

Starting and Running a Small Business

Chapter 1 – Legal Forms of Business

When you start a business, you must decide on a legal structure for it. Usually you'll choose either a sole proprietorship, a partnership, a limited liability company (LLC) or a corporation. There's no right or wrong choice that fits everyone. Your job is to understand how each legal structure works and then pick the one that best meets your needs. The best choice isn't always obvious—after reading this chapter, you may decide to seek some guidance from a lawyer or an accountant.

For many small businesses, the best initial choice is either a sole proprietorship or—if more than one owner is involved—a partnership. Either of these structures makes especially good sense in a business where personal liability isn't a big worry—for example, a small service business in which you are unlikely to be sued and for which you won't be borrowing much money. Sole proprietorships and partnerships are relatively simple and inexpensive to establish and maintain.

Forming an LLC or a corporation is more complicated and costly, but it's worth it for some small businesses. The main feature of LLCs and corporations that attracts small businesses is the limit they provide on their owners' personal liability for business debts and court judgments against the business. Another factor might be income taxes: You can set up an LLC or a corporation in a way that lets you enjoy more favorable tax rates. In certain circumstances, your business may be able to stash away earnings at a relatively low tax rate. In addition, an LLC or corporation may be able to provide a range of fringe benefits to employees (including the owners) and deduct the cost as a business expense.

Given the choice between creating an LLC or a corporation, many small business owners will generally be better off going the LLC route. For one thing, if your business will have several owners, the LLC can be more flexible than a corporation in the way you can parcel out profits and management duties. Also, setting up and maintaining an LLC can be a bit less complicated and expensive than a corporation. But there may be times a corporation will be more beneficial. For example, because a corporation—unlike other types of business entities—issues stock certificates to its owners, a corporation can be an ideal vehicle if you want to bring in outside investors or reward loyal employees with stock options.

Keep in mind that your initial choice of a business form doesn't have to be permanent. You can start out as sole proprietorship or partnership and, later, if your business grows or the risks of personal liability increase, you can convert your business to an LLC or a corporation.

For some small business owners, a less common type of business structure may be appropriate. *While most small businesses will find at least one good choice among the four basic business formats described above, a handful will have special situations in which a different format is required or at least is desirable. For example, a pair of dentists looking to limit their personal liability may need to set up a professional corporation or a professional limited liability company (PLLC). A group of real estate investors may find that a limited partnership is the best vehicle for them.*

You may need professional advice in choosing the best entity for your business. *This chapter gives you a great deal of information to assist you in deciding how to best organize your business. Obviously, however, it's impossible to cover every nuance of tax and business law that applies to your business. This is especially so if your business has several owners with different and complex tax situations. And keep in mind that especially for businesses owned by several people who have different personal tax situations, sorting out the effects of "pass-through" taxation (where partners and most LLC members are taxed on their personal tax returns for their share of business profits and losses) is no picnic, even for seasoned tax pros. The bottom line is that unless your business will start small and have a very simple ownership structure, before you make your final decision on a business entity, you'll want to check with a tax advisor after learning about the basic attributes of each type of business structure.*

A. Sole Proprietorships

The simplest form of business entity is the sole proprietorship. If you choose this legal structure, then legally speaking you and the business are the same. You can continue operating as a sole proprietor as long as you're the only owner of the business.

Establishing a sole proprietorship is cheap and relatively uncomplicated. While you do not have to file articles of incorporation or organization (as you would with a corporation or an LLC), you may have to obtain a business license to do business under state laws or local ordinances. States differ on the amount of licensing required. In California, for example, almost all businesses need a business license, which is available to anyone for a small fee. In other states, business licenses are the exception rather than the rule. But most states do require a sales tax license or permit for all retail businesses. Dealing with these routine licensing requirements generally involves little time or expense. However, many specialized businesses—such as an asbestos removal service or a restaurant that serves liquor—require additional licenses which may be harder to qualify for. In addition, if you're going to conduct your business under a trade name such as Smith Furniture Store rather than John Smith, you'll have to file an assumed name or fictitious name certificate at a local or state public office. This is so people who deal with your business will know who the real owner is.

From an income tax standpoint, a sole proprietorship and its owner are treated as a single entity. Business income and business losses are reported on your own federal tax return (Form 1040, Schedule C). If you have a business loss, you may be able to use it to offset income that you receive from other sources.

1. Personal Liability

A potential disadvantage of doing business as a sole proprietor is that you have unlimited personal liability on all business debts and court judgments related to your business.

EXAMPLE 1: Lester is the sole proprietor of a small manufacturing business. When business prospects look good, he orders \$50,000 worth of supplies and uses them up. Unfortunately, there's a sudden drop in demand for his products, and Lester can't sell the items he's produced. When the company that sold Lester the supplies demands payment, he can't pay the bill.

As sole proprietor, Lester is personally liable for this business obligation. This means that the creditor can sue him and go after not only Lester's business assets, but his other property as well. This can include his house, his car and his personal bank account.

EXAMPLE 2: Shirley is the sole proprietor of a flower shop. One day Roger, one of Shirley's employees, is delivering flowers using a truck owned by the business. Roger strikes and seriously injures a pedestrian. The injured pedestrian sues Roger, claiming that he drove carelessly and caused the accident. The lawsuit names Shirley as a co-defendant. After a trial, the jury returns a large verdict against Roger—and Shirley as owner of the business. Shirley is personally liable to the injured pedestrian. This means the pedestrian can go after all of Shirley's assets, business and personal.

One of the major reasons to form a corporation or a limited liability company (LLC) is that, in theory at least, you'll avoid most personal liability.

2. Income Taxes

As a sole proprietor, you and your business are one entity for income tax purposes. The profits of your business are taxed to you in the year that the business makes them, whether or not you remove the money from the business (called "flow-through" taxation, because the profits "flow through" to the owner's income tax return). You report business profits on Schedule C of Form 1040.

By contrast, if you form an LLC or a corporation, you have a choice of two different types of tax treatment.

- **Flow-Through Taxation.** One choice is to have the IRS tax your LLC or corporation like a sole proprietorship or partnership (discussed above). The owners report their share of LLC or corporate profits on their own tax returns, whether or not the money has been distributed to them.
- **Entity Taxation.** The other choice is to make the business a separate entity for income tax purposes. If you form an LLC and make that choice, the LLC will pay its own taxes on the profits of the LLC. And as a member of the LLC, you won't pay tax on the money earned by the LLC until you receive payments as compensation for services or as dividends.

Similarly, if you form a corporation and choose this option, you as a shareholder won't pay tax on the money earned by the corporation until you receive payments as compensation for services or as dividends. The corporation will pay its own taxes on the corporate profits.

For now, just be aware that this tax flexibility of LLCs and corporations offers some tax advantages over a sole proprietorship if you're able to leave some income in the business as "retained earnings." For example, suppose you want to build up a reserve to buy new equipment or your small label manufacturing company accumulates valuable inventory as it expands. In either case, you might want to leave \$50,000 of profits or assets in the business at the end of the year. If you operated as a sole proprietor, those "retained" profits would be taxed on your personal income tax return at your marginal tax rate. But with an LLC or corporation that's taxed as a separate entity, the tax rate will almost certainly be lower.

You can share ownership of your business with your spouse and still maintain its status as a sole proprietorship. *If you choose to do this, in the eyes of the IRS you'll be co-sole proprietors. You can either split the profits from your business if you and your spouse file separate returns (and separate Schedule Cs), or you can put them on your joint Schedule C if you file a joint return. Only a spouse can be a co-sole proprietor. If any other family member shares ownership with you, the business must be organized as a partnership, corporation or limited liability company.*

3. Fringe Benefits

If you operate your business as a sole proprietorship, tax-sheltered retirement programs are available. A Keogh plan, for example, allows a sole proprietor to salt away a substantial amount of income free of current taxes. You can't really do any better by setting up an LLC or a corporation.

An LLC or a corporation that chooses to be taxed as a separate entity does have an advantage when it comes to medical expenses for the owner and his or her spouse and dependents. As a sole proprietor, in 2000, you can deduct only 60% of your family's health insurance premiums on Form 1040. (In future years, that percentage will increase.) You can deduct the remaining 40% as an itemized deduction on Schedule A, but only to the extent that the 40% of the premiums, plus other uncovered medical expenses, exceed 7.5% of your adjusted gross income for the year.

If you form an LLC or a corporation, however, and choose to have it taxed as a separate entity, you can have the business hire you as an employee. The business can pay 100% of your family's health insurance premiums and uncovered medical expenses and then take these amounts as a business deduction; you won't be personally taxed for the value of this employment benefit.

Hiring Your Spouse Can Have Tax Benefits

If you choose to do business as a sole proprietor, there's a way you can deduct more of your family's medical expenses. First, hire your spouse at a reasonable wage. Then, set up a written health benefit plan covering your employees and their families. A sample form is shown below. Your business can then deduct 100% of the medical expenses it pays.

But balance whether such a plan can save you enough money to justify the effort. There may be some expense for setting up the plan and handling the associated paperwork. And remember that your business will be obligated for payroll taxes on your spouse's earnings. But this isn't all bad, since your spouse will become eligible for Social Security benefits in his or her own right, which can be of some value—especially if he or she hasn't already worked long enough to qualify.

If you're audited, the IRS will look closely to make sure your spouse is really an employee and performing needed services for the business.

4. Routine Business Expenses

As a sole proprietor, you can deduct day-to-day business expenses the same way an LLC, corporation or partnership can. Whether it's car expenses, meals, travel or entertainment, the same rules apply to all of these types of business entities.

You'll need to keep accurate books for your business that are clearly separate from your records of personal expenditures. The IRS has strict rules for tax-deductible business expenses, and you need to be able to document those expenses if challenged. One good approach is to keep separate checkbooks for your business and personal expenses—and pay for all of your business expenses out of the business checking account. But whatever your system, please pay attention to this basic advice: It's simple to keep track of business income and expenses if you keep them separate from the start—and murder if you don't.

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B. Partnerships

If two or more people are going to own and operate your business, you must choose between establishing a partnership, a corporation or a limited liability company (LLC). This section looks at the general partnership, which is the type of partnership that most small businesses will be considering.

LAW IN THE REAL WORLD

First Things First

Ellen, Mary and Barbara Kate, librarians all, planned to open an electronic information searching business with an emphasis on information of special interest to women. They would hold on to their daytime jobs until they could determine if their new business could support all three women.

At a planning meeting to discuss buying personal computers and modems, Ellen said she wanted the business to be run as professionally as possible, which to her meant promptly incorporating or forming an LLC. The discussion about equipment was put off while the three women tried to decide how to organize the legal structure of their business. After several frustrating hours, they agreed to continue the discussion later and to do some research about the organizational options in the meantime.

Before the next meeting, Ellen conferred with a small business advisor who suggested that the women refocus their energy on the computers and modems and getting their business operating, keeping its legal structure as simple as possible. One good way to do this, she suggested, was to form a partnership, using a written partnership agreement. Each partner would contribute \$10,000 to buy equipment and contribute roughly equal amounts of labor. Profits would be divided equally.

Later, if the business succeeded and grew, it might make sense to incorporate or form an LLC and consider other issues, like a health plan, pensions and other benefits. But for now, real professionalism meant getting on with the job—not consuming time and dollars forming an unneeded corporate or LLC entity.

The best way to form a partnership is to draw up and sign a partnership agreement. Legally, you can have a partnership without a written agreement, in which case you'd be governed entirely by either the Uniform Partnership Act or the Revised Uniform Partnership Act. Beyond a written agreement, the paperwork for setting up a partnership is minimal—about on a par with a sole proprietorship. You may have to file a partnership certificate with a public office to register your partnership name, and you may have to obtain a business license or two. The income tax paperwork for a partnership is marginally more complex than that for a sole proprietorship.

1. Personal Liability

As a partner in a general partnership, you face personal liability similar to that of the owner of a sole proprietorship. Your personal assets are at risk in addition to all assets of the partnership. In other words, you have unlimited personal liability on all business debts and court judgments related to your business.

In a partnership, any partner can take actions that legally bind the partnership entity. That means, for example, that if one partner signs a contract on behalf of the partnership, it will be fully enforceable against the partnership and each individual partner, even if the other partners weren't consulted in advance and didn't approve the contract. Also, the partnership is liable, as is each individual partner, for injuries caused by any partner while on partnership business.

EXAMPLE 1: Ted, a partner in Argon Associates, signs a contract on behalf of the partnership that obligates the partnership to pay \$50,000 for certain goods and services. Esther and Helen, the other partners, think Ted made a terrible deal. Nevertheless, Argon Associates is bound by Ted's contract even though Esther and Helen didn't sign it.

EXAMPLE 2: Juan is a partner in Universal Contractors. Elroy, one of his partners, causes an accident while using a partnership vehicle. Juan and all the other partners will be financially liable to people injured in the accident if the car isn't covered by adequate insurance. The same would be true if Elroy used his own car while on partnership business.

In both of these situations, the personal assets (home, car and bank accounts) of each partner will be at stake, in addition to partnership assets. But remember that a partnership can protect against many risks by carrying adequate liability insurance.

2. Partners' Rights and Responsibilities

Each partner is entitled to full information—financial and otherwise—about the affairs of the partnership. Also, the partners have a “fiduciary” relationship to one another. This means that each partner owes the others the highest legal duty of good faith, loyalty and fairness in everything having to do with the partnership.

EXAMPLE: Wheels & Deals, a partnership, is in the business of selling used cars. No partner is free to open a competing used-car business without the consent of the other partners. This would be an obvious conflict of interest and, as such, would violate the fiduciary duty the partners legally owe to one another.

Unless agreed otherwise, a person can't become a new partner without the consent of all the other partners. However, in larger partnerships, it's common for partners to provide in the partnership agreement that new partners can be admitted with the consent of a certain percentage of the existing partners—75%, for example.

State laws regulating partnerships dictate what occurs if one partner leaves your partnership and you don't have a partnership agreement that provides for what happens. In about half the states, the partnership is automatically dissolved when a partner withdraws or dies; the business is then liquidated. In such a state, it's an excellent idea to put a provision in your partnership agreement that allows the business to continue without interruption, despite the technical dissolution of the partnership. A partnership agreement, for instance, may provide a “buy-sell” provision that calls for a buy-out if one of the partners dies or wants to leave the partnership, avoiding a forced liquidation of the business.

EXAMPLE: Tom, Dick and Mary are equal partners. They agree in writing that if one of them dies, the other two will buy the deceased partner's interest in the partnership for \$50,000 so that the business will continue. (Be aware that often a partnership agreement doesn't fix a precise amount as the buy-out price but uses a more complicated formula based on such data as yearly sales, profits or book value.) To fund this arrangement, the partnership buys life insurance covering each partner in an amount large enough to cover the buyout. If Tom dies first, under the terms of the agreement, his wife and children will receive \$50,000 from the partnership to compensate them for the value of Tom's ownership interest in the business. Technically, the remaining partners would operate as a new partnership, but the important point is that the business would keep functioning.

Other states—generally those that have adopted the revised version of the Uniform Partnership Act—follow a slightly different rule. In those states, if your partnership was created to last for a fixed length of time or was created for a specific project, and a partner leaves before the fixed time expires or the project is done, the partnership isn't automatically dissolved. Instead, the remaining partners have the opportunity to continue the existing partnership rather than having to form a new one. But even if your state follows this more flexible approach, you'll still want to use buy-sell provisions to specify how the departing partner—or the family of a partner who's died—gets compensated for his partnership interest.

3. Income Taxes

In terms of income and losses, the tax picture for a partnership is basically the same as that of a sole proprietorship. A partnership doesn't pay income taxes. It must, however, file an informational return that tells the government how much money the partnership earned or lost during the tax year and how much profit (or loss) belongs to each partner. Each partner uses Schedule C of Form 1040 to report the business profits (or losses) allocated to him and then pays income tax on his or her share, whether or not this income was actually distributed during the tax year. If the partnership loses money, each partner can deduct his or her share of losses for that year from income earned from other sources (subject to some fairly complicated tax basis rules).

Investment Partnerships

The above analysis assumes that the partner who deducts losses from other income actively participates in the business. If, instead, a partner is a passive investor (as is often the case in partnerships designed to invest in real estate) or receives income from passive sources (such as royalties, rents or dividends), any loss from the partnership business is treated as a passive loss for that partner. That means that for federal income tax purposes the loss can be deducted only from other passive income—not from ordinary income.

4. Fringe Benefits and Business Expenses

When it comes to retained earnings, tax-sheltered retirement plans and fringe benefits, a partnership is like a sole proprietorship, and the discussion in Section A3, above, applies to partnerships as well.

Likewise, business expenses can be deducted in the same way for a partnership as for a sole proprietorship; the discussion in Section A4, above, applies here as well.

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C. Corporations

If you're concerned about limiting your personal liability for business debts, you'll want to consider organizing your business as either a limited liability company (LLC) or a corporation. (Of course, you may have other reasons in addition to limited liability for considering these two business structures.) Since the corporation has a longer legal history, I'll deal with it first, but the LLC—which is covered in Section D—may well be preferable for your particular business, despite its relative newness.

This information deals primarily with the small, privately owned corporation. I'll assume that all of the corporate stock is owned by one person or a few people, and that all shareholders are actively involved in the management of the business—with the possible exception of friends and relatives who have provided seed money in exchange for stock. Because there are many complexities involved in selling stock to the public, I don't discuss public corporations.

The most important feature of a corporation is that, legally, it's a separate entity from the individuals who own or operate it. You may own all the stock of your corporation, and you may be its only employee, but—if you follow sensible organizational and operating procedures—you and your corporation are separate legal entities.

All states have adopted legislation that permits a corporation to be formed by a single incorporator. All states permit a corporate board that has a single director, although the ability to set up a one-person board may depend on the number of shareholders. In addition, many states have streamlined the procedures for operating a small corporation to permit decisions to be made quickly and without needless formalities. For example, in most states, shareholders and directors can take action by unanimous written consent rather than by holding formal meetings, and directors' meetings can be held by telephone.

1. Limited Personal Liability

One of the main advantages of incorporating is that, in most circumstances, it limits your personal liability. If a court judgment is entered against the corporation, you stand to lose only the money that you've invested. Generally, as long as you've acted in your corporate capacity (as an employee, officer or director) and without the intent to defraud creditors, your home and personal bank accounts and other valuable property can't be touched by a creditor who has won a lawsuit against the corporation.

EXAMPLE: Andrea is the sole shareholder, director and officer of Market Basket Corporation, which runs a food store. Ronald, a Market Basket employee, drops a case of canned food on a customer's foot. The customer sues and wins a judgment against the business. Only corporate assets are available to pay the damages. Andrea is not personally liable.

Liability for your own acts. *If Andrea herself had dropped the case of cans, the fact that she is a shareholder, officer and director of the corporation wouldn't protect her from personal liability. She would still be personally liable for the wrongs (called torts, in legal lingo) that she personally commits. So much for theory. In practice, incorporating may not actually give you broad legal protection.*

In the real world, banks and some major corporate creditors often require the personal guarantee of individuals within the corporation. So the limited liability gained from incorporating isn't always as valuable a legal shield as it first seems.

EXAMPLE: Market Basket Corporation borrows \$75,000 from a bank. Andrea signs the promissory note as president of the corporation, but the bank also requires her to guarantee the note personally. The corporation runs into financial difficulties and can't repay the debt. The bank sues and wins a judgment against the business for the unpaid principal plus interest. In collecting on the judgment, the bank can go after Andrea's assets as well as the corporation's property. Incorporation offers no advantage over a sole proprietorship when an owner personally guarantees a loan.

As mentioned in Sections A and B, above, liability insurance can protect against many of the risks of doing business. Because of this, many businesses can structure themselves as sole proprietorships or partnerships without worrying about unlimited personal liability. But if you operate a high-risk business—child care center, chemical supply house, asbestos removal service or college town bar—and you can't get (or can't afford) liability insurance for some risks that you're concerned about, incorporation may be the wisest choice.

EXAMPLE: Loren is afraid that a clerk at his After Hours beverage store might inadvertently sell liquor to an under-aged customer or one who has had too much to drink. If that customer got drunk and hurt someone in a car accident, there might be a lawsuit against the business.

Loren contacts his insurance agent to arrange for coverage, but learns that his liquor store can afford only \$50,000 worth of liability insurance. Loren buys the \$50,000 worth of insurance, but also forms a corporation—After Hours Inc.—to run the business. Now if an injured person wins a large verdict, at least Loren won't be personally liable for the portion not covered by his insurance.

The lesson of these examples is clear: Before you decide to incorporate your business primarily to limit your personal liability, analyze what your exposure will be if you simply do business as a sole proprietor (or a partner in a partnership).

The limited liability feature of corporations can be valuable, protecting you from personal liability for:

- Debts that you haven't personally guaranteed, including most routine bills for supplies and small items of equipment.
- Injuries suffered by people who are injured by business activities not covered adequately by insurance.

Also, for a business with more than one owner, incorporating can offer a great deal of protection from the misdeeds or bad judgment of your co-owners. In contrast, in a partnership, as noted above, each partner is personally liable for the business-related activities of the other partners.

EXAMPLE: Ted, Mona and Maureen are partners in Mercury Enterprises. Mona writes a nasty letter about Harold, a former employee, which causes Harold to lose the chance of a good new job. Harold sues for defamation and wins a \$60,000 judgment against the partnership. Ted and Maureen are each personally liable to pay the judgment even though Mona wrote the letter.

If Mercury Enterprises had been a corporation, Mona and the corporation would have been liable for the judgment, but Ted and Maureen would not. Ted and Maureen would lose money if the assets of the corporation were seized to pay the judgment, but their own personal assets would be safe.

Payroll taxes. *Limited liability doesn't protect you if you fail to deposit taxes withheld from employees' wages—especially if you have anything to do with making decisions about what bills the corporation pays first. Also, because unpaid withheld taxes aren't dischargeable in bankruptcy, you want to pay these before you pay other debts (most of which can be wiped out in bankruptcy) in case your business goes downhill.*

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D. Limited Liability Companies

The limited liability company (LLC) is the newest form of business entity. It has enjoyed a meteoric rise in popularity among both entrepreneurs and lawyers—and for good reason. It's often a very attractive alternative to the traditional ways of doing business, which are described in Sections A, B and C, above. The state laws controlling how an LLC is created and the federal tax regulations controlling how an LLC is taxed are still evolving. Fortunately, the evolutionary trends are extremely favorable to small businesses. On the formation side, it's becoming simpler and simpler to set up an LLC. On the tax side, LLCs are benefitting from increased flexibility.

Once you've decided that your business should be organized as an entity that limits your personal liability for business debts, you'll have to weigh the pros and cons of forming an LLC against the pros and cons of forming a corporation. Sometimes, one or the other will clearly emerge as the better choice. Other times, the differences are more subtle—which often means that either will suit your needs equally well.

1. Limited Personal Liability

As with a corporation, all of the owners of an LLC enjoy limited personal liability. This means that being a member of an LLC doesn't normally expose you personally to legal liability for business debts and court judgments against the business. Generally, if you become an LLC member, you risk only your share of capital paid into the business. You will, however, be responsible for any business debts that you personally guarantee (of course, you can reduce your risk to zero by not doing this) and for any wrongs (torts) that you personally commit.

By contrast, as discussed in Sections A and B above, owners of a sole proprietorship or general partnership have unlimited liability for business debts, as do the general partners in a limited partnership.

Corporations and LLCs Use Different Terms

Although there are many similarities between corporations and LLCs, there are many differences as well—especially when it comes to terminology, as shown in the following chart:

<u>TERM</u>	<u>CORPORATION</u>	<u>LLC</u>
<i>What an Owner Is Called</i>	<i>Shareholder</i>	<i>Member</i>
<i>What an Owner Owns Interest</i>	<i>Shares of Stock</i>	<i>Membership</i>
<i>What Document Creates the Entity Organization</i>	<i>Articles of Incorporation</i> <i>(or, in some states, Certificate of Incorporation or Charter)</i>	<i>Articles of</i>
<i>What Document Spells Out Internal Agreement Operating Procedures</i>	<i>Bylaws</i>	<i>Operating</i>

2. Number of Owners

Nearly all states allow an LLC to be formed by just one person. (In Washington, D.C. and Massachusetts, however, you need two or more members to form an LLC.) This means that in most states, if you plan to be the sole owner of a business and you wish to limit your personal liability, you have a choice of forming a corporation or an LLC.

If your state still requires two or more members for a valid LLC, meeting that requirement should be no problem if you're married: simply invite your spouse to be a member. If that's not a possibility for you and you want limited personal liability for your one-person business, you'll need to form a corporation. All states do allow one-person corporations.

3. Tax Flexibility

If you create a single-member LLC, it will not be taxed as a separate entity, like a regular corporation, unless you elect to have it taxed in this manner. Normally, you won't choose corporate-style taxation, preferring to have your single-member LLC report its profits (or losses) on Schedule C of your personal return, just as a sole proprietorship would.

Similarly, if you have an LLC with two or more members, it will be treated as a partnership for tax purposes, with each partner reporting and paying income tax on her share of LLC profits unless you elect to have the LLC taxed as a corporation. Again, you normally won't elect to do this, preferring to have your

multi-member LLC follow the partnership tax route. This means that the LLC will report its income (or loss) on Form 1065, an informational return that notifies the IRS of how much each member earned (or lost). Each member will then report his or her share of profits or losses on her personal Form 1040.

Occasionally, the members of an LLC will conclude that there's an advantage to being taxed like a corporation, with two levels of tax—one at the business entity level (for company profits) and another at the owners' personal income tax level (for salaries and dividends). LLCs that are taxed like corporations are able to split monies between business owners and the business itself, resulting in some situations in a significant overall tax saving.

If, after reviewing all the financial implications—and perhaps seeking the advice of a tax pro—you decide to elect corporation-style taxation, you'll do this by filing IRS Form 8832, Entity Classification Election. Where the LLC has two or more members, they can all sign the form or authorize one member or manager to sign.

Electing to have your LLC taxed as a corporation can be advantageous if you want to receive tax-free fringe benefits from the business. *If you follow the usual practice of having pass-through taxation for your LLC—meaning that the business isn't taxed as a separate entity—then as a business owner you'll be taxed on the value of the fringe benefits you receive from the LLC (unlike other employees). A different rule applies if you elect to have your LLC taxed as a corporation. In that situation, as long as you meet the IRS guidelines, you can receive fringe benefits as an owner-employee of the LLC and not have to pay tax on the value of those benefits.*

4. Flexible Management Structure

An LLC member may be an individual or a separate legal entity such as a partnership or corporation that has invested in the LLC. You and the other members jointly run the LLC unless you choose to have it run by a single member, an outside manager or a management group—which may consist of some members, some nonmembers or both. If you decide to form an LLC, I recommend that all the members sign an operating agreement that spells out how the business will be managed.

5. Flexible Distribution of Profits and Losses

The members of an LLC can decide to split up the LLC profits and losses each will receive any way they want. Although it's common to divide LLC profits according to the percentage of the business's assets each member contributed, this isn't legally required.

EXAMPLE: Jim, Janna, Jill and Jerry—certified personal trainers—form Fit for Life LLC to operate a family fitness center. Each contributes \$25,000 to the enterprise. Because Jim, who has a strong business background, has put together the LLC, set up a bookkeeping system, arranged for a bank loan to purchase necessary equipment and negotiated a very favorable lease at a good location, the owners state in their operating agreement that for the first two years, Jim will receive 40% of the LLC's profits and that Janna, Jill and Jerry will each receive 20%. After that, they'll share profits equally.

By contrast, rules governing corporate profits and losses are considerably more restrictive. A regular corporation can't allocate profits and losses to shareholders; instead, shareholders must receive dividends according to the number of shares they own—if they receive dividends at all. (But it is possible, although more cumbersome, to establish two or more classes of stock, each with different dividend rights.)

Similarly, in an S corporation, profits and losses are attributed to the shareholders based on their shares: a shareholder who owns 25% of the shares in an S corporation ordinarily must be allocated 25% of profits and losses—no more and no less. Sometimes, however, corporations can get away from this strict formula by adjusting the salaries of shareholders who work in the business.

The easy flexibility allowed to LLCs in distributing profits and losses permits businesses to be creative and even make distributions to members who have contributed no cash.

EXAMPLE: Howard and Saul run a home repair business organized as an LLC. Howard puts up all the money to needed to buy a van, tools and supplies and to pay for advertising brochures and radio commercials. Saul, who has little cash but loads of experience in doing home repairs, will contribute future services to the LLC. Although the owners could agree to split profits and losses equally, they decide that Howard will get 60% for the first three years as a way of paying him back for taking the risk of putting up cash.

Excerpted from the "*Legal Guide for Starting and Running a Small Business*", by Fred S. Steingold

Chapter 2 – Naming Your Business & Products

Naming your business and products may not be as simple as it first appears. For one thing, you need to comply with legal procedures mandated by state law. If you incorporate, for example, or form a limited liability company, you must choose a corporate or LLC name acceptable to your state's business filing office. And all businesses—corporations, LLCs, partnerships and sole proprietorships—must comply with laws dealing with the registration and possible publication of assumed names or fictitious names.

Other legal procedures having to do with business names are not mandatory, but it nevertheless makes good sense to follow them. For example, before using a cool sounding name—especially one that will also be used to identify your products and services—it's extremely smart to find out whether someone else already has rights to the name and, as a result, can legally limit how you use it or tell you not to use it at all. This normally involves at least two steps. To avoid a claim of unfair competition, your first step is to do a local name search to make sure that no local business in your field uses a similar name. Don't start Jimmy's French Laundry if there's already a Jenny's French Laundry a few miles away.

Step two involves making sure you gain maximum protection for your trademarks or service marks—names you'll use to identify your products or services. Especially if you're looking for comprehensive protection for a trademark or service mark, you'll want to first carefully check and then register the mark under federal and state trademark laws.

Just how much effort and expense should you sensibly invest in protecting the name of your business, product or service? The answer depends on many factors, such as: the size of your business, the size of the market that you'll operate in, the type of product or service and your expectations for growth and expansion. As a general rule, the more customers your business will reach, the more you need to be sure you have the exclusive right to use your chosen name within your business or product niche. For example, if you're starting a local computer repair service, you won't need as much business name protection as if you were planning to sell a new line of low-fat salad dressings in all 50 states. But be aware that because of the Internet and other electronic communication methods, the number of small businesses that compete with one another is rapidly growing, meaning the need to do in-depth name searches and to consider the implications of trademark law is also rapidly growing.

Business Names and Trademarks: They Are Not the Same

Legally, there are two main types of business names:

- *the formal name of the business, called its trade name (Apple Computer Inc., for example), and*
- *the names that a business uses to market its products or services, called trademarks and service marks (Macintosh brand computer, for example).*

Use of either type of business name can raise legal issues, but the most serious lawsuits tend to focus on the trademarks and service marks a business uses to market its products or services.

By being the first to use and register a trademark or service mark, a business can prevent another business from using the same or very similar mark. Laws that protect the integrity of trademarks and service marks are intended to prevent consumers from being unfairly confused about the source of products and services. A buyer should be able to rely on the fact that the source of a computer bearing the trademark "Macintosh" is Apple Computer Inc., which has registered Macintosh as a trademark.

Obviously, if you're choosing a name to use as a trademark or service mark, you need to conduct a full search to make sure no other business is already using that name as a trademark or service mark. What may be less obvious is that you need to make exactly the same kind of search if you plan to use your business name to identify your goods or services—as when Ford Motor Company markets cars under the brand name (trademark) Ford.

*For a thorough discussion of business names, see *Trademark: Legal Care for Your Business & Product Name*, by Stephen Elias and Kate McGrath (Nolo). That book discusses in great depth how to choose a legally protectable name and offers step-by-step instructions on how to file a federal trademark registration. Also check out the Nolo website (<http://www.nolo.com>) where you'll find extensive legal information on patents, copyrights and trademarks.*

A. Business Names: An Overview

Complying with the few mandatory legal procedures for naming your small business is relatively simple. For some very small, local businesses, meeting these requirements and doing nothing more may be adequate.

EXAMPLE: Jeff wants to start a local word processing service called "Speedy Typing for All." He'll be a sole proprietor. Since his is a small, unincorporated local business, he is probably safe enough if he registers the name as an assumed or fictitious name. In most states, he will register it at the county level, but some states require registration at the state level and also require publishing the name in a newspaper. Jeff probably doesn't need to spend time and money to register the name as a state trademark or service mark. With a descriptive name and a small local business, there's little likelihood that the customers of any other business would be misled so there's not much to protect. However, Jeff should check to be sure there are no other word processing services in his area using the same or a very similar name. If there are, Jeff should change his name or risk a claim of unfair competition. If Jeff wants to go the extra legal mile, he should check his state's Trademark Register and the Federal Register to see if other "Speedy Typing" businesses are registered.

Until quite recently, a wide range of local businesses—small retail stores, repair services and craft studios, for example—didn't need to worry about registering a trademark or service mark. And to avoid possible claims that they were unfairly using another business' name, they could feel relatively secure if they checked for possible name conflicts in state and local business directories and Yellow Pages with no need to do a more formal state or federal trademark search. But today, the rules of the game are dramatically different. The reason is that in the world of the Internet, mail order and rapidly growing national chains, the idea of "local" isn't what it used to be. Today, even modest-sized businesses must consider taking name protection steps that used to be the sole concern of larger, more expansive enterprises. For example, you might think you have no problem if you're choosing a name for a shoe store in a small town. Think again. If you happen to pick a name that's similar to a shoe store that sells on the Internet, you are very likely to be accused of trademark infringement and probably forced to change your business name, even though the online store is located 2500 miles away.

Doing Business on the World Wide Web

Like many other business owners, you may decide to operate a website. If so, you'll need to select a domain name—a unique address that computers understand and customers can use to find you. The issues involved in choosing a domain name range from getting your hands on an available one to avoiding trademark lawsuits based on your choice of name.

A good domain name should be memorable, clever, and easily spelled. Unfortunately, many of the best names are already taken. To see if the name you have in mind has been registered, go to <http://www.networksolutions.com/cgi-bin/whois/whois>. This site allows you to search for a particular name. For example, if you are starting a speed typing business, you might check "speedy.com." If you find that speedy.com is already taken, the <http://www.networksolutions.com> website offers a function called "MyNameFinder" that allows you to peruse other possibilities. After you enter relevant keywords (such as quick, speedy, and typing), MyNameFinder will return a list of related names that are still up for grabs.

Once you've found an available name, you'll need to make sure it doesn't conflict with someone else's trademark. If your choice will cause customer confusion between your company and another, you're safer choosing another name. This is true even if the other business is halfway across the country. Once you've established a Web presence, you are in competition with businesses around the globe, and must address trademark issues equally broadly. A generic name such as "coffee.com" will keep you safest from lawsuits, but will also leave you unable to protect your name from use by other businesses—you'll need to strike a balance.

After you've chosen an appropriate domain name, you can register it online with a service such as Network Solutions, at the website mentioned above. Some businesses register under more than one name, or register common misspellings of their names.

*Courts are still grappling with the issues surrounding domain names and trademark law, and there's much more to know than I can cover here. For detailed and up-to-date information on choosing and registering domain names, as well as avoiding domain name conflicts, check out Nolo's free Internet Law Center at http://www.nolo.com/category/ilaw_home.html. Also read *Domain Names: How to Choose & Protect a Great Name for Your Website*, by Stephen Elias & Patricia Gima (Nolo).*

These days, about the only time you might be able to ignore thinking about trademarks and service marks is if you have a tiny, local business that uses your own name—or a very common name—to market goods and services locally. In short, if you plan to sell services using your own name (Harvey Walker Roof Repair) or if yours will be a one-person, home-based business such as a graphic design service (A+ Design), you're not likely to have a trademark problem. But if your business is just a little bigger, such as a large camping equipment store (Wilderness Outfitters) or sells goods or services beyond a very local or industry-specific niche (Lamps.com Online Lamp Store), you really should take time to understand the basics of trademark law—and conduct a name search to see if someone else in your field is already using your proposed name.

The reason to be absolutely sure you have the legal right to use your chosen business name is simple: You don't want to invest time and money in signs, stationery and ads for your business and then get a nasty letter from a large company that claims a right to the name you're using and threatens you with a trademark infringement lawsuit. Just defending such a case in federal court can cost you upwards of \$100,000, meaning that even if you're sure that you're in the legal right, you'll probably wind up changing your name just to duck the lawsuit—no fun, given the investment you've already made.

If you decide that you want the protection of federal or state trademark registration, see Trademark: Legal Care for Your Business & Product Name, by Stephen Elias and Kate McGrath (Nolo). You can probably handle the registration process yourself, but if you prefer to use a lawyer, the book will make you better able to take advantage of your lawyer's assistance.

Relying on a State-Filing Search May Not Be Adequate

When you form a corporation or LLC, the state filing office will check to see if your proposed business name is the same as or confusingly similar to one already on file. If so, your name will be rejected. But just because your name is accepted by the state filing office doesn't mean your business name is safe to use. That's because these offices don't check state or federal *trademark* registers. In short, even though a name may be available in your state to identify your business, you may run into costly trademark infringement problems if you use it to also identify your products and services.

EXAMPLE: Tony and Lars form a corporation that will design state-of-the-art sound systems for restaurants and jazz clubs. Their name—The Ears Have It Inc.—has been cleared by the secretary of state for their state. Can they now safely use this name as a service mark to market their services? No. When the secretary of state cleared the corporate name, it simply meant that the name didn't duplicate the name of another corporation in that state. Another company may have already been using the name as a trademark or service mark. This wouldn't show up in the secretary of state's corporate name records.

Since Tony and Lars are hoping to market their services in several states, they (or a name search company they hire) should do a thorough search, including checking federal and state trademark registers. If they don't, they may inadvertently find themselves in conflict with a company that's already using the name. If they find that their proposed name is clear, they should think about registering it as a federal trademark or service mark.

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B. Trademarks and Service Marks

A trademark or service mark consists of two parts. In reverse order, they are:

- The noun that specifies what kind of product or service you're talking about. Examples: automobile; health plan.
- The word or words that function as an adjective to identify a product or service as being different from all others. Examples: Buick automobile; Saab automobile; Blue Shield health plan; Kaiser health plan.

Think of these as the first and last names of products and services. The last name identifies the group; the first name uniquely specifies a member of that group. As such, the trademark is used as a proper adjective and is always capitalized.

Trademark law is the main tool that businesses use to protect the symbols and words that identify the origin of services and products. The basic premise is that the first user of a distinctive (that is, creative or unusual) name or symbol gets the exclusive right to use it. If you're the first user, you can make that right easier to enforce if you register the name or symbol with the federal trademark agency. The principal

purpose of registration is to protect rights that already existed because you used the mark first. But registration can also confer other rights. For example, if you're using an unregistered mark without knowing that someone else used it first, federal registration can give you priority in areas outside the first user's market territory.

The twin goals of trademark law are:

- to prevent businesses from getting a free ride off the creativity of others in naming and distinguishing services and products, and
- to prevent customers from being confused by names that are misleadingly similar.

From a legal protection standpoint, the best trademarks are coined words, such as Kodak or Yuban, or arbitrary words such as Arrow for shirts or Camel for cigarettes, which have nothing to do with the product. Nearly as good are suggestive trademarks—ones that hint at some aspect of the product. For example, Talon suggests the gripping power of a zipper.

Trademarks that consist of creative, unusual or otherwise memorable terms are called "distinctive" and "strong." If you're the first to use such a name or symbol, you can legally stop others from using it in most situations.

Trademarks that consist of ordinary terms are called "weak," and competitors are free to use them. Merely descriptive words (such as Easy Clean for a cleanser) generally are not legally protectable. These weak marks can, however, become strong if they acquire a secondary meaning through prolonged usage. If that happens, they may be federally registered and may also be protected under the law of unfair competition if there's a local conflict with a similar mark.

You can't acquire any rights in the name of the product itself; this is called a generic name. This means you can't adopt Bicycle or Refrigerator as your trademark for your version of those products. You can use the words as part of a distinctive name.

The law doesn't allow a business to claim the exclusive right to use descriptive words and generic names because competitors also need to describe their products. If you could tie up key words for your own exclusive use, your competitors would be unduly restricted in describing their goods. Also, descriptive terms aren't particularly memorable and don't further the purpose of trademarks and service marks.

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C. Strong and Weak Trademarks

As noted earlier, with very few exceptions, only strong trademarks or service marks have the full protection of federal and state trademark laws. Remember, too, that trademark laws don't automatically protect a business name (the name of your company); to be considered a mark, a business name must be used to identify a product or service in the marketplace.

A trademark is considered weak when others can use it (or something similar) on products or services that don't compete directly with yours. Most ordinary trademarks are weak. Examples: Liquor Barn, Cuts Deluxe, Charlie's Auto Parts, 10-Minute Lube.

A trademark is considered legally strong when others can't use it or anything similar on related goods or services. There are two kinds of strong trademarks: ones that contain distinctive terms and ones that contain ordinary terms that have acquired distinctiveness through use.

1. Distinctive Terms

Distinctive trademarks are memorable, evocative, unique or somehow surprising—for example, 7-Up, Lycra or Cherokee apparel. The words themselves have little or no descriptive function; they serve to set the product or service off from others.

So if you're naming a service or product and want a strong mark, try for a name that is either unusual or used in an unusual way. A judge is likely to treat a distinctive name as a trademark or service mark and protect it from use by others—unless someone else has used a similar trademark on the same type of product or service first.

EXAMPLE: "Buick" distinguishes a line of cars from others, and the name means nothing apart from its trademark use. It's a distinctive name. Conversely, "Dependable Dry Cleaners" merely tells you something about the business; it doesn't help you distinguish it from rivals who might also advertise their services as reliable or efficient. So the name would probably not qualify for trademark or service mark protection unless it had been in use for a long time and developed a sizable following—that is, a

secondary meaning.

2. Ordinary Words

Generic terms can't be protected by trademark law; original and distinctive words can be protected. But what about other words used to identify products and services—ordinary words that are neither generic nor distinctive? This category covers place names (Downtown Barbers), surnames (Harris Sales), words that describe the product or service (Slim-Fast Diet Food) and words of praise (Tip-Top Pet Shop). Ordinary words receive limited legal protection as trademarks. It's more difficult to keep others from using them or something similar.

Even a weak trademark can acquire limited protection under unfair competition laws. For example, an ordinary name (a weak trademark) can be protected from someone else using the name in a confusing way. The law of unfair competition is generally based on state law (statutes and judge-made law) that supplements federal and state trademark laws. Owners of weak and unregistered names can get some relief from a rival's use of the identical name on the identical product or service in a competing market.

Weak trademarks can become strong ones through long use and extensive public familiarity with the mark. A trademark that starts out being ordinary or otherwise weak (like Dependable Cleaners) can sometimes, over time and through use, become identified in the public's mind with a specific product or service. When that happens, it can be transformed into a strong trademark.

EXAMPLE: Chap Stick brand of lip balm was originally a weak trademark. It simply described the condition the product was designed to cure: chapped lips. But it became strong as advertising and word of mouth helped the public develop a clear association between the name and a specific product. Over time, the name developed distinctiveness based on familiarity rather than any quality inherent in the name.

Lawyers describe a trademark that has become distinctive over time as one that has acquired a "secondary meaning." McDonald's is another good example of a weak mark that developed a secondary meaning over the years—and now qualifies for broad protection.

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D. How to Protect Your Trademark

What do the words aspirin, escalator, cellophane and shredded wheat have in common? They are all former trademarks that have entered our language as product names. These words have lost their status as trademarks and are now generic terms. Other examples of former trademarks include harmonica, linoleum, raisin bran, thermos and milk of magnesia. In each of these cases, a business lost its exclusive right to use a valuable trademark.

Here are some steps that your business can take to prevent this from happening to your trademark.

- Use your trademark as a proper adjective that describes your product. You'll notice that ads refer to a Xerox copier, Jell-O gelatin and Band-Aid adhesive strips. If people continue to use the words Xerox, Jell-O and Band-Aid alone, these marks can easily go the way of other trademarks like nylon, mimeograph and yo-yo.
- Always capitalize the first letter of your trademark. And at some place on each ad or package, say specifically that the trademark is owned by your company.
- If your trademark has been placed on the federal trademark register, consistently give notice of that fact by using the ® symbol. If a trademark isn't federally registered or is registered only by a state, you may use the letters "TM" or "SM" to give notice of your claims. You may not use ® unless your mark is in fact on the federal register.
- Take prompt legal action if other businesses use your trademark without permission. A trademark may become weakened or even generic if others use it to describe their products and you do nothing about it. You or your lawyer should send a letter by certified mail (return receipt requested) demanding that the infringement cease. If your demand is ignored, be prepared to go to court to seek an injunction—but first do a careful cost/benefit analysis to satisfy yourself that it's worth the expense.
- If you discover that a newspaper or TV program has improperly used your trademark, send them a letter. Keep a copy in your records as proof that you have consistently enforced your trademark rights

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Fred S. Steingold

Chapter 3 – Licenses & Permits

You'll probably need a license or permit— maybe several—for your business. In some locations, every business needs a basic business license. But whether or not that is required, your business may need one or more specialized licenses. This is especially likely if you serve or sell food, liquor or firearms, work with hazardous materials or discharge any materials into the air or water.

There are licensing and permit requirements at all levels of government—federal, state, regional, county and city. It's not always easy to discover exactly what licenses and permits you'll need. But it's very important. You should thoroughly research this issue before you start a business, complete the purchase of a business, change locations or remodel or expand your operation. If you don't, you may face expenses and hassles you hadn't anticipated. In a worst case situation, you could be prevented from operating your planned business at a particular location but still be obligated to pay rent or a mortgage. For example, what if you sign a five-year lease for business space and then discover that the location isn't zoned properly for your business? What if you buy a restaurant and then find out that the liquor license isn't transferable? Or suppose you rent or buy business space thinking that you can afford to remodel or expand it, without realizing that remodeling means you must comply with all current ordinances? You might have to pay for \$15,000 worth of improvements to comply with the federal Americans With Disabilities Act or \$10,000 for a state-of-the-art waste disposal system.

Here are several examples that illustrate the types of licenses and permits many businesses need:

- Millie plans to open a new restaurant. Before doing so, she needs a permit from the department of building and safety for remodeling work and a license from the health department approving the kitchen equipment and ventilation system. She also needs a sign permit and approval of her customer and employee parking facilities from the city planning department. Finally, she has to get a sales tax license; even though in her state sit-down meals are not taxed, she must collect and report sales tax for take-out orders and miscellaneous items such as cookbooks.
- Leisure Time Enterprises, a partnership, buys a liquor store that also sells state lottery tickets. In addition to obtaining a basic business license issued by the city, the partners must have the state-issued alcoholic beverage license transferred to them. They also have to apply to the state lottery bureau for a transfer of the lottery license and to the state treasury department for a sales tax license.
- Electronic Assembly Inc., a corporation that assembles electronic components for manufacturers of stereo equipment, must obtain a conditional use permit from the planning and zoning board in order to conduct its "light manufacturing operation" in a commercial district. The company also needs clearance from a tri-county environmental agency concerned about possible air pollution and disposal of toxic chemicals. In addition, the new elevator must be inspected and approved by the state department of labor.
- Peaches and Cream, a new disco, has to get fire department clearance for its exit system and also must comply with the city's parking ordinance—which practically speaking means negotiating with the planning department for the number of off-street parking spaces the disco will provide for customers. The club also needs a liquor license from the state liquor control commission, a cabaret license from the city council and a sales tax license.
- Glenda needs an occupational license from the state department of cosmetology before she can open up her beauty shop. Because she carries a line of shampoos, conditioners and make-up, she needs a sales tax permit as well. In addition, because she's extending the front of her shop three feet into the front setback area, she needs a variance from the zoning board of appeals. Finally, because she's in an "historic preservation area," her sign must be approved by the local planning board.

In short, license and permit requirements can affect where you locate your business, how much you'll have to spend for remodeling and whether or not you'll have to provide off-street parking. If zoning requirements are too restrictive, you might even decide to avoid the hassle and move somewhere you don't have to fight City Hall for the right to do business. Similarly, if building codes require extensive—and expensive—remodeling to bring an older building up to current standards, you might want to look for newer space that already complies with building and safety laws.

Each state has its own system of licensing as does each unit of local government. Obviously, it's impossible to provide a comprehensive list of every permit and license in the United States. Fortunately, I can give you some general principles and a positive approach to help you learn about and comply with the licensing requirements that affect your business.

Double check license and permit rules. *When you investigate the type of licenses and permits you need for your business, check directly with the appropriate governmental agencies. Never rely on the fact that an existing business similar to yours didn't need a license or had to meet only minimal building code requirements. Laws and ordinances are amended frequently—generally to impose more stringent requirements. Often an existing business is allowed to continue under the old rules, but new businesses must meet the higher standards. Similarly, for obvious reasons, don't rely on the advice of real estate agents, business brokers, the seller of a business or anyone else with a financial interest in having a deal go through.*

The Purposes of Licenses and Permits

Governments require licenses and permits for two basic reasons. One is to raise money; the whole point behind some licenses or permits is to levy a tax on doing business. In a way, these are the easiest to comply with—you pay your money and get your license.

The other basic purpose behind licenses and permits is to protect public health and safety and, increasingly, aesthetics. A sign ordinance that dictates the size and placement of a business sign or an environmental regulation that prohibits you from releasing sulphur dioxide into the atmosphere are two of many possible examples. Complying with regulatory ordinances can often be far more difficult than those designed simply to raise money.

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Chapter 4 – Insuring Your Business

A well-designed insurance program can protect your business from many types of perils. Consider the following:

- A fire destroys all the furniture, fixtures and equipment in your restaurant.
- Burglars steal \$75,000 worth of computer equipment you use in your book publishing business.
- A customer visiting your yogurt store slips on the just-washed floor and shatters her elbow.
- On the way to an office supply store to pick up some fax paper, one of your employees runs a stop sign and injures a child.
- A house painter has a severe allergic reaction to a solvent that your company manufactures and distributes.
- One of your employees is hospitalized for four weeks with a severe back injury she received while trying to lift a heavy package.
- The building where you're located is severely damaged by a windstorm. You're forced to close your doors for two months while repairs are made. In addition to having to pay \$35,000 for continuing business expenses, you lose the \$25,000 of profits you expected for that period—a total loss of \$60,000.
- A client installs a lawn sprinkling system based on specifications you recommended as a landscape architect. Because you hadn't checked soil conditions carefully, the system malfunctions, flooding your client's basement and ruining the antique furniture stored there. Your client sues you for professional negligence.

Maybe none of these will happen to your business—but unless you consider yourself permanently exempt from Murphy's Law ("What Can Go Wrong Will Go Wrong"), don't bet on it. Fortunately, insurance is available to cover each of these events and for many, if not most of them, is reasonably cost-effective. Not every small business needs every type of coverage. In fact, a business that tried to buy insurance to cover all insurable risks probably wouldn't have money left over to do anything else. Deciding on insurance coverage usually involves some difficult choices. Here are some general rules to start with:

- Get enough property and liability coverage to protect yourself from common claims. These are the most important kinds of insurance for a small business.
- Buy insurance against serious risks where the insurance is reasonably priced.
- Keep costs down by selecting high deductibles.
- Self-insure if insurance is prohibitively expensive or the particular risk is highly unlikely.
- Adopt aggressive policies to reduce the likelihood of insurance claims, particularly in areas where you're self-insured.

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A. Property Coverage

In considering property coverage, there are four main issues to think about:

- What business property should you insure?
- What perils will the property be insured against? In other words, under what conditions will you be entitled to receive payment from the insurance company?
- What dollar amount of insurance should you carry? (Obviously, the higher the amount, the higher the premiums. You don't want to waste money on insurance but you do want to carry enough so that a loss wouldn't jeopardize your business.)
- Should you buy coverage for replacement cost or for the present value of the property?

1. Property Covered

Your insurance policy will contain a section called Building and Personal Property Coverage Form, which lists exactly what property is covered. If you own the building you're occupying, be sure the building is covered, including:

- completed additions
- permanently installed fixtures, machinery and equipment
- outdoor fixtures (such as pole lights)
- property used to maintain or service the building (such as fire extinguishing equipment).

The policy may also cover additions under construction as well as materials, equipment, supplies and temporary structures on or within 100 feet of the main building.

Be sure that your business personal property is also covered. A typical policy covers the following items located on the business premises:

- furniture and fixtures
- machinery and equipment
- inventory
- all other personal property used in the business (such as technical books and cassette tapes)
- leased personal property, if you're contractually obligated to insure it
- personal property of others that's in your custody.

Be sure that everything is covered. Check carefully to be sure the policy covers all the types of personal property that you own or expect to own: furniture, equipment, goods that you sell, products that you manufacture and raw materials used in the manufacturing process.

Typically, various items are excluded, such as accounting records, currency, deeds and vehicles held for sale. If you need coverage on excluded items, you can usually arrange it, for an additional premium.

2. Perils Covered

More than 90% of the time, property insurance for small businesses is written in one of three forms: Basic Form, Broad Form and Special Form. Special Form coverage is the most common and affords the best protection.

Whichever policy you decide on, read it carefully before you pay for it—not just when you've suffered a loss. You may discover that some coverage is narrower than it first seemed. For example, smoke loss may refer only to loss caused by a faulty heating or cooking unit; it may not cover smoke damage from industrial equipment. Similarly, an explosion may not include a burst steam boiler. Fortunately, most insurance policies today are written in plain English so you should have little problem in understanding what's covered and what isn't. If you need coverage not provided in the policy, talk to your agent about how to add it on.

Basic Form coverage includes losses caused by fire, lightning, explosion, windstorm or hail, smoke, aircraft or vehicles (but not loss or damage caused by vehicles you own or operate in the course of your business), riot, vandalism, sprinkler leaks, sinkholes and volcanoes. The policy defines these perils—and also lists some exclusions, such as nuclear hazards, power failures or mud slides.

Broad Form coverage contains everything that's in the Basic Form and adds protection from a few more perils, including breakage of glass (that is part of a building or structure), falling objects, weight of snow or ice and water damage. Again, these terms are defined in the policy and, again, exclusions are listed. Special Form policies are constructed differently than Basic and Broad Form policies and offer wider and slightly more expensive coverage. Instead of listing specific perils such as fire and lightning, Special Form policies simply say that your business property is covered against all risks of physical loss unless the

policy specifically excludes or limits the loss. This type of policy offers the most protection. For example, it's a convenient way to insure against loss by theft, which isn't covered by Basic and Broad Form policies. (Section D2 discusses theft insurance.)

If you need additional coverage. *If you're concerned about property loss caused by perils not covered or, in the case of a Special Form policy, excluded from an insurance policy, you can often get the additional coverage through an endorsement (add-on page) to the policy by paying an additional premium. For example, such coverage is usually available for losses due to earthquakes and floods.*

Earthquake and Flood Insurance

Earthquake insurance can be handled through a separate policy or an endorsement to Basic, Broad or Special Form coverage. Deductibles in an earthquake endorsement are typically stated as a percentage—such as 10%—rather than as a dollar amount. This means that the higher your policy limit, the bigger the deductible. As a result, some business people choose a \$200,000 policy with a \$20,000 deductible rather than a \$400,000 policy with a \$40,000 deductible. They reason that the deductible on the latter policy is so high they're unlikely to ever collect anything.

Flood insurance, by contrast, is usually handled through a separate policy called "Difference in Conditions."

Combining property and liability insurance in one policy. You can purchase property insurance as a stand-alone and buy a separate stand-alone policy for liability coverage, or you can buy a policy that combines both coverages. It's often—but not always—cheaper to buy a combination policy. Here's where comparison shopping definitely pays off.

3. Amount of Coverage

Be sure to carry enough insurance on the building to rebuild it. But there's no need to insure the total value of your real property (the legal term that includes land and buildings), because land doesn't burn. Especially if you're in an area where land is very valuable, this is a big consideration. If you're in doubt as to how much it would cost you to rebuild, have an appraisal made so you know that your idea of value is realistic. Because the value of the building and other property may increase, it's wise to get a new appraisal every few years. Your insurance agent should be able to help you do this. Usually it's best to insure your property for 100% of its value. If doing this is prohibitively expensive, consider a policy with a higher deductible rather than underinsuring. Underinsuring to get a reduced premium is a false economy for several reasons. Not only are you not covered if you suffer a total loss, but it may also reduce your ability to recover for a smaller loss. This is because most insurance policies carry a co-insurance clause which states that to recover the full policy amount, you have to carry insurance to cover at least 80% (this percentage may vary) of the property's replacement cost or actual cash value. If you don't, you become a co-insurer if there's a loss, even if it's less than the policy maximum; the policy will only pay off a percentage of its face value.

EXAMPLE 1: Fluoro Corporation owns a \$100,000 building. If Fluoro carries \$80,000 worth of insurance or more, the insurance company will pay Fluoro for the full amount of any loss up to the policy limit. For example, if the loss is \$50,000 Fluoro will get the full \$50,000. If the loss is \$90,000, Fluoro will receive only \$80,000, the policy limit.

EXAMPLE 2: Pluto Associates owns a similar \$100,000 building. To get a reduced premium, the partners decide to carry only \$40,000 worth of insurance. If there's a fire and Pluto has a loss of \$20,000, its insurance company will pay only \$10,000. Because Pluto carried only half of the 80% figure mentioned in the policy, it's entitled to only a proportional payment.

4. Replacement Cost vs. Current Value

Historically, in case of a loss, a basic fire insurance contract covered the actual current value of the property, not its full replacement value. Today, policies are routinely available with replacement cost coverage. This is the coverage you want.

EXAMPLE: Sure-Lock Corporation owns a 20-year-old building. The current cash value of the building (the amount someone would pay to buy it) is \$150,000. But if the building burned down, Sure-Lock would have to pay \$200,000 to replace it. If Sure-Lock buys insurance based on the building's cash value and the policy has an 80% co-insurance clause, the company will need to insure the building for \$120,000. If Sure-Lock buys insurance based on replacement cost, it will need to

insure for \$160,000, which is 80% of \$200,000.

The real cost of insurance is reduced when you consider that insurance premiums for a business are a recognized business expense—which means they are tax-deductible.

5. Ordinance or Law Coverage

If you're purchasing insurance for an older building—either because you own it or your lease requires it—understand that a normal Basic Form, Broad Form or Special Form policy designed to replace your existing building should it be destroyed probably won't be adequate. The problem is that legal requirements adopted since the building was constructed will normally require that a stronger, safer, more fire resistant building be constructed. Doing this can cost far more than simply replacing the old building. To cope with this possibility, you want a policy that will not only replace the building but pay for all legally required upgrades. This coverage is called "Ordinance or Law Coverage."

EXAMPLE: Time Warp Inc., sells antique furniture and building materials removed from old homes. In keeping with its image of days gone by, Time Warp does business in a 100-year-old building in a historic part of town. Time Warp carries insurance for the full replacement cost, \$100,000. One day a fire destroys 50% of the building. The insurance pays \$50,000 toward reconstruction, but the Time Warp owners learn to their dismay that rebuilding will cost much more and that the additional costs are not covered by their insurance policy. The items excluded by their typical property insurance policy include the following:

- The cost of meeting current health and safety codes. The old building was of wood frame construction and lacked an elevator and sprinkler system. That was OK before the fire. The building pre-dated the health and safety ordinances and was "grandfathered"—specifically exempted from the new construction requirements. After the fire, it's a whole new ball game. In rebuilding, Time Warp must spend an additional \$100,000 for masonry construction, an elevator and a sprinkler system required by current health and safety codes.
- The cost of rebuilding the undamaged portion of the building. The local ordinance requires that if a building built before current codes is destroyed by fire to the extent of 50% or more, the entire building must be replaced. The cost of replacing the undamaged 50% of the building is another \$200,000.
- The cost of demolition. The local ordinance requires that, because of the extent of damage, the entire building—both the damaged and undamaged portions—must be torn down before reconstruction begins. That will cost another \$25,000.

"Ordinance or Law Coverage" would pay for all of these items.

6. Tenant's Insurance

If you're a tenant, read the insurance portion of your lease. You may have agreed to insure the building and protect the landlord against any liability suits based on your activities, in which case you'll need the type of coverage an owner would carry. This is available through a renter's commercial package policy, which also provides routine product liability coverage for businesses not involved in hazardous activities and allows you to name your landlord as an additional insured.

Even if you haven't agreed to provide insurance coverage in your lease, a renter's commercial policy can make excellent sense. Not only will it cover any of your "leasehold improvements," such as paneling and partitions, but it will also cover damage to the premises caused by your negligence. For example, if the building you rent suffers fire or water damage as a result of an employee's negligence (a fire in an area where food is prepared spreads and damages the walls and ceiling), you may be liable. This is true even if the building owner is insured and recovers from his or her insurance company, because the owner's insurer has the right to try to recover.

What the insurer will pay you for loss to leasehold improvements is based not on replacement value but on what's called the "use interest" in the improvements. Basically, the insurance company looks at how long you would have had the use of the improvements and reimburses you for the use you lose.

EXAMPLE: Court Reporting Associates (CRA) installs \$20,000 worth of paneling in their rented offices. They have a five-year lease with an option to renew for five more years—which, for insurance purposes, is treated as a ten-year lease. Two years into the lease, a fire destroys the paneling. Because CRA used up 20% of the lease before the fire, it will receive payment for only 80% of value of the paneling.

Insurance clauses in leases vary widely.

B. Liability Insurance

The second major category of insurance coverage for a small business is liability insurance. Your business can be legally liable to people injured and for property damaged because you or your employees didn't use reasonable care. For example, if a customer falls on a slippery floor and then sues you, you may be liable because you negligently failed to provide safe premises.

As you probably know, when it comes to personal injuries, judges are broadening the scope of what people can sue for—and juries are increasingly generous in awarding damages. Because an injured person can collect not only for lost wages and medical bills but also for such intangibles as pain, suffering and mental anguish, a single personal injury verdict against your business has the potential to wipe it out. For that reason, unless you have a very unusual business that has no personal contact with customers, suppliers or anyone else, your insurance program should include liability coverage. Some intentional acts not involving bodily injuries are also usually covered under the liability portions of an insurance policy. Examples are libel, slander, defamation, false imprisonment and false arrest.

Toxic Waste Clean-Up

Suppose the government orders your company to clean up a toxic waste problem on your property. This can and does regularly occur even if the pollution occurred years before you bought the property. Will your liability insurance policy cover the clean-up costs (called the "response costs")? Most courts that have considered this question ruled that response costs are covered by a liability insurance policy, but a significant minority have ruled otherwise. If you have a business or own property that by any stretch of the imagination could become involved in a toxic waste or pollution problem, try to find out exactly how far your liability coverage extends in environmental situations. You may need to buy supplementary coverage (if available and affordable) to cover this risk.

Keep yourself informed on this subject. It's likely that faced with court decisions saying that general liability coverage requires insurance companies to pay for response costs under clean-up orders, insurance companies will tighten up their policy language to exclude these expenses. You may need to buy special coverage if your business faces the possibility of a clean-up order.

1. General Liability Policies

Liability policies are designed to protect you against lawsuit judgments up to the amount of the policy limit plus the cost of defending the lawsuit. They provide coverage for a host of common perils, including customers and guests falling and getting mangled by your front door or otherwise being injured. Liability policies usually state a dollar limit per occurrence and an aggregate dollar limit for the policy year. For example, your policy may say that it will pay \$500,000 per occurrence for personal injury or a total of \$1 million in any one policy year.

Excluded claims. Punitive damages—damages intended to punish your business for willful or malicious behavior rather than compensate the injured person—are not covered by the typical general liability policy. And liability coverage won't protect your business if an employee intentionally assaults a customer. In addition, a general liability policy doesn't cover injuries caused by defective products or motor vehicles, or by an employer's liability for injuries received by workers on the job. Special coverage for these types of liability is discussed in the next three subsections.

As noted, both building owners and tenants may purchase liability coverage separately or as part of a package policy that also provides a number of other types of insurance, including fire insurance for the building itself.

2. Product Liability Insurance

Product liability insurance covers liability for injuries caused by products you design, manufacture or sell. You may be liable to a person injured by a defective product or one that came without adequate instructions or warnings. Product liability insurance can be very expensive, but if your business manufactures, distributes or sells a product that may injure people, you should seriously consider it. For example, if you manufacture medical instruments or chemicals, you'll definitely want to consider buying this coverage. If you're a retailer and sell products in their original packages and provide no product assembly or service or advice, your exposure is drastically reduced; the manufacturer is primarily liable and the product liability coverage provided by standard renter's commercial policies should be adequate.

The amount of product liability insurance that you need depends on the nature of your product and not on your gross sales. Obviously, a company that sells \$2 million of paper clips a year will need less coverage than a firm that manufactures gauges critical to the safe operation of heaters and also has \$2 million worth of sales annually.

3. Vehicle Insurance

Make sure your business carries liability insurance not only on its own cars and trucks but also on employees' cars and trucks when those vehicles are used for business purposes. This coverage is known as Employer's Non-Owned Automobile Liability and is relatively inexpensive—a premium of \$65 to \$100 may buy you coverage of \$1 million for one year. Vehicle insurance isn't provided under general liability policies.

It wouldn't hurt to check your employees' driving records before you entrust company vehicles to them or send them on business errands using their own cars, but failure to check won't be a problem under most vehicle policies unless the insurance company has listed that employee as an excluded driver. To do this, insurance companies periodically ask businesses for the names of employees who are driving on company business. They then check the names against state driving records. If this results in the discovery of a poor driving record for a particular employee, the insurer will likely exclude that driver from coverage and notify you.

Coverage for injury or property damage while using leased vehicles can be added to either your motor vehicle policy or your general liability policy—which is what a company would do if it owned no vehicles. This is known as Hired Vehicle coverage.

Most vehicle policies also cover physical damage to the car or truck caused by collision, fire or theft.

4. Workers' Compensation Insurance

As the name implies, workers' compensation insurance covers your liability for injuries received by employees on the job. All businesses with employees are required to provide for some kind of workers' compensation coverage.

Usually, an injured worker can't sue your business for negligence. But as a trade-off, he or she can collect specified benefits from your business for work-related injuries whether or not the business was negligent. All the worker must prove is that the injury came about in the course of employment—a concept that has a very broad definition in many states. For example, an employee injured at a company picnic may have a valid workers' compensation claim.

The amount of money that the employee can recover is limited. The worker can recover for medical treatment and lost wages and, in serious cases, for impaired future earning capacity. But there are no awards for pain and suffering or mental anguish. A growing portion of workers' compensation claims, however, result from mental or emotional stress. In California, an employee who proves that as little as 10% of his or her disability was caused by job-related stress can qualify for worker's compensation benefits.

As a sole proprietor, you usually can't be personally covered by workers' compensation insurance for any work-related injuries you sustain; only your employees can be covered. Workers' comp coverage of a partner or of an officer of a small corporation usually isn't required but can be obtained if you choose.

Each state has a law setting out what an employer must do to provide for workers' compensation benefits. Sometimes an employer can self-insure. Usually, that isn't practical for small businesses because they can't afford the type of cash reserve required by state law. Most small businesses buy insurance through a state fund or from a private insurance carrier. Insurance rates are based on the industry and occupation, as well as the size of the payroll. Your business's safety record can also influence the rate; if you have more accidents than are usually anticipated, your rate is likely to be increased.

Although workers' compensation laws cover virtually all injury claims by an employee against an employer, in a few instances employees can still sue an employer for pain and suffering resulting from a work-related injury. For example, in some states, an employer whose gross negligence or intentional conduct caused an injury can be sued. A second part of a workers' compensation policy (sometimes called Coverage B or employer's liability) insures the employer against liability for these types of claims. I recommend policy limits of \$500,000 for most businesses for this coverage.

Workers' compensation insurance is required only for employees—not for independent contractors. Small businesses sometimes buy services from independent contractors to save money on workers'

compensation insurance, as well as taxes and other expenses normally associated with employees. That's fine as long as you correctly label people as independent contractors rather than employees. But if you make a mistake, and a person improperly labeled as an independent contractor is injured while doing work for your business, you may have to pay large sums to cover medical bills and lost wages which should have been covered by workers' compensation insurance.

In addition, you can sometimes have a problem with a properly classified independent contractor who hires employees to perform some work for you. If you hire an independent contractor who has employees, insist on seeing a certificate of insurance establishing that the employees are covered by workers' compensation insurance.

EXAMPLE: You hire Sharon, who is doing business as Superior Painters, to paint your store. Sharon will be doing the work along with two of her employees. If Sharon doesn't carry workers' compensation insurance for her employees, and any of them are injured on the job, they may be treated as your employees, which would increase your own workers' compensation premiums. Also, have Sharon show you that she has general liability coverage; if she or one of her employees injures one of your customers while painting your store, such injuries may not be covered by your own insurance.

For comprehensive guidance on workers' compensation insurance, see Workers' Comp for Employers—Taking Control; How to Cut Claims, Reduce Premiums and Stay Out of Trouble, by James Walsh (Merritt Publishing).

The Expanding Boundaries of Workers' Comp

Premiums for workers' compensation insurance are on the rise—partly because judges are extending the types of claims for which workers can receive payment. A key factor in many cases is stressful working conditions. Money has been awarded to:

- *A worker who suffered a heart attack after an argument with his boss.*
- *A truck driver who blacked out while driving and was then unable to drive because of anxiety that he might black out again.*
- *A worker who fainted, fell and suffered a head injury after his supervisor told him he would be transferred to a new department and had to take a pay cut.*

Judges have also expanded the right to receive workers' comp in other situations. For example, benefits were awarded to the family of a convenience store clerk who died after getting into a fist fight with a disorderly customer. And a woman who bought a cold tablet from her employer received payments when the tablet caused her to have tremors due to a congenital condition.

In another case, a cocktail waitress at a resort was on her way home when she stopped to help a resort guest who was having car trouble. The guest sexually assaulted her. The waitress was awarded workers' comp for injuries she received in the assault. The court's reasoning: The waitress had been told to be "very cordial and nice to guests." Therefore, her offer of assistance on the road was related to her employment.

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Excerpted from the "*Legal Guide for Starting and Running a Small Business*", by Fred S. Steingold

Chapter 5 – Negotiating a Favorable Lease

Almost all small businesses start out in leased premises; many businesses prefer to use leased space throughout their business lives. By leasing rather than owning, you avoid tying up valuable working capital. Also, it's easier to move to new quarters if your space needs change. This chapter looks at how to find the right place for your business and how to negotiate your lease.

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A. Leases and Rental Agreements: An Overview

A lease is a contract between you and the landlord. A lease can be for a short term (as little as one month) or long term, and it can be written or oral—although a lease for more than a year must be in writ-

ing to be legally enforceable. Some people use the phrase “rental agreement” to describe a short or oral lease for which rent is typically paid once a month and the tenancy can be terminated on a 30-day written notice. To avoid confusion, I’ll stick to the word “lease.”

Terminology

Sometimes a written lease talks about the “Lessor” and the “Lessee.” The lessor is the landlord; the lessee is the tenant. If you have a choice in terminology, go with the plain English “landlord” and “tenant”; you’ll reduce the risk of typos!

In theory, all terms of a lease are negotiable. Just how far you can negotiate, however, depends on economic conditions. If desirable properties are close to full occupancy in your city, landlords may not be willing to negotiate with you over price or other major lease terms. On the other hand, in many parts of the country where commercial space has been over-built, landlords are eager to bargain with small businesses to fill empty units. Even in a tight market you may come across some acceptable space that, for one reason or another, the landlord is anxious to fill, giving you greater bargaining power. This is often true where there’s a new building or one under construction and the landlord needs cash. Also, if you’re one of the first tenants in the building, you may get an especially attractive deal, because your presence may help the landlord attract other tenants.

If you find a landlord willing to negotiate, what should you ask for? Since you’re not likely to get everything you want, it’s important to get your priorities straight in your own mind and concentrate on achieving what’s most important. What do you really care about? What would be nice to have but not essential? What benefits can you offer the landlord for things you really need?

A lower rent is likely to be high on everybody’s bargaining list. But how about physical changes in the building? Would you want the landlord to redesign the entryway? Add some office space at the back of the warehouse? Customize the interior for your needs? More or better parking for your customers might be worth more than slightly lowered rent. Your priorities may be unique to your business, so think them through carefully before making proposals and counter-proposals to the landlord.

Let’s look at how you might approach the matter of rent. A landlord who is reluctant to lower the basic rent may be willing make other adjustments—which may be even more valuable. The landlord might do this so he or she can truthfully tell other prospective tenants that you’re paying a high dollar amount per square foot. (It may sound silly, but some landlords do play this game.) For example, in a slack market, the landlord may be willing to give you a move-in allowance. Also, check out what the landlord is willing to do in paying for improvements (often called build-outs) to the space.

B. Landlord-Tenant Disputes

There’s almost no limit to the kinds of disputes that landlords and tenants can have. Your landlord may claim that you’re damaging the building, or that you’re consistently late paying rent or that you or your customers or visitors park in other tenants’ spaces. You may feel that your landlord hasn’t been furnishing services that were promised, such as security, janitorial or landscaping, or that your landlord is failing to attend to the leaky roof or having the windows washed frequently enough.

No matter what the cause, it’s usually best to compromise a landlord-tenant dispute through negotiation. Sometimes a frank discussion and a little give and take by each side can resolve what seems like an impossible problem. If the dispute is serious and not amenable to face-to-face negotiations, have your lawyer help you analyze your legal rights. They may be stronger than you think. Legal trends in many parts of the country have improved the tenant’s position.

If your lease has a mediation or arbitration clause, this is the obvious next step. But even if it doesn’t, you may wish to suggest one or both of these approaches. Going to court can be expensive and time-consuming—something the landlord probably wants to avoid. In short, a sensible landlord has good reason to listen to your complaints and to mediate or arbitrate disputes.

1. Put Your Complaints in Writing

If you think your landlord has violated the lease, put your concern in writing in a straightforward, non-hostile way. State specifically what the violation is and what part of the lease it involves. Deliver your notice or letter to the landlord either in person or by certified mail (return receipt requested). Putting a landlord on early notice can help bolster your legal position if the dispute ever goes to court. If rent withholding is allowed in your state or by a specific clause in your lease, you may want to write a letter or

two to the landlord before you hold back on the rent. An example of such a letter is shown below.

SAMPLE LETTER TO LANDLORD

August 5, 20__

Arnold Ace
Ace Real Estate Associates
1234 Main Street
Anytown, U.S.A. 12345

I am writing to you about some problems we are having with our store space at 567 Enterprise Drive.

As you know, paragraph 12 of our lease specifically says that Ace Real Estate Associates will maintain the heating and air conditioning system and keep it in good repair. I have called your office twice this week and left word that the air conditioning is not working. No one has come to fix it or given us a date by which the work will be done. Our customers have complained, and on Tuesday we had to close early.

Also, under paragraph 14 of our lease, the Landlord agreed to replace the broken floor tiles in the entry area within two weeks after we took possession. We have been here for six weeks now and nothing has been done about the tiles. The broken tiles are hazardous.

These are serious violations of our lease. I am requesting that you immediately repair the air conditioning and promptly replace the broken floor tiles. We cannot operate without the air conditioning during this hot weather. Its lack has already caused us to lose substantial revenues and has damaged customer relationships.

If you do not take care of these matters within five days, I plan to have the work done myself and to deduct the cost from next month's rent.

If the cost of fixing the air conditioning is excessive, I may choose to terminate the lease and to sue your company for damages caused by your breaching the lease, including moving expenses and lost profits.

I hope that this will not be necessary. Please proceed at once to make the repairs as required by the lease.

Very truly yours,

Peter Olsen

2. Coping With the Threat of Eviction

Many leases contain stern language that appears to give the landlord the right to enter your space and regain possession if you don't pay your rent on time or fail to live up to some other lease obligation. Don't be intimidated. No matter what the lease says, in most states a landlord can't evict you without going to court and getting a court order first. This process requires that you be given notice and an opportunity to present your side of the dispute.

A hearing by a judge—or, if your lease so provides, by a mediator or arbitrator—gives you a chance to explain any legal defenses you have. For example, perhaps the reason you didn't pay your rent by the first of the month was that the landlord failed to repair the air conditioning as required by the lease. The right to a court hearing also gives you valuable time to develop your case and perhaps resolve the dispute. Court hearings don't take place instantly. You usually have some breathing space in which to build your legal response.

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Chapter 6 – Home-Based Businesses

Ah, Home Sweet Home. Or is it Home Sweet Workplace? One of the major business trends is the dramatic increase in the number of consultants, artists, craftspeople, therapists, mail order specialists, professionals and others who use their homes as a business base.

One reason for this trend is the amazing array of electronic equipment that makes it possible to be productive and in touch with the rest of the world without leaving the comforts of home. By investing in a computer, a copier, a fax and an extra phone line or two, you can now duplicate conditions that until recently were practical only in leased commercial space.

But the upsurge in home-based businesses also reflects a new emphasis on the quality of life. Working at home gives you the chance to spend more time with your family, to be more flexible in the hours that you work and to avoid the gridlock of the highway.

From a legal standpoint, a home-based business isn't much different from any other business. You still need to pick a business name; decide whether to be a sole proprietor or to form a partnership or corporation; purchase insurance; pay taxes; sign contracts; and collect from customers. But a few special legal issues are peculiar to the at-home business, including land use restrictions, insurance and special tax provisions.

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A. Zoning Laws

Planned communities and condominiums often have their own detailed rules affecting home-based businesses. Typically, these rules are stricter than local zoning ordinances. Skip ahead to Section B if your home is subject to these rules.

Is it legal to run a business in your home? The answer depends on where you live and what you do. To understand how this works, let's start with the case of Bob Mullin, (Metropolitan Development Commission v. Mullin, 339 N.E.2d 751 (Ind. App. 1979), whose plight made its way into the lawbooks. Bob ran his insurance business from his two-bedroom home in Indianapolis. He thought he was on safe legal ground. After all, unlike in some cities, the local zoning ordinance allowed people to use their homes for "home occupations." As long as a home was used primarily as a residence, it could also be used for "professions and domestic occupations, crafts or services." The ordinance specifically allowed homes to be used for such occupations as law, medicine, dentistry, architecture, engineering, writing, painting, music lessons and photography. Also, people could use their homes for such businesses as dressmaking, tailoring, hair grooming, washing, ironing and cabinetmaking. So why not an insurance business?

Bob Mullin used his living room as a reception room and office, complete with a secretary's desk and filing cabinet. He put his own desk in the dining room in place of a dining room table. The photocopier stood in the kitchen next to the stove and refrigerator, and he converted one of the bedrooms into an office. The zoning board took Bob to court, claiming he'd gone too far. The Indiana Court of Appeals agreed. The court ruled that it was okay for Bob to conduct an insurance business at home, but that Bob's usage was excessive. The business had taken over the house to the point that the primary use was no longer residential. The court told Bob to cut back or close down.

This case demonstrates but one of the many ways that local zoning ordinances can have a devastating effect on a home-based business. The good news is that by learning the law and using discretion, you may find that zoning isn't a real problem for your business.

1. How Zoning Ordinances Are Organized and Applied

Most cities have zoning ordinances. Areas outside of cities are usually covered by zoning ordinances adopted by county, village or township governments. Zoning ordinances come in many shapes and sizes, but they all do basically the same thing: they divide the area into districts in which various types of activities are allowed or prohibited. For example, there are usually residential districts for single-family and two-family homes and other districts for apartments. Other areas or zones are earmarked for commercial usage. Ordinances often break down the types of commercial usage; in some zoning districts, only offices or retail and service businesses are allowed. Usually some part of town is reserved for manufacturing operations, which are typically broken down into light and heavy industrial.

In some areas, more than one use is allowed in a district; for example, commercial and light industrial, or residential and commercial. Outside of cities, zones allow various types of agricultural activities.

Some zoning ordinances, especially in affluent areas, exclude home-based businesses. More commonly, zoning ordinances restrict—but don't prohibit—using a home for a business. An ordinance might say, for example, that in general you can't run a business from your home, but then go on to list several types of business that are permitted. The Indianapolis ordinance mentioned earlier specifically allowed professions such as law, medicine and architecture, as well as painting, music lessons and photography. Some ordinances are vague, simply allowing "customary home occupations"—a term that must be interpreted by a judge if a given use is challenged.

Zoning ordinances that regulate home businesses frequently also limit:

- the amount of car and truck traffic
- outside signs
- on-street parking
- the number of employees
- the percentage of floor space devoted to the business.

It's not always easy to tell whether or not a particular business is allowed in a home under the zoning ordinance you're looking at. Some zoning ordinances were written years ago and don't adequately deal with many contemporary businesses that people wish to operate from home—especially sophisticated businesses that depend on high-tech communications equipment.

The level of enforcement varies widely. In more enlightened communities, zoning officials recognize that residential zoning is intended primarily to preserve the residential character of a neighborhood—not to prohibit low-profile businesses. Officials don't go out looking for violations but take their cues from the neighbors: If people living near a home-based business don't complain, why search for a possible technical violation? Even where it's clear that there's a violation, these officials work with the business owner to see if changes can be made to make the business conform to the ordinance before ordering the owner to end the business or taking administrative or court action.

On the other hand, you may have the misfortune of living in a community that believes in strict enforcement of all ordinances. In such a community, your home-based business may be at the mercy of fairly rigid bureaucrats—although, as we'll see, you may fight arbitrary or unreasonable action.

If municipal officials are determined to close down your home-based business, their first step is to write you a cease and desist letter. If you ignore this, you'll probably get another letter or two followed eventually by a misdemeanor prosecution (seeking a fine or, in an extreme case, a jail term) or a civil lawsuit requesting an injunction—a court order prohibiting future violations of the ordinance. If you violate such an injunction, the judge can fine you for contempt of court or even put you in jail.

2. Investigating Zoning Laws

Before setting up a home-based business, it's a good idea to learn not only what your local zoning ordinance provides but also to find out about enforcement attitudes. If you're in a strict enforcement community and you file for a local business license or tax permit, this may trigger an inquiry about whether you comply with the zoning ordinance. Talk to people who run other home-based businesses, local contractors, your city's business development office, small business advisors and lawyers about how to make the fewest legal waves.

You may find yourself in a gray area. Your planned home-based business may or may not violate a vaguely worded local ordinance—for example, a computerized information searching business in an area that allows traditional home-based businesses. It's hard to predict whether the local zoning officials will take action against you or not. One approach is to just go ahead and chance it. If you're simply planning to set up your desk and computer in an unused room in a home you already own, you have little to lose. This approach is far less sensible if you plan to buy or renovate a house to accommodate your business. Before you spend a significant sum to house your business, you want assurance that you won't be closed down. It's best to approach the city, explain your plans and ask for an official green light. If a purchase is involved, put a clause in your offer making the deal contingent on getting approval from the zoning authorities. Then, if your use isn't approved, you're free to cancel your purchase.

If you plan to operate out of your existing residence and decide that your business is doubtful legally, or that you could be closed down if the ordinance were strictly enforced, you can minimize the risks. Start by being a good neighbor. Make sure that your business has little if any impact on the people who live around you. For example, if all you do is convert one room to an office equipped for a consulting business, it's unlikely that anyone will complain—as long as you have no employees and see only an occasional client or customer at your home. This is true even if you generate \$1 million a year in gross income. You'll also be in a better position if you cleared your plans with your neighbors or if several of them also have home-based businesses.

What kinds of things are most likely to get you trouble? Anything that a neighbor can see, hear or smell outside of your home that causes inconvenience or smacks of a commercial venture. Increased traffic, parking problems, signs, outside storage of supplies, noises or unpleasant odors emanating from your home—any of these can lead to neighborhood complaints. Pollution is another red flag.

EXAMPLE: A craftsman who worked at home with stained glass and even taught classes there was doing quite well until he started dumping lead-laced fluids down a storm drain. The neighbors properly insisted that the city attorney put him out of business. Look for alternatives to frequent deliveries. A daily procession of FedEx, UPS and U.S. Post Office trucks making deliveries to your house can annoy the neighbors. Consider having mail and packages sent to a private mailbox service such the one run by Mail Box Etc. or a similar operation—especially if there’s one located nearby.

LAW IN THE REAL WORLD

Get the Neighbors on Your Side

Ted operates a business in his home helping non-lawyers prepare their own divorce and bankruptcy forms. Several customers come and go each day, often in the early evening and on Saturdays. One of Ted’s neighbors, who has no idea of what Ted is doing, jumps to the conclusion that he’s dealing drugs.

She calls a meeting of other neighbors and convinces the others that there can be no other explanation for all the coming and going. They complain to the police and zoning board. When the truth comes out, the police laugh and leave.

The zoning officials are another matter. They cite a local ordinance prohibiting businesses that generate traffic and tell Ted to close down. Eventually, when Ted gets all his chagrined neighbors to sign a statement saying a few cars a day aren’t a problem, the zoning officials reverse their position. Ted could have avoided this time-consuming, anxiety-producing process if he’d simply told folks what was going on when he began his business.

3. Dealing With Zoning Officials

Suppose you receive a complaint from the city. What steps can you take? Start by going to City Hall and talking to the person who administers the zoning law—someone in the Zoning or Planning Department. There are both practical and legal reasons for attempting to resolve zoning matters without filing a lawsuit. On the practical level, administrative (agency) relief is quicker, less expensive and often more flexible than a judicial solution. And the law usually requires you to pursue your available administrative solutions before you go to court; this is known in legal lingo as “exhausting your administrative remedies.”

The kind of response you can hope for at City Hall depends greatly on community attitudes. If some home-based businesses are allowed, you clearly want to show that yours meets the spirit of the criteria for allowing businesses. Emphasize how small and unobtrusive your business is. When faced with the facts, the city may become more reasonable. Or you may be able to negotiate a settlement under which you scale down your operations. For example, you might agree to limit your business to weekdays from 8 a.m. to 5 p.m. and to provide off-street parking for your one employee.

If you can’t negotiate with the city staff, there are more formal approaches. Most places have a planning or zoning board with power to grant exceptions (variances or conditional use permits) if compliance with an ordinance would cause unreasonable hardship. For example, a zoning board might allow a physically handicapped person to operate a therapy practice at home even though some traffic is generated. The board may also have power to overturn a zoning official’s interpretation of an ordinance. If you appeal to a local zoning or planning board, try to get neighbors to attend the hearing to speak on your behalf. If that is too inconvenient, ask as many neighbors as possible to write letters or sign a petition stating that they support your business use. Neighborhood support or opposition is likely to be crucial to the success or failure of your appeal. Also, come to the hearing with any photographs or documents that accurately show the nature and extent of your business.

In many cities, if you’re turned down by a zoning or planning board or commission, you can appeal to a second board—often the city council itself. While it’s less likely that you’ll prevail at this level, it does happen.

Going beyond administrative channels, you may be able to get the zoning ordinance amended by the city council or county legislative body. For example, in some communities moves are afoot to change ordinances that allow “traditional home-based businesses” to include those based on the use of computer and other high-tech equipment—businesses that are unobtrusive, but hardly traditional.

To push through an ordinance change, you’ll probably have to lobby some city council members or planning commissioners. You may also need to enlist the local chamber of commerce and other groups representing business people. With increased use of homes for businesses, the time may be ripe in your community for ordinance revisions of this sort. It’s politically attractive to revamp an archaic ordinance to allow more home-based businesses, especially if the city is struggling with traffic and parking problems.

Also consider trying to get your property rezoned. This works best if your home is on the edge of a commercial district. Ask the city to move the boundary line separating the two zoning districts so that your home falls within the commercial district—which, of course, would give you much greater latitude to run your business out of your home.

4. Going to Court

If you decide municipal officials are being unreasonable in attempting to close down your home-based business and you can’t get administrative relief or an ordinance amendment, you may want to take the matter to court yourself before the city starts a prosecution or requests an injunction. By acting first, you have a chance to frame the factual and legal issues more favorably, putting the municipality on the defensive. At this stage, you’ll probably need a lawyer’s help; zoning cases are relatively complicated and specialized. Consulting and perhaps hiring a lawyer who works in this area regularly will be well worth the fee. Make sure you find a lawyer who’s familiar with zoning practices. You needn’t turn the whole case over to a lawyer—there’s plenty you can do to organize support from neighbors and other home-based businesses as well as researching how courts have decided other similar cases.

You can assert several legal theories in a zoning lawsuit, including the following:

- The city’s legal interpretation of its zoning ordinance was incorrect. For example, you might claim that your word processing business is a “home occupation” even though the zoning officials decided that it isn’t. You’d ask the judge to issue a judgment declaring that your business does qualify as a home occupation.
- The ordinance is invalid because it violates the state statute (called an “enabling law”) that gives cities authority to enact zoning ordinances. For example, you might claim that the zoning ordinance is invalid because it doesn’t permit homeowners to have “reasonable accessory uses” or “home occupations” as required by the state enabling law.
- The ordinance is invalid because the city didn’t use proper procedures in adopting or enforcing it. For example, the city may not have held the necessary public hearings before it amended the zoning ordinance to prohibit certain types of home-based businesses.
- The authorities have acted in a discriminatory manner by enforcing the ordinance against you. For example, they’ve allowed similar home-based businesses for years but now have singled you out for special treatment.

EXAMPLE: Dr. William Brady lived in Beverly Hills, California. He wrote a syndicated column and, with the help of secretaries, mailed out 150,000 pamphlets a year from his home office. The city tried to close his business because the local zoning ordinance prohibited home businesses that involved the purchase or sale of materials for profit. But the court ruled that the doctor wasn’t violating the zoning ordinance; sending out the pamphlets was basically the same as a person answering his or her mail. *City of Beverly Hills v. Brady*, 215 P.2d 460 (Cal. 1950).

You aren’t limited to just one legal theory. Your lawsuit can allege as many theories as apply.

Lawsuits are expensive, but yours may be settled before there’s a full-scale hearing or trial. The city may agree on an acceptable compromise to avoid the expense or inconvenience of fighting your lawsuit, or may not want to put its zoning ordinance in jeopardy just for the sake of closing down one in-home business.

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B. Private Land Use Restrictions

Zoning ordinances are not the only source of potential problems for a home-based business. You must also check out private restrictions on your use of your home, condo or co-op unit. Depending on the part of the country and the type of ownership arrangement, use restrictions commonly are found in the

following documents:

- property deed (the restrictions are called “restrictive covenants”)
- a subdivision’s declaration of building and use restrictions or covenants, conditions and restrictions (CC&Rs)
- planned unit development (PUD) rules
- condominium regulations
- co-op regulations
- leases.

Language in these and similar documents is likely to restrict or even prohibit business uses. If your residence is covered by a title insurance policy (virtually every piece of real estate is), use restrictions may be identified there. If you’ve lost your deed or your subdivision, condo or co-op restrictions, get a copy from your association or go to the county office where title papers are recorded (usually the county recorder or register of deeds) and purchase a copy.

If your neighbors believe you’re violating these restrictions, they may take action to stop you. Often—especially for condo, co-op or PUD units—they can take you before an owners’ association board empowered to enforce regulations. If you don’t come into compliance, you may lose privileges and face other penalties. Beyond these private sanctions, your neighbors can take you to court and try to stop your business. Judges can be very strict in enforcing these private restrictions. Here are three real-life instances where a judge sided with the neighbors.

EXAMPLE 1: Salvador, a field manager for a brush manufacturer, supervised a staff of door-to-door salespeople and supplied them from his residence in Metairie, Louisiana. He interviewed prospective salespeople at his home and received stored merchandise in his garage. The court ruled that merely receiving samples wouldn’t violate the restrictive covenants in the deed to Salvador’s property. But Salvador had a problem because he used his home to hire and outfit new employees with samples stored at home. He wasn’t using his home “for residential purposes only” as required by the restrictive covenants. *Woolley v. Cinquigranna*, 188 So.2d 701 (La. App. 1966).

EXAMPLE 2: Sheldon and Raye practiced psychotherapy in their home in Illinois. The subdivision restrictions covering their home said that “No lot shall be used except for single residential purposes.” Their neighbors took them to court, claiming a violation of that restrictive rule. The judge ordered Sheldon and Raye to discontinue their professional use of their home even though the exterior appearance of the home as a single-family home hadn’t been altered. *Wier v. Isenberg*, 420 N.E.2d 790 (Ill. App. 1981).

EXAMPLE 3: Myrtle operated a part-time beauty parlor in her Sunnyvale, California, home, receiving six customers per day. Myrtle didn’t advertise her services, there was no external evidence of her business, and neighbors weren’t inconvenienced. Still, the judge ruled that Myrtle violated the subdivision restriction that said “No lot shall be used except for residential purposes.” *Biagini v. Hyde*, 3 Cal. App. 3d 877, 83 Cal. Rptr. 875 (Cal. App. 1970).

If you’re taken to court, you have two main lines of defense. The first is that your neighbors or the condo association are misinterpreting the restrictions and that your business use is allowable. Second, if the neighbors did not object to prior business uses, they have, in legal effect, waived the right to do so now. In other words, their inaction in the past has nullified the restrictions.

Judges are often sympathetic to homeowners seeking to enjoy the use of their property. If neighbors have been lax or the restriction is vague, you have a good chance of getting a favorable ruling if your business use doesn’t really hurt your neighbors or change the residential character of your neighborhood. On the other hand, if the legal restrictions are tightly drafted and your neighbors acted swiftly to enforce them whenever a violation came to their attention, even a sympathetic judge won’t be able to help you.

But slugging it out in court should be a last resort. If you’re both dogged and diplomatic, you may be able to find a way to operate your home-based business. Look first at the rule to see how restrictive it is. Some specifically allow certain types of home-based businesses while others simply adopt the standard in your municipality’s zoning ordinance, which in turn may be fairly permissive. If you don’t qualify under the rules, consider trying to change them. Other people in your subdivision may also feel they are too restrictive. Often the document creating restrictive covenants says that restrictions can be changed if a certain number—say 70%—of the homeowners in the subdivision agree. Similarly, condo regulations can often be changed by agreement of a specified number of owners.

Leases. If you live in a rented house or apartment, read your lease carefully. Your landlord may have the right to evict you if you use the premises for business. It’s best to get clearance in advance and have it written into the lease. Most landlords won’t care if you use the property partly for business as long as you don’t cause any damage or create any problems with your neighbors.

Excerpted from the "*Legal Guide for Starting and Running a Small Business*", by Fred S. Steingold

Chapter 7 – Cash & Credit Cards

This chapter considers the three most common ways that businesses get paid for the goods and services they sell: cash, credit cards and checks.

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A. Cash

Cash includes not only currency but also equivalents that are as good as cash—certified checks, cashier's checks, traveler's checks and (less common these days) money orders. Personal and business checks are quite another matter.

If you have very large cash transactions, you may have to report them to the IRS. The reporting requirements are intended primarily to deter money-laundering schemes by customers (often drug dealers) who want to conceal income.

If you receive more than \$10,000 in cash in one transaction or two or more related transactions, traveler's checks or money orders (but not certified, cashier's or business or personal checks), you're required to provide information about the transaction to the IRS—including the name, address and Social Security number of the buyer. In addition, if you're a retail merchant, you must report:

- cash transactions in which you receive more than \$10,000 in installment payments in one year
- transactions of more than \$10,000 in which part of the payment is in cash, traveler's checks or money orders; and
- any "suspicious transaction," no matter what the amount.

In calculating whether a transaction or related transactions involve more than \$10,000 in cash, you must include not only cash, but also each cashier's check, traveler's check, bank draft or money order that's made out for \$10,000 or less.

EXAMPLE 1: Gloria buys a boat from Todd, a boat dealer, for \$16,500. She pays Todd with a \$16,500 cashier's check payable to him. The cashier's check isn't treated as cash because the face amount is more than \$10,000. Todd doesn't have to report this sale to the IRS as a cash transaction.

EXAMPLE 2: Donald buys gold coins from Maryanne, a coin dealer, for \$13,200. Donald pays Maryanne \$6,200 in \$100 bills and a \$7,000 cashier's check that he's purchased. Because the cashier's check is less than \$10,000 it's treated as cash, so Maryanne must report this to the IRS as a cash transaction.

Use IRS Form 8300 (Report of Cash Payments Over \$10,000 Received in a Trade or Business). You must also provide a copy of the completed form to the customer.

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B. Credit Cards

Depending on the business you're in, your customers or clients may want to pay with plastic—the familiar Visa, MasterCard, Discover, American Express and other cards. Technically, there's a distinction between "credit cards" (such as Visa or MasterCard) and "travel and entertainment cards" (such as American Express and Diners Club) also called "charge cards." Credit cards are administered through banks; charge cards are usually administered through the issuing company. For most practical purposes, the same legal concepts apply, so I'll simply use "credit card" to cover both types.

In deciding which credit cards to recognize, take into account the preferences of your customers and clients, as well as the size of the discount exacted by the credit card issuer and how quickly you get paid.

When a customer charges goods or services using a bank-administered credit card, the bank credits your account with the amount of the sale less a discount—usually 3% to 5%—which is the bank's fee for handling the transaction and accepting the risk that the customer doesn't pay. In addition, the bank may

charge you a start-up fee and an annual rental fee for the imprinting machine you use to record credit card information on sales slips.

If you're in a retail or other business where customers or clients expect to pay on credit, credit cards are often more cost-effective than directly extending credit. In general, if you follow the bank's rules—such as checking the credit card to make sure it hasn't expired and getting approval for all or at least larger transactions—the credit card issuer (not you) absorbs the loss if the customer doesn't pay up. Some of the newer electronic systems used by credit card issuers do most or all of the checking for you and get the money into your bank account almost immediately.

But whether you check credit cards the old-fashioned phone-in way or rely on the new systems, there are still a few exceptions to this general rule that if you follow the bank's procedures, you're sure to get your money. For example, if the goods are defective and the customer refuses to pay the bank, you may have to bear the loss. This will be spelled out in your contract with the bank. Read it carefully.

About a dozen states restrict your ability to record personal identification information about a credit card holder. The laws on this subject differ from state to state, but the California statute provides a good illustration of the kinds of restrictions that may apply to you. In California, in most circumstances you can't require the cardholder to give you personal identification information such as an address or phone number. There are, however, a few exceptions. You can require the cardholder to provide this information if:

- The bank or other agency that issued the credit card requires it to complete the transaction; or
- You need the information for a special purpose related to the transaction, for example, shipping, delivery, servicing or installation of the merchandise or for special orders.

There can be hefty penalties for violating these statutes, so learn the rules in your state and make sure that your employees know them.

But even if your state does permit you to record this information, ask yourself if you really need it. After all, if the customer doesn't pay the bill, it's a problem for the bank that issued the credit card, not for you. And because some customers regard the request for personal information as an invasion of their privacy, doing so may be poor marketing. If your main reason to gather this information is to build a mailing list, it's better simply to ask your customers if they'd like to be added to your list.

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Excerpted from the "*Legal Guide for Starting and Running a Small Business*", by Fred S. Steingold

Chapter 8 – Extending Credit & Getting Paid

In this chapter, you'll find out how to establish credit practices that help ensure that you get paid when you should. You'll also learn how to comply with federal and state credit laws and what to do if customers, clients or patients don't pay when they're supposed to.

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A. The Practical Side of Extending Credit

Some businesses give customers 30 or 60 days to pay for goods and services. They may even let customers make installment payments over a longer period. For example, a small wholesaler of children's music products might require retail customers to pay at the time of sale, but extend 30 days' credit to wholesale customers. Similarly, many professionals and other service providers extend short-term credit to clients and customers, who are expected to pay after receiving a monthly invoice.

If you extend credit, you need to set up a well-organized, accurate, easy-to-use system of accounts, send out bills periodically and keep after those who pay slowly or not at all—all of which takes time, money and effort. Many small business people fantasize about avoiding the whole mess by requiring customers to pay cash. Unfortunately, this sort of day-dreaming is normally just that; in many businesses and professional practices it's almost impossible to operate if you don't extend credit.

1. Professional and Personal Service Businesses

In many professional or consulting practices, it used to be considered unusual to require a client or patient to complete a formal credit application. No longer. Today, credit applications are becoming routine, because businesses simply can't afford to work for deadbeats. But if you shy away from a formal application, you can still gather much pertinent information from your new client or patient intake sheet.

Ask where the person works and banks. Ask for the name of the “nearest relative not living with you”—useful information if the client or patient skips out.

Health care professionals will, of course, want to inquire about insurance or Medicaid/Medicare coverage. Consider offering a modest discount (say, 5%) for payment at the time services are rendered—it usually leads to prompt payment. And think about posting a dignified sign saying: “If it’s convenient, payment is appreciated when the bill is presented.” If you accept credit cards, there’s really no reason for the patient not to pay on the spot.

Lawyers, accountants, appraisers, engineers, dentists and other professionals may appropriately ask for advance payment to be applied against the first batch of services, especially if a new client or patient needs extensive services. One way to do this is to present a fee letter to each new client. The letter might state that new clients are asked to pay a retainer and that future payments are due ten days from billing.

Another positive thing a professional or consultant can do is to routinely record bank account data about the client or patient as payment is received. Then, if you have to sue the client or patient, you have one more place to turn to try to satisfy your judgment.

If you’re worried that someone isn’t creditworthy—particularly if the bill is likely to mount rapidly—you can run a quick credit check with a credit reporting agency. Credit checks are so routine these days that this won’t drive away business. However, you should notify the client or patient beforehand. Also, before using credit reports, familiarize yourself with the Fair Credit Reporting Act and similar state laws. For example, if you reject credit for a client or patient based on a credit report, you need to disclose this to the person, as well as the name, address and phone number of the credit reporting agency that gave you the negative information.

Putting Professional Relationships on a Sound Financial Footing

If you have a professional practice or run a consulting or personal service business, consider giving each client or patient a written statement of your billing procedures, so that they know what to expect.

It is also businesslike and inoffensive to prepare a letter of retention spelling out the services you’ll be performing, how much you’ll be charging, when you’ll be billing and when payment is due. Such letters may even be legally required. In California, for example, lawyers and clients must sign a fee agreement if the expected fee is more than \$1,000 or the fee is contingent on the outcome of a lawsuit.

You could even take the retention letter one step further by providing payment envelopes for the patients to use in sending their monthly checks. This approach works for professionals where fairly predictable services are delivered over a defined time period.

Your letter should state when you expect to be paid—usually within ten days of the statement date. Also, list the amount of any interest or finance charges you’ll assess (as permitted by state law) if payment is late, and reserve your right to stop rendering services. (In a few professions, rules of professional ethics may affect how and when you can terminate the relationship.) Have the client or patient acknowledge in writing that he or she has received your letter and agrees to its terms.

To find out legal limits on interest or finance charges, check the index to the annotated statutes (sometimes called a “code”) for your state—available in any good law library. Look under the terms “interest,” “usury” or “finance charges.” Also, your professional or trade organization should have helpful information.

2. Wholesale and Manufacturing Businesses

If you’re a shoe wholesaler, software company or clothing manufacturer—or if you’re in any other wholesale or service business—you should have a credit policy, and you should insist that customers complete a formal application for credit. The details of your credit policy will depend on the kind of business you’re in and the type of customers you serve. Here are some issues to think about:

- How many days after billing is payment due?

- Is there a discount for early payment?
- Do you require pre-payment or COD terms for certain classes of customers?
- Do you add interest or finance charges? If so, how much?
- When are credit checks required? (For example, you obviously wouldn't require a credit check if the customer is the government, and probably wouldn't for a major, well-established company. On the other hand, you likely would want to check on the credit of a new small business or an individual making a large purchase.)
- How are credit limits determined?
- When and how often do you send past due notices and follow up with phone calls?
- Do you keep selling to a customer whose account is overdue?
- At what point will you begin aggressive credit efforts?

When you approve credit for new trade accounts, let them know the maximum credit you're allowing and when they're expected to pay—as well as other relevant features of your credit policy.

Should You Charge Interest?

Most businesses don't charge interest or impose finance charges in exchange for granting credit. More typically, interest is charged when bills aren't paid within the agreed time, often between ten and 30 days. If you decide to impose these charges, you must inform the customer how the charges will be computed. The Truth in Lending Act, which applies primarily to sales to consumers, prescribes the disclosures you must make—but not the rates you can charge. That's done by state law.

One reason to consider adding interest or finance charges after a certain date is that customers who are short of cash tend to pay first the bills that carry such charges. Other incentives for early payment include:

- *Discounts for prompt payment—for example, 5% off if the customer pays his or her bill on the spot or within ten days.*
- *Free shipping and handling (a big item these days) for customers who pre-pay.*
- *Making the customer responsible for paying for court costs and reasonable attorney fees required to enforce collection if the customer doesn't pay as agreed. The customer must agree to this, either in a credit application or a separate contract.*

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B. Collection Options

Suppose you can't get the customer to pay up voluntarily. What next? If you're not willing to write off the debt (which is sometimes the wisest thing to do), you have three collection options:

- sue in small claims court
- hire a lawyer
- turn the account over to a collection agency.

Each choice has pros and cons. Small claims court is inexpensive and speedy. The downside is that it can take a good chunk of your time. Furthermore, any judgment that you receive may be worthless if the debtor lacks a job or bank account.

Lawyers can be effective, but they're expensive. Consider using a lawyer to write dunning letters. Many lawyers are willing to do this for a nominal charge. Collection agencies are good at tracing elusive debtors, but they take a big percentage of what they collect for you.

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Excerpted from the "*Legal Guide for Starting and Running a Small Business*", by Fred S. Steingold

Chapter 9 – Put it in Writing: Small Business Contracts

As the owner of a small business, it's likely that you'll often encounter both written and oral contracts. The most important piece of advice about contracts is obvious: Put all important agreements in writing. This chapter shows you how, and tells you what to do if something goes wrong.

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A. What Makes a Valid Contract

A valid contract requires two and sometimes three elements:

- An agreement (meeting of the minds) between the parties.
- "Consideration"—a legal term meaning the exchange of things of value.
- Something in writing, if the contract covers certain matters, such as the sale of real estate and tasks that can't be completed in one year.

For example, suppose you're opening a new store. You meet with Joe, a sign maker, to discuss the construction and installation of a five-foot by three-foot sign. Joe offers to do the work for \$450 and to have the sign ready for your grand opening on June 15. "It's a deal," you say. You now have a legally binding contract, enforceable in court or by arbitration. All the necessary elements are present:

- An Agreement. Joe offered to build and install the sign at a certain price by a certain date. You accepted the offer by telling Joe, "It's a deal."
- Consideration. The two of you are exchanging something of value. You're giving your promise to pay \$450. Joe is giving his promise to build and install the sign.
- Written Agreement Not Required Here. Normal business contracts that can be performed in less than a year don't have to be in writing to be enforceable.

To understand why "consideration" is important, let's explore the difference between a contract and a gift. Assume that Joe installs the sign on time and you pay him \$450 as agreed. Impressed by the high quality of his work, you say: "Joe, to thank you for the great job you did, I'm going to send you a \$100 bonus next week." Can Joe enforce your promise to pay the bonus? No. He got what he bargained for—the \$450 payment. He didn't promise you anything (consideration) for the extra \$100 payment. If you pay it, fine. If not, Joe can't force you to.

1. Negotiations

Negotiations, which may or may not lead to an agreement, do not constitute a contract. So if instead of meeting face to face with Joe, you call him and describe the job, and he says he can probably do it for about \$450, you don't have a contract.

2. Offer and Acceptance

If after negotiations, two people reach an agreement, a contract is formed. Say that after discussing the job with you by phone, Joe promptly sends you a letter in which he says: "I can build and install the sign shown on the enclosed sketch for \$450. I'll have it in place by June 15 when you open. You can pay me then." You send back a fax saying: "Sounds good. Go ahead." This is a valid contract. Joe has made a clear offer. You've just as clearly accepted that offer. The fact that you and Joe didn't meet face-to-face and didn't even use the same type of communication medium doesn't alter this conclusion.

In this example, you accepted Joe's offer promptly. But what if you'd waited two weeks or two months to accept? The legal rule is that an offer without a stated expiration date remains open for a reasonable time. What's reasonable depends on the type of business and the facts of the situation. If you're offered a truckload of fish or flowers, it might be unreasonable to delay your acceptance more than a few hours or even minutes, while an offer to sell surplus wood chips at a time when the market is glutted might reasonably be assumed to be good for a month or more. But there's really no need to tolerate any uncertainty in this regard. Include a clear deadline for acceptance when you present an offer. If you want to accept an offer, do it as promptly as possible.

3. Counter-Offers

In the real world, negotiations aren't usually as simple as making an offer and having it accepted. And until an agreement is reached, there's no contract.

For example, say Joe sends you the letter offering to provide your sign for \$450. You call his office and leave a message on his voice mail saying: "Go ahead, but I can only pay \$400." So far, there's no contract. By changing the terms of Joe's offer, you've rejected it and made a counter-offer. The two of you are still negotiating. If Joe calls back and says, "Okay, I'll do it for \$400," you now have a binding contract. Joe has accepted your counter-offer. Again, the fact that you and Joe weren't in the same room or never spoke to each other isn't significant. What is key is that one of you made an offer (in this case, in the form of a counter-offer), and the other accepted it.

4. Revoking an Offer

Until an offer is accepted, it can be revoked by the person who made it. So if you're about to write Joe a

letter accepting his offer, and Joe calls to revoke his offer because he's decided \$450 isn't enough, you're out of luck. Joe revoked his offer before you accepted it, so there's no contract.

How an Offer to Contract Ends

- *The person who made the offer revokes it before it's accepted.*
- *The offer expires. Example: "This offer will expire automatically if I don't receive your acceptance by noon on May 10." But unless you've been paid something to keep the offer open (as is common for an option to buy real property), you (the offeror) can still revoke the unaccepted offer before the period for acceptance expires.*
- *A reasonable time elapses. As discussed in Section 2, above, there are no hard and fast rules as to what's reasonable. It all depends on circumstances and the practices in your industry.*
- *The offer is rejected. If you reject an offer and then change your mind, it's too late. To get the deal going again, you'll need to make an offer to the other party.*
- *Either party dies before the offer is accepted.*

5. Option to Keep Offer Open

If you want someone to keep an offer open while you think about it, you may have to pay for the privilege. If you do, and the person who made the offer agrees to keep it open, your agreement (which is itself a contract) is called an "option." Options are commonly used when real estate or businesses are sold.

To stay with our sign example, say that when Joe sends you the letter offering to provide your sign, you tell him you're not ready to respond yet, but you want to be sure the offer will stay open while you think about it. Joe responds that if you pay \$100 now, he'll keep his offer open for two more weeks. You pay the \$100 and accept the offer within the two-week period. The resulting contract would be valid even if Joe tried to withdraw his offer before the end of the two-week period. You and Joe already have a contract (an option), which consists of your right to purchase his services at the \$450 price if you act within the two-week period. He received something of value (your \$100) in return for granting you this option.

6. How Offers Are Accepted

Usually, offers are accepted either in writing or orally. But that's not always necessary. It is an area of considerable legal complexity, but generally an offer can be accepted by a prompt action that conforms with the terms of the offer. For example, you might leave the sign builder Joe a note at his workshop, saying "Please add a red border to this sign today; I'll pay you an extra \$100." Joe comes back that afternoon and adds the red border. You're obligated to pay him.

7. An Advertisement as an Offer

Under traditional contract law, ads are considered only invitations to negotiate or to make an offer; you have no obligation to go through with the deal just because someone offers to meet your advertised price. So if a customer appears and says she wants to buy the house, land or business that you advertised in the classifieds for \$200,000, there's no binding contract. One major exception to this rule involves rewards. Generally, an ad offering to pay a reward is binding if someone performs the requested act.

Consumer protection laws have also changed this traditional rule. For example, the law in many states requires merchants to stock advertised items in quantities large enough to meet reasonably expected demand, unless the ad states that stock is limited. And some states require the merchant to give a rain check allowing the consumer to purchase the same merchandise at the same price at a later date.

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B. Unfair or Illegal Contracts

What if a person makes a bad bargain? Suppose you agree to pay \$800 for a used laser printer that's worth only \$200. Can you call off the deal on the ground that the contract was grossly unfair? Probably not. As long as there's a valid contract, it doesn't usually matter whether or not the item is objectively worth the price paid for it.

Sometimes, however, a court sets aside a contract if the terms are unconscionable—that is, shockingly unfair. For example, a judge or arbitrator may release an unsophisticated consumer (say a recent immigrant with a language problem) from a grossly unfair contract extracted by a sophisticated, high-pressure salesperson. Applying this principle of law, a contract to sell a \$500 television for \$5,000 might be set aside. But even though a judge might cite contract law, the decision would probably be based more on the doctrine of fraud or misrepresentation. Or the decision might be based on a state consumer

protection statute that prohibits taking advantage of someone who can't protect his or her interests because of disability, illiteracy or a language problem.

When it comes to reasonably experienced business people working out contracts with each other, however, unfairness is rarely if ever a legal ground for setting aside a contract. Usually, a party who negotiates a bad deal is stuck with it.

If a contract clause is illegal or against public policy, a judge or arbitrator won't enforce it. For example, a remodeling contract stating that neither party will obtain a legally required building permit would be void as a violation of public policy, as would a similar contract obligating a party to bribe a building inspector.

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Excerpted from the "*Legal Guide for Starting and Running a Small Business*", by Fred S. Steingold

Chapter 10 – The Financially Troubled Business

A new business doesn't come with a guarantee. Even with the best planning, there's a possibility that your business will go through hard times and maybe even fail. Many an entrepreneur has weathered a number of shaky ventures before landing in a business that proved solidly successful. So if your business becomes troubled, or even if it needs to be put out of its misery, it shouldn't be viewed as the end of the world.

And, although it's always unpleasant—and can be heart-breaking—to have your business go bad, it's important to understand that there are many steps you can take to limit your losses so that you can get back on your feet and move on to other, more productive ventures. Especially if faced promptly, business troubles don't have to be long-term financial disasters.

A key economic preservation strategy is to protect your personal assets from business debts to the greatest extent possible. How you organize and run your business can make a decisive difference in whether you're able to do this. In addition, if your enterprise should find itself in financial trouble, your day-to-day management decisions should be guided at least in part by your knowledge of what legal and business actions can help or hurt your personal situation. Finally, if your financial troubles become so severe that you consider ending your business and maybe even declaring bankruptcy, you'll need to know exactly what legal options and protections are available.

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A. Managing the Financially Troubled Business

So far this chapter has reviewed things small business owners can do in advance to limit potential liability. Now let's shift gears and assume your business is currently facing financial problems. My focus here is to present several practical strategies that will help legally protect both you and your personal assets.

1. Keep Taxes Current

Rule Number One for the owner of any struggling business is to meticulously pay on time all taxes withheld from employees' paychecks. Even if you operate your business as a corporation or LLC, the IRS and state tax authorities can hold you personally liable for these taxes—plus penalties—if they're not paid. And you're still legally on the hook to pay these taxes, even if the business goes bankrupt.

So if your business starts having financial problems, stave off the other creditors as best you can—and use whatever cash is available to take care of employment taxes. Paying these taxes is so crucial that if your business is financially disorganized, you should pay for any accounting help you need to be sure these taxes are computed accurately and paid on time.

And remember that you don't have to wait until the last day to deposit employment taxes. It's often wise to deposit the employment taxes as soon as you know the figures so the money will be out of your bank account and legitimately beyond the reach of any other creditor who is attempting to collect a court judgment against your business.

Don't pay employment taxes with a charge card. If possible, use a check or cash to pay employment taxes, since this means they're really paid. By contrast, if you use your personal charge card and can't pay the bill later, you'll continue to be responsible to the charge card company for the amount you charged for

taxes—even if you go through personal bankruptcy. A discharge in bankruptcy won't cancel your personal liability for the portion of your credit card debt that's attributable to the tax payments.

2. Don't Lie About Debts

When a business starts to have financial troubles, its owner may frantically try to borrow more money. Before doing this, think carefully about whether your business is really likely to do better in the near future or if you're only likely to compound your debt problems. If you apply for a new loan or to consolidate old ones, be forthright in disclosing the financial condition of your business. If you misrepresent your debts to get a loan, you may not be able to get rid of your personal liability for the debt—even if you go through bankruptcy—because the law will regard your new debt as being obtained by fraud. Where big bucks are involved, the debt could haunt you for many years.

The key to avoiding trouble with lenders is to be very careful that all facts appear—and appear accurately—on any financial statement you give a potential creditor. Even if you borrow money or have credit extended to you without having to fill out a financial statement, it can be treated as fraud if you knew that the business was having financial trouble and didn't make all the facts clear to your creditor.

Don't rely on shortcuts suggested by the lender's agent. Some finance company employees have been known to deliberately tell people—orally, of course—that they don't need to list all their debts. Often this is done because the person in the finance company office is under pressure to make loans and therefore has a motive to bend the rules to qualify you. Don't fall for this. If you later default on the loan and the company claims you obtained the money by fraudulently withholding information about your finances, chances are the employee will either be long gone or will say, "Of course I didn't say to deliberately omit debts." Either way, chances are you'll be unable to discharge the "fraudulent" debt in bankruptcy.

Also, be aware that the bankruptcy laws take a broad view of what constitutes fraud. Not disclosing negative financial information may be considered fraudulent even if you acted with the best of intentions.

EXAMPLE: Jimmy, a sole proprietor, owns a secondhand furniture store. One day, the landlord raises the store rent by 50%. Based on past performance, Jimmy knows that with the rent increase, he'll have difficulty making a profit. Nevertheless, he decides to stay at that location because it would cost even more money to move elsewhere. At this time, he has a line of credit for \$25,000 with a local bank of which only \$10,000 has been used. A month later, already feeling the sting of the higher rent, he draws against the additional \$15,000 and uses it to keep afloat. Because Jimmy neglected to tell the bank about the significant rent increase that put his business in a precarious financial condition, the additional draws can be considered to be a fraudulent use of credit and may well not be discharged in bankruptcy. If the bank sues Jimmy in bankruptcy court after he's gone through bankruptcy, Jimmy may still be liable for the \$15,000.

This doesn't mean that drawing on a line of credit to meet the ordinary ebb and flow of business constitutes fraud. It doesn't. After all, the bank expects that you'll use your line of credit to cover leaner times. But you do need to disclose significant changes in your business such as a lawsuit or the bankruptcy of your largest customer that threatens the financial well-being of your business.

3. Be Careful About Transferring Business Property

Occasionally, out of desperation, a business owner will consider trying to protect personal assets by hiding them. Since creditors are used to ferreting out such tactics, by and large they prove ineffective and are likely to give rise to civil and perhaps even criminal charges of fraud. Specifically, a business owner shouldn't:

- transfer assets to friends or relatives in any effort to hide them from creditors or from the bankruptcy court, or
- conceal property or income from a court.

4. Avoid Preferential Payments to Creditors

The Bankruptcy Code frowns on your preferring certain creditors over others by making what are called "preferential payments." If you file for bankruptcy, all payments you make during the year before the filing will be scrutinized by creditors to make sure that some creditors weren't given an unfair advantage by being paid while others received little or nothing. If you did improperly single out some creditors for more favorable treatment by paying money or transferring property to them, the bankruptcy judge can order those creditors to return the money or property so it can be added to the total (called your bankruptcy estate) available to all of your creditors.

Fortunately, most payments you make as part of your business's ordinary operations won't be considered to be illegal preferences should you declare bankruptcy. Here's a brief overview of the types of payments that are safe and those likely to cause problems.

- Payments in the Ordinary Course of Business. Neither you nor the payee has to worry about the payments you make in the ordinary course of business. These payments are considered to be safe and won't be undone—even if you made them the day before you filed for bankruptcy. Examples of payments you can safely make include:
 - utilities
 - rent
 - payroll deposits
 - retirement plan contributions
 - insurance premiums
 - payments to suppliers whom you pay on delivery or with 30 to 60 day terms, and
 - salaries—as long as they're kept at the same level you've been paying right along.
- Payments to Family Members or Insiders. If you repay money or transfer property to a family member or insider and then you file for bankruptcy within one year after the payment or transfer, the family member or insider will probably have to return the money or property to the bankruptcy court so it can be divided among your creditors. (An insider is someone who's in or close to your business such as a partner, a corporate director or a corporate officer.)
- Payments to Other Creditors. When you repay money or transfer property to someone who's neither a relative nor an insider and the payment isn't in the ordinary course of business, the 90 days before you file for bankruptcy are crucial. (Example: Paying off a bank loan that's not due for six months.) If you make such payments or transfers of property during the 90-day period, the recipient may have to return the money or property to the bankruptcy court to be added to the pool of funds available to your creditors.

5. Protect Your Bank Account

If you face serious financial problems and owe money to a bank, it's often wise to keep most of your checking and other accounts elsewhere. This is because typically your loan agreement gives the bank the right to take your funds without prior notice if the bank thinks you're in financial trouble. (This is called a setoff.) To put it mildly, it can be a rude surprise to learn that your favorite lender has suddenly drained your account.

6. Plan for Ongoing Insurance Coverage

If your business winds up in a Chapter 11 or Chapter 13 reorganization under the Bankruptcy Code, you may have a tough time finding a carrier that's willing to renew your business coverage or one that's willing to issue a new policy. So if you're planning to seek protection under either of those bankruptcy sections, make sure you have insurance in place that extends at least 12 months into the future. You'll need to make payments on the policy as payments become due, but as long as you pay on time, the insurance can't be canceled and you'll enjoy some peace of mind as you continue in business.

7. Don't Panic About Utilities or Your Lease

If you declare bankruptcy, the utility companies can't use your filing as an excuse for shutting off services—although they can require you to post a reasonable deposit if you want to keep the lights, phone service and heat.

Similarly, as long as you continue to pay your rent, your landlord can't kick you out. Don't be spooked by the scary clause commonly placed in commercial leases that says you're automatically in default if you file for bankruptcy. You can't believe everything you read. These clauses are not enforceable.

8. Consider Returning Some Leased Property

If you're leasing equipment and know you won't want to retain it after you file for bankruptcy, consider giving it back to the leasing company before you file. If you do so and the equipment is currently worth less than what you owe under the lease, the deficiency will get discharged in bankruptcy. On the other hand, if you prefer to keep the leased property, you'll need to continue making your lease payments on time. When you choose to hang onto leased property, the obligation to make lease payments isn't discharged by your going through bankruptcy.

B. Selling or Closing the Business

Although selling your financially troubled business may seem like a long shot, it's always worth a try. Naturally, you won't get top dollar for your business when it's in distress—but if you arrange a sale, it may give you enough to pay creditors and come away with a few bucks. Selling an operating business, even one that's in trouble, almost always brings more money than closing it down and selling off the assets.

Before you give up and conclude that no one will buy your business, consider that people buy businesses—even those with financial problems—for all sorts of reasons, including:

- The buyer may have lower personal financial needs and expectations and may be willing to squeak by on a modest return that's wholly unacceptable to you.
- The buyer may have a similar business and by combining the two operate more efficiently than you can.
- The buyer may be extremely anxious to take over one or more of your business assets—its location, key employees or name.
- The buyer may have better access to needed financing than you do and therefore be able to stay the course until your good business idea ultimately proves itself.
- The buyer may have greater expertise in your business than you do and see a way to turn a profit by changing how the business is run.
- The buyer may conclude that it's cheaper to buy your business and turn it around than to start a similar business from scratch.

Value is in the eye of the beholder. *Even if you believe it is an illusion, the fact that the buyer merely thinks that he or she has greater expertise than you do or that the business has unrecognized potential may be enough to produce a purchase offer. Don't let your ego get in the way of making the deal by defending your business decisions and strategy so forcefully that you talk the potential purchaser into withdrawing his or her offer.*

If you have an opportunity to sell your business but the proceeds of the sale won't yield enough money to pay off all the business debts, look carefully at what remaining debts you'll be personally responsible for and what personal assets have been pledged as security for the business debts. Merely selling the business won't be enough to relieve you from your personal liability to creditors or the risk that creditors may take property that you've pledged as security. To reduce or eliminate your personal liability or the danger of losing pledged property, there are some solutions worth looking into. On debts for which you're personally liable, see if the bank or other creditor is willing to substitute the purchaser of your business on the indebtedness and release. The creditor may be willing to do this if the person buying your business is financially stronger than you are or, in the case of a currently unsecured debt, is willing to pledge security. A buyer who's enthusiastic about the prospects of the business may be willing to be substituted for you.

If the creditor won't let you off the hook, another way of dealing with unsecured debts that you'll be personally liable for is to ask the buyer to agree in writing to pay the specified debts and to indemnify and save you harmless from those obligations. This means that if the bank or other creditor comes after you because the debt isn't paid, the buyer guarantees to pay the debt and protect you from any liability. Of course, this kind of guarantee is only as good as the buyer's financial condition, so you won't want to rely on such a guarantee if you have any reason to believe the buyer is financially shaky.

Where you've secured a business debt by pledging your personal property as collateral—for example, your home, car or stocks—see if the creditor is willing to release your property as security if the buyer substitutes property of equal or greater value. The buyer, for example, may have as much or more equity in his or her home than you do in yours and the bank may be willing to substitute that home as security in place of yours, if the buyer consents.

So much for selling your financially troubled business. If you can't sell it, consider closing it down. Even if you can't pay all your debts immediately, this option at least allows you to avoid running up more. In addition, you'll normally want to negotiate with your creditors to pay them off for less than the full amount the business owes. Why should creditors accept this? It's often a better choice than either of their other options: suing you and chasing down your assets to collect every last dollar or taking what's available in a bankruptcy liquidation. Trying this approach can be particularly sensible, too, if you have a corporation or LLC and have personally guaranteed some business debts. If you can reach a negotiated settlement, you'll not only avoid a business bankruptcy but also you won't have to go through personal bankruptcy to get out from under the debts you've guaranteed.

If you haven't personally guaranteed any debts of the corporation or LLC, one option is to simply close the business and pay the debts on a prorata basis to the extent the business has funds. Then, let the corporation or LLC die on its own. Since any remaining debts aren't your personal responsibility, this should, in theory at least, end matters. Sometimes, however, you may want to consider having the business file for bankruptcy in this situation. If the corporation or LLC hasn't gone through bankruptcy,

some creditors may go ahead and sue the business and get judgments against it. If that happens, you may be subpoenaed and have to go to court to explain that the business used up all its assets. That can be a nuisance. So if you have a number of creditors who are likely to pursue you to the bitter end, putting the business through bankruptcy may make sense since it will save you from having to testify in multiple lawsuits. Creditors, of course, lose their right to sue once the corporation or LLC is bankrupt.

Watch out for preferential treatment. *If at first you decide simply to close down your business but later decide to file for bankruptcy, you may have backed into trouble. If your business eventually has to file for bankruptcy, giving preferential treatment to some creditors in the months before you file by paying off all or part of their bills can create a problem. Creditors who didn't receive preferential treatment may complain, in which case the favored creditors will have to return the money or property they received so it can part of an asset pool available for equitable distribution among all creditors. So even if you hope not to file for bankruptcy, try to work out similar deals with all creditors.*

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C. Understanding Bankruptcy

If your business is in serious financial trouble, you'll want to consider the possibility that you'll eventually need to file for bankruptcy if the other strategies mentioned in this chapter won't work for you. Fortunately, thoroughly understanding how bankruptcy works and how you can best cope with it if it becomes inevitable can result in major savings later on.

1. Different Types of Bankruptcy

Bankruptcy is a legal proceeding handled in the federal court system. It's based on the federal Bankruptcy Code, which is divided into different chapters, each covering a different type of bankruptcy as described below. Bankruptcy is usually voluntary, but be aware that one or more creditors may force you into bankruptcy by filing an involuntary bankruptcy petition against you. Because lawyers and others with bankruptcy knowledge refer to the various types of bankruptcy protection by their chapter numbers, you too will need to learn this jargon which I explain below.

Legal advice may be essential. *If you're a sole proprietor and have a relatively small amount of business debt, you may be able to handle a bankruptcy yourself or with a limited amount of professional help. But be forewarned: a number of issues (property exempt from being taken to pay debts, for one example) can be complicated when business and personal affairs are intertwined. For sole proprietors with significant debt and for partnerships, corporations and LLCs, it generally makes sense to seek advice from a lawyer who specializes in small business bankruptcy. Professional help is essential for corporations and LLCs because you can't represent these entities in a bankruptcy proceeding unless you're a lawyer. Seek out an experienced bankruptcy lawyer who will take the time to explain all your options—both bankruptcy and nonbankruptcy—before he or she files papers for you. Be wary of any lawyer who instantly assumes that you should proceed with a Chapter 7 liquidation which, in many cases, will prove to be a poor choice.*

2. Liquidating the Business Under Chapter 7

A Chapter 7 filing is sometimes called a "straight bankruptcy." It's available to businesses organized in all the usual ways—sole proprietorship, partnership, corporation and LLC. Under Chapter 7, your business property is sold and the proceeds are used to pay off debts to the extent funds are available.

If your business is a partnership, each partner is personally liable for all partnership debts. Putting the partnership through Chapter 7 won't do away with your personal liability for these debts. To accomplish that, you'd need to file for personal bankruptcy.

If your business is a corporation or LLC, you're generally not personally liable for debts of the business, unless you've personally guaranteed a business debt, in which case you're liable for repaying it. And if you've put up any property as collateral, that property can be taken unless you pay the creditor—known as a "secured creditor"—the value of the property or agree to have the debt survive the bankruptcy. To escape from personal liability for business debts, you'll have to file for personal bankruptcy after the corporate or LLC bankruptcy is wound up.

A personal filing under Chapter 7 will free you from personal liability for most business debts—but it bears some potential disadvantages. The fact that you've filed for personal bankruptcy remains on your credit record for ten years. This can cause trouble when you apply for a mortgage, a bank loan, a charge account or a credit card. What's more, employers sometimes use credit information to screen job applicants as do some landlords in checking out potential tenants.

Co-signers and guarantors are still on the hook. *If a friend or family member has co-signed*

for a business loan or guaranteed payment of a business debt, putting the business or yourself through Chapter 7 bankruptcy won't relieve the co-signer or guarantor from personal liability for the debt. This can be an added reason to try to resolve your debt problems through a workout or other non-bankruptcy alternative.

Two Kinds of Creditors

Bankruptcy law distinguishes broadly between two types of creditors: secured and unsecured.

A secured creditor is either one to whom you or your business has pledged collateral in exchange for a loan or line of credit (voluntary secured creditor) or one who has filed a lien (tax, judgment or mechanic's) against your property (involuntary secured creditor). Pledged collateral to a voluntary secured creditor may consist of business property such as inventory and equipment or your own property such as your house, car or boat. Either way, the creditor ends up with a lien on the property. This means that if you or the business can't pay back the debt, the creditor can take the property to satisfy the debt.

An unsecured creditor is either one to whom no collateral has been pledged or one who hasn't filed a lien. Typically, these debts will include amounts your business owes for inventory, office supplies, minor equipment and furnishings, rent and advertising, as well as what's owed for services such as maintenance contracts, equipment repair and professional advice. Credit card charges, too, are unsecured.

In bankruptcy, the secured creditor is in a much more favorable legal position than one who is unsecured. If the bankrupt business has little or no money, the unsecured creditor is likely to wind up with little or nothing, whereas the secured creditor walks away with whatever the collateral is worth. A Chapter 7 bankruptcy gets rid of the debt but not the security interest.

3. Reorganizing Your Business Debts

As an alternative to liquidation under Chapter 7, you may prefer to reorganize your debts under Chapters 11, 12 or 13 so that you can continue to operate your business while the bankruptcy court protects you from the demands of creditors. In a reorganization, you can often reduce the amounts you must pay back to unsecured creditors. In addition, under a court-approved repayment plan, you can spread your payments over a number of years.

Among the situations in which Chapters 11, 12 and 13 are worth considering are these:

- You want to retain all your assets and keep the business going.
- You want to partially liquidate your assets and then keep the business alive on a scaled-down basis.
- You want to totally liquidate the business by selling it either as a going concern or by selling any remaining assets.
- You want to buy time to put the business in decent shape so that it's more attractive to potential purchasers.
- You want to pay your taxes in installments to stave off the IRS or state or local tax collectors who are poised to seize your assets, which would put you out of business.

In each case, a Chapter 11, 12 or 13 proceeding may offer the possibility of helping you achieve your objectives.

a. Chapter 11

A Chapter 11 reorganization allows your sole proprietorship, partnership, corporation or LLC to continue doing business while often reducing or even eliminating the amounts you must pay back to unsecured creditors. Under a court-approved repayment plan, you can spread your payments over a number of years. Five years is typical.

If you file for a Chapter 11 reorganization, you'll immediately receive the protection of the bankruptcy court. All lawsuits and other collection actions against your business will come to a screeching halt. You'll then have 90 days in which to submit a plan—called a reorganization plan—showing how you propose to pay past-due debts while keeping up to date on current ones. If your business debts don't exceed \$2 million, you can use a new, fast-track version of Chapter 11 that simplifies procedures and gives the creditors less control than they have in a regular Chapter 11 reorganization.

Your plan will have to meet a few legal guidelines; for example, it must show that back taxes will be fully paid within five years. And secured creditors—those to whom your business has pledged collateral—must receive the collateral or the current value of the collateral or the current value of the debt. Your plan

doesn't have to include payment to unsecured creditors unless those creditors would receive some payment if your business were to file for liquidation under Chapter 7.

After you file the plan, creditors vote on it. Secured and unsecured vote separately and, to be adopted, the plan must be approved by 51% of the creditors in each class. If your plan is carefully crafted, the creditors will likely accept it. But if the creditors reject the reorganization plan, all may not be lost. A solution may be found in the "cram down"—a phrase used to describe the last-resort powers of the bankruptcy court. If your plan is basically fair and equitable, the judge can cram it down the throats of all the creditors.

To help your business stay alive, the judge can terminate burdensome or unprofitable leases or contracts. If, for example, your business is occupying expensive space under a lease that runs for seven years, your business is contractually obligated to keep paying rent throughout those seven years. But in Chapter 11, the judge can allow your business to move to a less costly location, with no further obligation to your current landlord.

With these many benefits, Chapter 11 sounds like a good deal for a financially troubled business, but the grim truth is that it rarely succeeds. It's usually an overwhelming task for a typical business owner to keep up with current bills while simultaneously chopping away at large past-due debts and paying chunky administrative and legal fees. The result is that more than 90% of businesses that file under Chapter 11 eventually switch to Chapter 7 and liquidate their assets—although the new, fast-track procedures may lead to a higher success rate.

Compare the payoffs to creditors. *Basically, if you're convinced that you can get more money for the creditors by reorganizing under Chapters 11, 12 or 13 than by filing for a straight liquidation under Chapter 7, then reorganize. Otherwise, don't waste your time, energy and money. Proceed directly with a Chapter 7 filing. Why worry about how much the creditors get? Because the more they get, the less you may be personally liable for.*

b. Chapter 12

A Chapter 12 bankruptcy is available to family-owned farming businesses. As in a Chapter 11 proceeding, the total amount of debt owed to unsecured creditors may be reduced in the Chapter 12 plan. In addition, the financially ailing farm operation is allowed to continue doing business under a court-approved plan for repaying its remaining debts over a number of years. A court-appointed trustee serves as the intermediary between the farm and its creditors. Because this book is primarily for nonfarm businesses, Chapter 12 won't be treated further.

c. Chapter 13

Businesses, per se, are not permitted to file for Chapter 13 bankruptcy. A sole proprietor, however, may file as an individual and include the business debts for which he or she is personally liable. There are financial limits: you can have no more than \$750,000 in secured debts and no more than \$250,000 in unsecured debts. As in a Chapter 11 reorganization, the amount you must pay back to unsecured creditors is reduced (sometimes to as little as zero) and, under a court-approved plan, you continue to run the business while paying off debts over a period that can last up to five years. A court-appointed trustee—whose fees you pay—makes payments to creditors under the pay-back plan.

As noted in the next section, there can be advantages to filing under Chapter 13 rather than Chapter 11 if your business qualifies. Prospects for keeping your business afloat over the long term are better with a Chapter 13.

d. Choosing between Chapter 11 and Chapter 13

All types of business entities—sole proprietorships, partnerships, corporations and limited liability companies—can choose to file under Chapter 7 for a straight liquidation bankruptcy or under Chapter 11 for a reorganization of their business debts. And as noted above, sole proprietors with no more than \$750,000 in secured debts and no more than \$250,000 in unsecured debts have still a third choice: a reorganization under Chapter 13. Since Chapter 11 and Chapter 13 both allow a business to remain in operation under a court-approved plan, a sole proprietor who qualifies for both may face the dilemma of choosing between the two. Generally, it's more advantageous to choose Chapter 13, for a number of reasons:

- A Chapter 13 reorganization plan is usually approved by the court in less time than a Chapter 11 plan.
- You don't have to deal with a creditors' committee—a committee that's appointed in a Chapter 11 filing to represent the interests of the unsecured creditors. This means you'll expend a lot less time and energy on paperwork, meetings and possibly attorney fees. Creditors may object separately to

- your Chapter 13 plan, but they don't carry the same weight as a committee would in a Chapter 11.
- You'll be able to pay less than 100 cents on the dollar for unsecured debts. The bankruptcy judge in a Chapter 13 can approve a plan which provides for partial debt repayment.
- If you meet the terms of the court-approved payment plan, virtually all remaining, unpaid debts will be wiped away even if some of them were obtained under circumstances the law might consider fraudulent. For example, if you obtain credit by misrepresenting your credit history, the debt probably won't be discharged under either Chapter 7 or 11 and the creditor will be able to sue you personally—but under Chapter 13, if you make all payments as called for by the plan, the creditor can't sue you for that debt.
- A Chapter 13 filing will stop collection action against a co-signer or guarantor if the Chapter 13 plan treats creditors fairly. In short, this option can help you protect friends and relatives who have obligated themselves to pay your debts.

There is, however, one area in which Chapter 11 may be a better choice. In a Chapter 13 reorganization, you generally can't modify the terms of a mortgage loan or other credit agreement which is secured by your home. This means that even if your house is worth less than what you owe, you must still pay the balance. There are a few technical exceptions to this rule, but they're of little practical value to most people. A different rule applies to Chapter 11 filings, creating the possibility of reducing the loan if the value of your home has dropped. So if you have a huge mortgage on your home and the value of the property has dropped, then Chapter 11 is probably better for you than Chapter 13.

4. Who's Who in Bankruptcy

In addition to understanding the various types of bankruptcy, you'll quickly need to understand who the major players are and at least some of the jargon involved in a bankruptcy proceeding. Here's a brief overview.

- **Debtor.** The debtor is the person or business entity that owes the money—this can be your business or yourself or both. Generally, it's the debtor that files for bankruptcy, although creditors can sometimes start the ball rolling, in which case it's called an involuntary bankruptcy.
- **Creditor.** This can be any person, business or governmental agency that has or may have a claim against you or your business. A secured creditor is one that has a lien (claim) against specific property—usually either in the form of a real estate mortgage or a security interest in a vehicle or other equipment. A secured creditor is usually in a better legal position than an unsecured creditor because if money isn't available to pay the debt, the secured creditor is entitled to grab the assets pledged as security.
- **Trustee.** A bankruptcy trustee takes possession of the debtor's business assets in a Chapter 7 proceeding and liquidates them to pay creditors. In a Chapter 7 personal bankruptcy, the trustee gathers the debtor's nonexempt property (a second home, for example), liquidates it and distributes the proceeds to the unsecured creditors. In a Chapter 11 proceeding, the debtor usually retains control over the business assets while the business continues to operate. But, especially if the business owner has committed fraud or seriously mismanaged the business, the court may appoint a trustee to take over in a Chapter 11 proceeding so that the creditors' interests are better protected. In a Chapter 12 or 13 bankruptcy, the debtor remains in possession of the property; the trustee collects monthly payments and distributes them to creditors. Trustees are appointed by the bankruptcy judge unless the district has a U.S. Trustee—a full-time federal employee with a staff of assistant trustees who serve as trustees in Chapter 11 cases and appoint and supervise outside trustees in Chapter 7, 12 and 13 cases.
- **Judge.** A bankruptcy judge is part of the federal district court and has broad control over bankruptcy proceedings, including authority to resolve all disputes between the business and its creditors, as well as any issues involving the business's property. Despite this broad authority, the judge may abstain from trying issues that can be litigated in a state court—for example, actions to foreclose on real estate or to gain possession of cars and equipment, and cases involving environmental cleanups. Bankruptcies are supervised, for the most part, by the trustee where one's been appointed—but debtors and creditors who disagree with a trustee's decision can seek a ruling from the bankruptcy judge who can overrule the trustee.
- **Creditors' Committee.** In a Chapter 11 proceeding, an unsecured creditors' committee may be appointed to represent the interests of all the unsecured creditors. If the proceeding is complicated, there may be additional creditors' committees representing special interests—for example, pension and profit-sharing recipients, under-secured creditors and secured creditors. A creditor's committee may object that a proposed plan writes off too much of the debt owed to its members or that it gives the debtor too much time to pay.

5. Key Bankruptcy Concepts

Unfortunately, your mini-education in how bankruptcy works isn't quite complete. Since bankruptcy law is unique, with its own concepts, procedures and jargon, it's crucially important to understand the legal basics.

a. Bankruptcy estate

Once you or your business file for bankruptcy, the property—called the bankruptcy estate—is controlled by the bankruptcy proceedings. Creditors can't get their hands on it without the court's permission. Property subject to court control includes not only the property your business owned when you filed the bankruptcy papers, but also money your business earned but hadn't collected before you filed for bankruptcy. Also, in a Chapter 11, 12 or 13 proceeding, if your business acquires property after your case is filed, that property becomes part of the bankruptcy estate. However, if your business holds money in trust for third parties—such as withholding taxes that are to be paid to the IRS—that money isn't part of the bankruptcy estate.

You may need a separate bank account. *If you don't pay the employment taxes immediately, keep them in a separate bank account designated as a trust account so that it's clear that these funds are separate from other funds of the business. Then you'll be able to use these funds to pay the taxes and avoid personal liability and penalties.*

b. The automatic stay

As soon as your business has filed a bankruptcy petition, creditors are stayed (stopped) from continuing their collection efforts against the business. In addition, creditors can no longer seize any property owned or leased by the business that secures its debts, such as a car, building or equipment. Further, it's illegal for creditors to contact you to push for payment, start a lawsuit against you or pursue any other collection action. Utilities such as the power, phone and water company must continue to serve your business as long as you can guarantee payment for future services—for example, by posting a deposit. Be aware that the IRS can continue an audit, issue a tax deficiency notice, demand a tax return, issue a tax assessment and demand payment, but can't record a lien or seize your property.

c. The bankruptcy filing

To start a bankruptcy case, your business must file a form called a Petition for Relief with the clerk of the federal bankruptcy court. To learn the location of the bankruptcy court, call the clerk of the U.S. District Court that's nearest your business.

A list of creditors (everyone your business owes money to) should accompany your Petition, using a special format so that copies of your creditor list can be used as a mailing list. Within 15 days, you must also file lists of debts, assets and a history of your business. In bankruptcy jargon, these lists are called bankruptcy schedules and Statement of Financial Affairs. You'll want to include all debts your business may owe and any claims that creditors may have against your business—even those you have some doubts about or you dispute.

d. Claims

Once notified of your bankruptcy, creditors may file claims for payment of their debts with the bankruptcy court. Your business has the right to challenge a claim if you think it's improper. The judge will decide if the claim is valid. In a liquidation of a business, since there's almost never enough money to pay all allowed claims, the law establishes priorities. Your bankruptcy estate (any money or property salvaged from your business) is used to pay the highest priority claims first, then the next highest priority, and so on as long as the money lasts. Creditors in the lowest category, to actually receive any money, will typically have to take much less than the amount they're owed since by definition there isn't enough money to go around. In fact, it's not uncommon for unsecured creditors to receive nothing.

Some creditors can obtain a super-priority status. In a Chapter 11, 12 or 13 bankruptcy where the trustee or debtor must borrow new money to keep the business running, the lender of these funds would obtain a super-priority claim and be first in line when assets are distributed. Next come the secured creditors who have liens on specific real estate, vehicles, equipment or other property. After that come such claims as the expenses of administering the bankruptcy, wages and commissions earned during the 90 days before the bankruptcy started, money owed to an employee benefit plan, deposits made on consumer goods and most taxes. At the bottom of the heap are general, unsecured claimants who, if they're lucky, receive a pittance. Often, unsecured claimants get a few cents for each dollar they were owed or come away entirely empty-handed. In a Chapter 13, secured creditors with liens and priority debts could be paid simultaneously through the Chapter 13 plan.

e. The effect of bankruptcy on secured debts

If you go through a Chapter 7 personal bankruptcy, the creditor will lose the right to get a personal judgment against you requiring you to pay the debt that's owed. But even though the creditor can no longer demand that you repay the debt, if you've pledged property as collateral, the creditor will still have

a lien on that specific property. Because the creditor will be able to enforce the lien and take or sell the property, you need to be aware of the three options available to you—which can be summarized as The Three Rs:

- Relinquishment. You can simply give up the house, car or other property on which the creditor has a lien.
- Redemption. You may buy it by paying the creditor, usually in a lump sum, the value of the property. If there's a dispute about how much the property is worth, the bankruptcy judge will determine the value.
- Reaffirmation. You may reaffirm your obligation to pay the debt secured by your property before the debt is discharged in bankruptcy. Then, you continue to make payments as you had agreed before the bankruptcy. Of course, the lien will remain on the property and, if you later miss payments, the creditor will be able to enforce the lien by taking back property to pay for the balance of the reaffirmed debt.

f. Exempt property

If you go through a Chapter 7 personal bankruptcy where your assets are liquidated to pay your debts, you don't have to give up all of your personal property to pay back creditors. The law allows you to keep some items (called exempt property) to help you get a fresh start. Exempt property is listed in the federal bankruptcy code, but states also have laws listing exemptions. Generally, you'll rely on your state law exemptions—either because the state law exemptions are more advantageous or because, as is the case in most states, the state law gives you no choice. If you do have a choice, check the homestead allowance carefully as it's usually more generous under state law.

Most state exemptions allow you to keep property in these broad categories:

- motor vehicles, to a certain modest value
- clothing other than furs
- household furnishings and goods
- household appliances
- jewelry such as a wedding or engagement ring and a watch
- personal effects—personal possessions that don't fall into the categories of clothing and jewelry
- life insurance (cash or loan value, or proceeds) to a certain value
- pensions for public employees or pensions that qualify under ERISA
- part of the equity in your home
- tools of your trade or profession, to a certain value
- portion of unpaid but earned wages, and
- public benefits (welfare, Social Security, unemployment compensation) accumulated in a bank account.

For detailed state-by-state lists of exemptions, see *Money Troubles: Legal Strategies to Cope With Your Debts*, by Robin Leonard (Nolo), or *Bankruptcy: Is It the Right Solution to Your Debt Problems?*, by Robin Leonard (Nolo).

LAW IN THE REAL WORLD

Carl and Phyllis Save Their Home

Carl starts a neighborhood restaurant, organizing his business as a one-person corporation. To raise capital, Carl and his wife Phyllis borrow \$50,000 from a bank on their signature and additionally secure the loan by giving the bank a second mortgage on their home.

In its first year, the business runs up a pile of debts. With prospects of becoming profitable looking bleak, Carl decides to close down. Carl considers putting the corporation through bankruptcy to make a clean break with creditors. Unfortunately, this won't help with the bank loan since Carl and Phyllis are personally liable for that debt and their home is at risk if they can't pay it. Since this is a secured debt, even if they go through personal bankruptcy, they'll lose their home.

So Carl and Phyllis reduce the bank loan with \$10,000 of personal savings that Phyllis had set aside from her salary as a school teacher. They then refinance their home by getting a new first mortgage that pays off both the old mortgages. (Fortunately, Carl is able to get his old job back, so he and Phyllis have income to qualify for the new mortgage.) Carl and Phyllis now have 30 years to pay off the new mortgage in monthly installment payments.

Carl closes the business, sells the corporation's few remaining assets and, before dissolving the corporation, distributes the proceeds prorata to the business's unsecured creditors. The business failed but with this small-scale workout, Carl and Phyllis saved their home.

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