



# LEGAL CONCERNS

by Diane M. Calabrese

## BEWARE OF TRAPS THAT ENDANGER A BUSINESS

A business owner is made of stern stuff. It takes unshakable determination to succeed in a mix roiled by proliferating laws and a litigious society.

Ownership structure reins in certain legal concerns. "Incorporating offers some protection of your assets from frivolous and valid lawsuits due to damages, car accidents, or employee injuries," says Henry Bockman, president, Henry's Housework Inc., in Germantown, MD.

And good business practices always matter. Contractors must avoid situations that could put them in jeopardy. For instance, says Bockman, contractors "taking on a job that is too large for them or promising more than they can provide" can result in problems. Contractors must be scrupulous about products they use, too.

"Using home-made products that are cheaper but don't work as well as professional grade products" poses a risk, says Bockman. "In some cases, companies using home-made cleaners end up getting sued for damages to property and [for] health issues. Also, creating home-made cleaners makes you the manufacturer, leaving you responsible for any damages or injuries sustained to property, employees, and anything else that goes wrong while using the product."

## Structure Basics

"The legal issue that trips up new businesses [most often] is how they form," says Don Williams, president, Northstar Cleaning Systems Inc., Spokane, WA. "They start off as a sole proprietor and then, soon after that, they decide to switch to a corporation and they don't notify the SBA [Small Business Administration] or their lender."

When the SBA or lender finds out about the change "they are not too happy," explains Williams, because support to an incipient business is predicated on structure. Sole proprietors have unlimited liability and are legally responsible for all debts with personal assets on the line; that is not the case with a corporate structure.

Williams, a former business broker and a business mentor, recommends incorporation for a new business—and as soon as possible "so you close the loan in the name of the corporation."

An incorporated business enforces clarity, bypassing potential trouble spots such as a single checking account for home and business. "A lot of Mom and Pop businesses really think, 'They're not going to sue me,'" says Williams. But there are no guarantees.

Separate records are critical documents if questions arise. They are also needed when planning an "exit strategy" to enable income verification and to ensure the business fetches a "proper price" if sold.

## Choices Aplenty

Options for structuring a business are many. The SBA provides extensive assistance weighing the pros and cons in a primer titled "Choose a Structure" ([www.sba.gov/smallbusinessplanner/start/choosestructure/index.html](http://www.sba.gov/smallbusinessplanner/start/choosestructure/index.html)). Pluses and minuses of each structure, as well as links to the Internal Revenue Service (IRS) website with relevant information about tax implications of each choice, are given.

Settling on an appropriate structure begins with self-appraisal. Lawsuits are one consideration. Level of control, number of owners, tax implications, and cash flow needs must also be evaluated.

Sole proprietorship and corporation are two possibilities among several. Partnerships are roughly the joint-owner equivalent of a sole proprietorship. The Limited Liability Company (LLC) combines some properties of a sole proprietorship (e.g., tax advantages) and some of a corporation (e.g., limited individual liability).

The Sub Chapter S Corporation avoids double taxation because it is taxed like a partnership. In a C Corporation profits are taxed at the corporate level and again when they are distributed to shareholders (i.e., owners).

Some states allow more business structures than those sanctioned by the federal government. The Limited Liability Partnership (LLP), which is often used by physicians and lawyers and other licensed practitioners, protects one partner from liability for the negligent acts of another.

The Professional Service Corporation (PS) has some similarities to the LLP. For contractors, manufacturers, or distributors with a silent partner, the Limited Partnership (LP) is sometimes useful because it protects the investor, who does not get involved in the day-to-day operations, from liability exceeding investment.

## Thorny Issues

Legal concerns begin with structure, but pop up everywhere. Two especially tricky ones are dispensing fair compensation for employees and avoiding competition of employees who leave and set up independent shops.

"The most widespread failure of employers today is the failure to pay employees who work more than 40 hours per week at the overtime rate of pay," says Martin Gringer, a partner at Franklin, Gringer & Cohen, PC. "Unless an employee meets all criteria for one of the exemptions of the requirement to pay overtime, such as professional, executive, and administrative exemptions, employers must pay time-and-half the regular rate of pay for all hours worked over 40 per week."

Gringer explains, "Lawyers for employees are working 'overtime' to file lawsuits on behalf of all kinds

of employees seeking to recover unpaid overtime. Such lawsuits are profitable for lawyers because they are entitled to collect attorneys' fees if they are successful...In addition, under federal law, employees can obtain liquidated damages equal to 100 percent of paid overtime. There is presently no more active area of employment litigation than in these wage and hour cases being filed."

Some states will allow a non-compete agreement to be entered into after an employee is hired; in other states, it must be entered into at hiring.

The many layers of the Fair Labor Standards Act (FLSA) make compliance regarding overtime a challenge. For instance, for manufacturers and distributors, inside sales personnel usually fall in a different category than outside sales personnel.

To comply with FLSA, time records must be kept for each employee, says Rachel Steely, partner in the labor group at the Houston, TX, office of Gardere Wynne Sewell LLP. They must be complete and easily retrievable, but no form is specified.

"If an employer does not keep accurate records of hours worked by non-exempt employees, the Department of Labor will rely on the employees' recitation of their hours worked when determining overtime payments," says Steely. "Typically, an employee's recollection of hours worked over a two- to three-year period [is] much more generous than the employer's."

An employer found wanting in time records is vulnerable to complaints from each person in a similar

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job category as the original complainant. "The payment of overtime to an entire job group based on their own analysis of overtime worked could be very costly, and very inaccurate," says Steely.

### Degrees of Independence

Independent contractors may fill certain roles necessary to sustain a company, such as delivering goods. But defining an independent contractor to the satisfaction of the labor regulators and IRS lands an owner in another thicket.

Rules of thumb regarding the definition of independent contractor get bandied. For example, if an individual uses his own equipment and determines his own approach to the job, including hours, that is usually sufficient to define an independent contractor. Correct? "No," says Audrey Mross, shareholder and head of the labor and employment group at Munck Butrus, PC, Dallas, TX.

"I could give you a 50-page white paper on this topic and there would still be no clear answer since the definition varies under each applicable federal and state law," says Mross. "The two-criteria test is completely wrong in virtually every jurisdiction."

If someone considered an independent contractor is declared an employee by regulators, the employer is in the position of having failed at a whole range of obligations. They include "failure to collect/pay taxes to federal/state government, failure to pay into unemployment compensation systems, failure to pay in the state disability system..." says Mross. The employer would also have failed to provide medical insurance, employee benefits, and protection against discrimination; the list of possible transgressions is long.

Given the responsibilities of being an employer, there must be recourse when an employee who has learned from and made contacts on the job decides to quit and become a competitor. Do non-compete clauses work?

"It is certainly not a waste of time" to pursue a non-compete agreement,

says Jeffrey L. Braff, shareholder in the Philadelphia, PA. office of Cozen O'Connor. But the effort ought to be tempered with reality.

"There's a general philosophy that courts do not like to enforce non-compete provisions," explains Braff. "Some states, such as California, are extremely antagonistic to non-compete" agreements. The exception in the Golden State is when the sale of a business might be affected.

"What I find to be a good way of increasing the likelihood of enforceability is to have a two-way agreement," says Braff. A restrictive covenant between two business entities is often palatable to the courts.

For instance, a contractor enters into a service contract with a client to provide exterior cleaning every two months for "x" dollars for two years; the contract includes a provision that during the interval no employee who leaves the employ of the contractor may be hired by the client to do same

work. Even at that, the non-compete is difficult.

"It's extremely state specific," says Braff, and governed not only by statutes but by common law. Some states will allow a non-compete agreement to be entered into after an employee is hired; in other states, it must be entered into at hiring. In California, requiring an employee to sign a non-compete agreement as a condition of employment could result in a lawsuit.

*Next month: Insurance concerns.*

### Sources:

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