, including corporate mergers, acquisitions, divisions, consolidations, recapitalizations, and formations as well as real estate transactions and secured and unsecured loans, loan workouts and foreclosures. You may reach Craig with any questions at cetem@fclaw.com or (775) 788-2224. Fennemore Craig is a regional law firm with six offices in three states employing nearly 200 lawyers offering a wide range of legal expertise. For more information about the firm, you may contact Craig or consult the firm's website at www.fennemorecraig.com.