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Seven Sadly Common Mistakes When Forming a New Company

Eying startups through a legal lens: Steven Gladstone, of Hall Booth Smith in Nashville, Tenn.

Entrepreneurs face a smorgasbord of risk. Have they identified a real market need? (Strategic risk.) Are they executing effectively? (Operational risk.) Will they go broke wooing customers? (Financial risk.) Will their (likely) failure tarnish their image? (Reputational risk.) But there's another risk that threatens new companies even before they're born: ***legal risk****.*

Steven Gladstone, a lawyer at Hall Booth Smith, headquartered in Atlanta, knows about managing legal risk. Gladstone, 65, has four decades of experience forming companies and structuring private placements, often based on the value of intellectual property. He has counseled entrepreneurs in everything from film production to real estate—and he has acute appreciation for how legal snafus can sting.

Gladstone shared seven legal mistakes that new entrepreneurs tend to make, including real-world anecdotes drawn from his own practice. Bottom line, he says: If you don't take proper precautions, your startup may be dead on arrival.

Mistake #1: Not getting legal assistance *from the beginning*.

A recent study by LegalShield found that, while 60% of small businesses experienced a "significant legal event" in the last two years, just half of those sought the help of a lawyer to deal with them. That means over 3 million, legally untrained business owners did their own legal work. Some may have escaped without a scratch, and lawyers—let's face it—don't work for free. But years of experience tell me that entrepreneurs who go it alone court everything from embarrassment to financial disaster.

Just one example: A potential client called me a few months ago with a big problem. Six months before consulting a lawyer, he had taken a partner in a new business. Soon enough, that fellow had eaten $100,000 of my client's money—on trips to Singapore, designer suits and other flagrant outlays. He also refused to sign a flurry of routine but important documents, and still my client continued to make funds available to him.

Painful result: a high-dollar collection matter three states away, a nasty fraud claim, a corporate dissolution, and a nightmarish settlement negotiation. What should have cost the client $3,000 to $5,000 in legal advice at inception ballooned into a tab five times that amount to untangle a big mess. And to top it off, the venture flat-lined within the next month.

Mistake #2: Not disclosing important information to your lawyer or your partners.

Whatever is going on, tell your lawyer and your partners about it. All of it. If you don't, bad things happen.

In one instance I painfully recall, the parties were starting a venture where state law required all principals and managers be without a criminal record if they wanted to obtain a state license for operating the business. Well into the registration process, the state denied approval when it turned out that the managing employee had a

prior felony conviction for fraud and embezzlement. Apparently that "just slipped his mind"—and ended up costing tens of thousands of dollars in legal fees (paid mostly by the partner) and months of lost work. (*Additional tip: Do background checks on all parties you're doing business with.)*

Mistake #3: Not completing important documents.

Let me repeat: Make sure *all parties sign, date, initial, copy and distribute all documents* required for the transaction.

One of my longtime clients—a very creative guy who's not exactly detail-oriented—hit this pitfall hard. He sold a significant interest in a company he had started, and the buyer was obligated to pay a percentage of revenue as part of the purchase price. Several months after completing the sale, the buyer stopped paying his share of the revenue. There was enough money involved (about $50,000) that my client considered suing. When he called, I asked for signed originals of all documents used to ink the sale. His response: "I thought you had those?" Nope—even though I had asked to be present at the closing of the deal (which would have cost money), and even though I had pestered him many times to give me the signed docs for safekeeping.

No surprise that a separate litigator advised my client not to waste more money on a suit because he couldn't produce the paperwork. Result: The buyer kept the property and paid only a small fraction of the price agreed upon. Life isn't always fair, especially when the dog eats your homework. *(Additional tip: Have your attorney present at the closing. It costs money, but it's worth it.)*

Mistake #4: Using cheap legal forms available on the Internet.

This trap is growing teeth. Last year a young entrepreneur wanted to add two new partners to her online business. She had already filed the Limited Liability Company (LLC) paperwork using free forms she found on the Web, and all she wanted from me was the minimum work required to add the two partners. I suggested I should review *all* of her documents before any partners came on board. That took a few weeks of convincing, but she reluctantly agreed.

Whoops! Her plain-vanilla docs contained the provision that any voting rights be tallied *per capita* (by head count), not by percentage ownership. So, even though she was giving each new partner 10% voting rights, thus retaining her majority control of the company, her original papers would have handed over the reins to the new partners who owned just 20%. Lesson: When it comes to cheap online forms, *download with caution*.

Mistake #5: When in doubt, hiring a generalist.

An old rule for which there are still too many examples: Paying a little more—perhaps up to 100%—for good legal advice beats wasting a lot more money on bad advice. If the situation is remotely complex, hire a specialist. She'll do the work faster and better.

Mistake #6: Building a picket fence—instead of a fortress—around your ideas.

Protecting intellectual property is a tricky task. For a brand new concept or thought process, few bulletproof legal safeguards exist. (*Copyrights* apply to original works when they can be physically copied, as with a compact disc, whereas *trademarks* like the Nike "swoosh" protect words, symbols and designs that distinguish products from competitors.) When discussing new ideas, always demand a signed Non-Disclosure Agreement drafted by an able attorney; you may not get it, but the act of asking shows you mean business.

Once created, intellectual property requires plenty of care and feeding, too. With both copyrights and trademarks, licensees should be contractually bound to protect those assets and to notify licensors of potential

infringement. With trademarks, failure to require certain protections *might cause you to lose exclusive use of the name of your company's products or services*. Not good.

Mistake #7: Doing business with friends when some can't afford to lose.

This little monster takes many shapes. Like the up-and-coming recording artist who's sure that his brother-in-law, currently running the local car wash, can manage his career. Or the well-meaning chump who goes into business with his old high-school buddy, even though he hasn't seen the guy in 20 years.

Friendly suggestion: Don't do business with friends—even with lawyers involved—if someone can't afford to lose the purse. Chances are, you'll lose a lot more.