

# GOVERNMENT REGULATIONS

BE A LEGAL EAGLE!



## What's This Session All About?

How does the legal system affect your business? How can you use it to protect your interests? We'll answer these and other questions by discussing the legal system, and some of the major areas of business regulation.

There's a lot of information in this chapter, but don't let that scare you off! No one expects you to become an expert in

any of these topics overnight, and some of the information here will not apply to you at all. The aim of this session is to give you a brief overview of the types of legal issues businesses face, and to serve as a simplified reference guide. The issues that actually apply to your business idea will be addressed—briefly!—in the worksheets for this session.

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*A law is valuable not because it is law, but because there is right in it.*

—Henry Ward Beecher

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## Highlights

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In this session, we'll look at the following topics:

**Setting up your business legally.** This session will help you understand the most common ways of establishing small business ownership. To decide which one is best for your business, you must consider things like ownership control, taxes, and legal liability.

**Laws that affect your business.** This session discusses government laws that may affect your business. The most important of these are tax laws, which will definitely affect your business. The importance of getting professional tax advice can't be overstressed!

**Contracts and leases.** No matter what type of business you run, you need a basic understanding of contract law. You'll also need expert legal help to ensure that your contracts are wise, safe, and legally enforceable.

**Protecting intellectual property.** Intellectual property law prevents other people from stealing your ideas, products, and business methods. This section will help you to become familiar with the basic protections available for patents, copyrights, trademarks, and trade secrets, so that you'll be better able to seek professional help from experts in this complex field.

## Setting Up Your Business Legally

This section discusses the advantages and disadvantages of the most common types of business ownership. Selecting the one that's right for you means considering liability, taxation, financing, and other issues. The worksheets at the end of the session will help you determine the best form of ownership for your business.

### Sole Proprietorship

This is the most common form of business ownership. It's run by one person, often under a **trade name**, with no outside owners or investors. Sole proprietorships are the easiest business entity to form. They're so easy, in fact, that you can form one without knowing it! For instance, if you're a freelance writer who doesn't appear on any employer's regular payroll, you're automatically a sole proprietor.

Pros:

- Simplest way of doing business
- You have complete control of the business
- You receive all the income

Cons:

- You're personally responsible for every act and debt of the business, so creditors can legally come after your home, car, and personal bank account.
- The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 may make it much more difficult for you to clear your debts by declaring bankruptcy.
- You can't expand your business through new owners and their capital.

### Tax considerations

Sole proprietors record business income and expenses on their personal tax returns. They must also make contributions to Social Security and Medicare, and pay estimated income taxes throughout the year.

We strongly recommend that you keep your business and personal finances and recordkeeping completely separate. Your business should have its own bank accounts, its own credit arrangements, and its own books and records. This is especially important when you have credit accounts, because interest payments are deductible for business debt, but not for personal debt.

### How to form a sole proprietorship

There are usually few or no costs involved in setting up a sole proprietorship. Most cities and many counties require sole proprietorships to register with them, and to pay some level of taxes.

If you have employees, you must fill out Internal Revenue Service SS-4 form to obtain an **Employer**

### Sole Proprietors

- Have complete control of the business
- Receive all the income
- Are personally responsible for every act and debt of the business
- Can't expand the business through new owners and their capital.

**Identification Number (EIN).** Otherwise, you can use your social security number for income tax, self-employment, and other tax purposes.

If you do business under a name other than your own, you'll probably need to file the name with the appropriate state, county, or city office.

## General Partnership

A general partnership forms when two or more persons agree to operate an ongoing business for profit. Although a general partnership can be formed by verbal agreement, it's best to get the agreement in writing, and to specify each party's rights and obligations.

Pros:

- Fairly simple to set up.
- Partners may bring new expertise to your business.
- Partners may bring additional funding to the business.

Cons:

- More recordkeeping requirements.
- All partners are collectively liable for debts, and each partner is individually liable for the full debt. Creditors will go after whoever has enough assets to cover the debt.
- You must really know, like, and trust your business partner. Not being able to get along is the number-one cause of partnership break-ups.
- Most partnerships end if one partner dies.

## How to form a general partnership

Generally, there are few costs or paperwork involved in setting up a general partnership. As with a sole proprietorship, you'll need to register as a business, and file an assumed business name.

The main concern is to draft a clear and comprehensive partnership agreement that specifies:

- The rights and duties of the partners
- How much capital each will contribute
- How disputes will be resolved
- How you will share profit and losses
- Who can authorize cash withdrawals and salaries
- How the partnership will be dissolved

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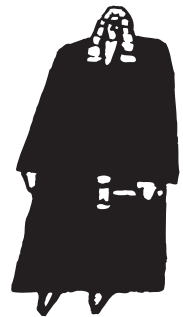
*I'm definitely not disabled. I wouldn't even say I'm handicapped, really. But whatever you want to call it, doing the work I did before is just not possible. At least, not in a way where I'm going to do it as good or as fast as the competition.*

*I might wake up and feel 100 percent better tomorrow, for all I know. But I can't count on it, and I'm not going to hang around and wait for it. I couldn't just sit around waiting for a day that may never come, not when I have a wife and two kids. So I had to try to figure out what I could do well enough to make a living. It had to be something where I used my hands, and it had to be something where the time was flexible, because some days are worse than others.*

Tom Pritchard's a veteran of the first Gulf War. He was in the motor pool, because he had all the skills going in. But for some reason, he's had weakness and pain in his arms and legs ever since he got back to his home town of New Orleans, Louisiana.

It was almost impossible for him to do heavy work on cars, though he earned some money on the side for smaller jobs. But eventually, his wife Regine had twins, and he knew he needed a source of income beyond his disability payments and the odd jobs he could still manage. While he was trying to sort out the possibilities, Hurricane Katrina struck.

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### When considering a partnership...

If you are considering a **partnership**, a contingency plan is extremely important. Because business partnerships can go bad, a written contingency plan is necessary. Both partners should know how the partnership would be dissolved if the business failed, or if one partner wanted to leave. Typically, this is included in a legal agreement written with the assistance of an attorney.

## Limited Partnership

In a limited partnership, individuals or corporations operate as general partners, and are in charge of managing the day-to-day activities of the business. Limited partners are investors who've given up the right to control the business in return for limited liability.

Pros:

- Limited partners are only liable for debts to the extent of their investment.
- Partners can provide additional source of funding for the business.

Cons:

- More expensive to form.
- General partners remain jointly and severally liable for the company's debts.
- It may be hard to find a suitable partner who's willing to invest without having the authority to make any decisions.
- If limited partners get too involved in the business, they can be held liable for losses that exceed their investment, like general partners.

## How to form a limited partnership

In most states, the Uniform Limited Partnership Act addresses the partners' duties, liabilities, and rights. You must file a certificate of limited partnership (or a similar document) with your department of commerce or secretary of state, and you'll also need to file to protect your trade name.

## Limited Liability Partnership (LLP)

This is basically a general partnership, but with limited liability for all partners. If you're a partner in an LLP, you won't be liable for debts and obligations arising from the acts of other partners.

LLPs are not recognized by all states, and some states restrict them to professional groups like accountants and lawyers. If you do business as an LLP in a state that doesn't recognize them, your business will probably be treated as a general partnership.

Pros:

- Limited liability for all partners.

Cons:

- Not recognized in all states.

## How to form a limited partnership

An LLP can usually be formed by filing a Certificate of Partnership with the appropriate state body (e.g., the secretary of state).

## Corporations

A corporation is a legal entity separate from the shareholders who own it. All states have laws describing how corporations may operate within that state.

One of the main reasons to do business as a corporation is the "corporate shield" doctrine, which limits personal liability as long as the corporation is properly organized and operated. If corporations don't follow the laws that govern them, the corporate shield can be "pierced" by creditors.

You must seek legal advice before forming a corporation.

Pros:

- The corporation can shield owners from financial debts or liabilities. In other words, if someone falls in your store and sues your business, the business is responsible for any financial or legal judgments, instead of you personally.
- You can raise money by selling stock.



- The business continues even if the owner dies or sells to a new owner.
- Possible tax advantages.
- May allow you to deduct employee health insurance, as well as such fringe benefits as group term life insurance, company vehicles, and public transportation passes.

Cons:

- If corporate rules aren't followed properly, the individuals that make up the corporation can be held personally responsible for corporation debts and liabilities.
- Time-consuming and expensive to form.
- More recordkeeping required. More regulations to keep track of.
- Possibility of double taxation. The corporation pays taxes on its income, and you pay income tax on any dividends you receive as a shareholder. While no one likes the sound of "double taxation," it's not a serious problem for most small businesses. With an accountant's help, it can often be avoided by careful planning.

## S corporations

S corporations are different in that their profits and losses are reported on the owner's personal tax returns, in much the same way as partnerships. This avoids the risk of double taxation. S corporations are limited to one class of stock, and must file their tax returns on a calendar year.

In order for your company to become an S corporation, you must file a special election with the Internal Revenue Service. You can switch your corporate status only once during the existence of your company, so consider the change carefully!

The S corporation provides another substantial tax benefit, in that it may allow you to pass the losses of

your business through to your personal tax return. This often has a significant benefit in the early years of a business, because the business may generate "paper losses," but still make enough money to pay a salary.

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*Katrina was just the worst thing ever. I can't tell you what it was like down here, with all that water and wind. Sometimes I almost feel guilty that's where my business idea came from. But really, what I'm doing is necessary. I give people security. I give them value for their money.*

After the hurricane, Tom found that his house was in pretty good shape. It was a little higher than most. There was water damage everywhere, but his foundation hadn't shifted. He was lucky.

But his neighborhood was in bad shape. They had no power, little food, and less water.

*What did people needed right after the flood, I mean absolutely need? They needed drinking water, the kids especially. So I figured out how to make sure that next time, they'd have it. The problem was, I couldn't handle it myself. So I called up my brother-in-law Luther Jefferson. Luther needed work and he was a skilled woodworker. Not a contractor or a cabinetmaker or anything like that, but good with rough construction.*

Tom reasoned that if every house had had a tightly sealed 55-gallon water tank set up on a platform and anchored in concrete, things wouldn't have been nearly so bad. When the hurricane warning came, families would simply fill the tank with a garden hose. A 55-gallon tank would sustain a family of four reasonably well for about two weeks.

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## Cooperatives

Cooperatives don't offer the tax benefits of a corporation, but they *do* have the unique feature

### Tips on choosing a legal structure

- Know clearly who the owners will be
- Get legal advice before you choose from:
  - Private attorneys
  - State bar associations
  - Nonprofit agency counselors
- Get advice from an accountant. Your legal advisor and tax advisor should work together. You want the best tax advantage and liability protection possible.

of passing all profits through to its members (who are usually its employees). Basically, it combines the management style of a partnership with the legal status of a corporation. Natural food stores often choose this form of operating entity. It's also increasingly common among smaller agricultural businesses in the Midwest and elsewhere.

If you want to do business as a cooperative, you'll need a written contract establishing the cooperative enterprise and describing how it will be managed on a day-to-day basis.

Pros:

- Can obtain a variety of expertise from members.
- Can exist as a corporation or partnership, so you can choose your structure and limit your liabilities as members see fit.

Cons:

- Group decision-making, and other aspects of shared ownership, can lead to mismanagement.
- The cooperative structure carries with it many management, tax and legal issues for members.

## Limited Liability Company (LLC)

The **limited liability company (LLC)** is a hybrid form of ownership that combines the best attributes of partnerships and S corporations; they're taxed like a partnership, but liability is limited like a corporation (note that the "shield" of an LLC can be pierced, as in corporate law).

Pros:

- Limited liability, like a corporation
- No double taxation, like a partnership

- If one partner can utilize tax losses better than another, the LLC allows beneficial allocation of that tax benefit.

Cons:

- Expensive to organize.
- May be complicated to form.

## How to form an LLC

Check with your lawyer or accountant about the advantages of the LLC in your particular state. Ask up front what it would cost to form a corporation versus an LLC. In some states, forming an LLC requires nothing more than to file a simple, one-page document that lays out the Articles of Organization with the secretary of state.

## Joint Ventures

Joint ventures are agreements between two or more businesses to accomplish a specific business goal that benefits both companies. The virtue of joint ventures is that by pooling their skills and resources, businesses can do things together that they couldn't do alone.

Pros:

- Allows you to offer a product or service that you might not be able to offer by yourself.
- You may learn new things from your partner.
- Allows you to reach a new market.
- When the project is over, the partners can go separate ways.

Cons:

- Joint ventures are short-term projects, so your potential for added income is temporary.
- Working with another company may be difficult if goals and management practices conflict

### Questions to ask when choosing a legal structure

- Who will be the owners?
- Will the business have partners? What role will the partners play?
- Who is investing money into the business? What do they get in return?
- What are the possible liabilities (things that could go wrong)?

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Tom went out in his backyard, and started thinking about how he'd go about putting in a water tank. It'd have to be strong enough to withstand the force of water and wind, and tall enough to stay viable in all but the worst floods. The platform would have to be strong, too. 55 gallons of water would weigh almost 500 pounds!

He sat on the back porch with a notepad and a stubby carpenter's pencil, and sketched out a design. He knew a thing or two about reinforcing structures from his time in the military, and he also had the benefit of hindsight: he could walk around the neighborhood and see which types of construction had made it through Katrina, and which hadn't.

Later that week, he and Luther and drove over to Covington to see Luther's other brother-in-law, an attorney named Mike Delacroix. After talking to Mike for a while, they figured that a general partnership was the way to go. At first, Luther had thought a limited partnership sounded good. He liked the idea of being protected from any liability. But when he found out it would be more expensive to form—and that as the limited partner, he'd have no rights when it came to business decisions—he changed his tune.

*Before we did anything else, we got ourselves legal. Scam artists were all over the place after Katrina, and I wanted a piece of paper that clearly said we were legit.*

*I guess we could have just canvassed the neighborhood and started work right then. But if things went as well as I thought they would, I wanted everything in place. I didn't want to be fussing about the money.*

*So we filed as a general partnership, fifty/fifty down the line. Luther was a little uneasy about his being responsible for anything I signed, but I said "Well, that goes both ways." And besides, my wife Regine—his sister—was going to be the one keep-*

*ing the books and records. He knew he could trust her, so that settled that.*

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## Laws That Affect Your Business

City, county, state, and federal laws apply to different aspects of running a business. There are also state agencies or boards that regulate certain industries, such as pest control or day care. Before you start your business you'll need to see whether your business or job skill is one that requires a special license. A good place to start is at your state's Department of Commerce.

It'd be impossible to describe all the legal requirements that affect different types of businesses. Again, the goal here is to give you some general knowledge, so that you can seek expert help.

This session's worksheets will help you figure out which taxes, regulations, and other laws are likely to apply to your business.

### Business Registry

A state's Department of Commerce or Secretary of State office often maintains the state's business registry. Its duties include the registration of business names and trademarks, and annual corporate and partnership filings. Check with your state to determine the requirements to register your business. These requirements will vary state by state, and by the form of ownership you choose.

### Zoning

Zoning laws regulate land use in order to protect public health, safety, and general welfare. If you'll be running your business out of your home, you need to be familiar with the zoning laws in your neighborhood. The most common restrictions



are:

- No onsite sales
- No deliveries
- No inventory storage
- Restrictions on noise, hazardous waste, and odors
- Sign restrictions
- Fire regulations
- No employees other than family members

For information about zoning laws in your area, check with your local building or zoning department.

## State Taxation

Federal, state, and local governments all have the power to collect taxes. In most states, taxation of personal and corporate income follows the federal system.

## Sales tax

All but three states have a sales tax. Some states tax nearly all transactions, while others exempt necessity items like food and clothing.

Check with your accountant or state to see if your business is subject to sales tax. If you're in the retail business, you'll probably have to collect sales tax.

## Property tax

Most states assess taxes on real estate as a means of funding state government. Depending on its location, your business may have unique tax benefits or burdens. Many states have "enterprise zones," where businesses get tax breaks if they locate in economically disadvantaged areas. Urban renewal districts can also result in favorable real property taxation assessments.

## Business license fees

Many cities and towns can tax local businesses under a system of business license fees. Consult your city and county government for more information; many local governments have a small business assistance office. Your closest Small Business Development Center (SBDC) or SBA Business Information Center are other good places to check.

## Federal Taxation

The type of business ownership you choose determines which federal tax forms you must file, which taxes you must pay, and when you must pay them. For instance, most sole proprietors, corporations, and other entities subject to federal income tax have to pay estimated tax payments. Rather than waiting till the end of the year, they estimate their taxes and make regular (usually quarterly) deposits towards their annual tax bill.

Taxes are one of the most complicated issues any small business faces. For information on federal taxes you can ask a tax consultant, or call the Internal Revenue Service at 1-800-829-1040.

### To research the taxes that apply to your business, you can contact:

- City and county clerk's office
- City and county tax assessor's office
- Chamber of commerce
- Local chapter of Service Corps of Retired Executives (SCORE)
- Local Small Business Development Center (SBDC)
- State Department of Economic and Community Development
- State Department of Revenue
- IRS Office (800-829-1040)
- Certified Public Accountant (CPA) Associations
- Local Women's Business Centers

## What You Must Know About Taxes

- Even if your business does not show a profit, you must file a tax return
- Money you collect for sales tax or withholding tax is not yours to keep!
- If you don't pay taxes, your business's name will be printed in the newspaper
- Penalties for failing to pay taxes add up quickly, and may cost much more than you save by not paying
- Bankruptcy will not clear your tax debt
- Owing back taxes will make it harder for you to get a business loan



## Payroll taxes

The federal government requires employers to withhold payroll taxes from their employees. These taxes include the Federal Insurance Contributions Act (FICA), and the Federal Unemployment Tax Act (FUTA).

FICA is better known as the social security tax. It requires you to do two things. First, you must withhold a certain portion of each employee's payroll to pay the employee's share of social security. Second, your business must match the employee's withheld amount, and send the total amount to the federal government.

FUTA is better known as unemployment insurance. It requires you to collect a portion of the employee's payroll, and send it to the government to pay for the employee's unemployment insurance benefits. You must collect this same amount for state unemployment insurance (SUI). As with social security, your business must pay a portion of the employee's contribution to FUTA.

Another type of insurance coverage that benefits employees is workers' compensation insurance, often called "workers' comp." Employers are typically required to pay this on behalf of their employees. The amount depends on the type of work (e.g., steelworker versus secretary), and by the number and size of the claims filed against the employer.

In large metropolitan areas, city taxes are often withheld, too. As an employer, you must make quarterly (sometimes monthly) payments of withholdings to the government; incorrect or late payments can result in severe penalties.

Some employers legally avoid federal withholding requirements by hiring independent contractors. An independent contractor is a person or business that does work for your business, but is not your employee.

The difference between an employee and an independent contractor can be confusing. In most states, persons or businesses performing labor or services for a business owner are considered independent contractors only if they:

- Are free from the direction and control of the owner, except that the owner specifies the desired results
- Are responsible for obtaining their own licenses and business regulations
- Provide their own tools or equipment
- Have the authority to hire employees to assist them
- Are paid upon completion of specific portions of the project
- File tax returns as a business, rather than as a W-2 wage earner from the owner's business
- Advertise to the public as an independent business through business cards, advertisements, telephone listings, and the like
- Perform work for more than two owners in a year
- Have a place of business outside that of the owner

You should carefully review the IRS qualifications for independent contractor relationships. Also, you will want to review your state's laws regarding independent contractors.



### Taxes and Your Business—Which Ones Affect You?

- Income
- Federal
- State
- Local
- Self-employment
- Sales
- Property
- Real Estate
- Payroll
- Excise

### IRS 20-Point Checklist: Independent Contractor or Employee?

#### Primary Factors

1. Does the service recipient have the right to require compliance with significant instructions? Yes ☐ No ☐
2. Does the service recipient have the right to set the hours of work? Yes ☐ No ☐
3. Does the service recipient have the right to set the order or sequence of services to be performed? Yes ☐ No ☐
4. Does the service recipient have the right to discharge the service provider?  
Yes ☐ No ☐
5. Does the service provider have the right to hire, pay and supervise assistants as the nature of the work requires? Yes ☐ No ☐
6. Does the service provider have no ability to realize a profit or loss? Yes ☐ No ☐
7. Does the service provider have no investment in significant tools, materials and other equipment when such items are necessary to accomplish the task and are customarily provided by the service provider?  
Yes ☐ No ☐
8. Does the service provider have no significant investment in facilities when they are necessary to accomplish the task and they are customarily provided? Yes ☐ No ☐

#### Secondary Factors

9. Does the service recipient train the service provider? Yes ☐ No ☐
10. Does the service recipient have the right to require oral or written reports?  
Yes ☐ No ☐

11. Does the service recipient pay by the hour, week or month? Yes ☐ No ☐
12. Does the service recipient pay for business and/or travel expenses? Yes ☐ No ☐
13. Does the service recipient have the right to require personal service? Yes ☐ No ☐
14. Does the service provider usually not work for more than one firm at a time?  
Yes ☐ No ☐
15. Does the service provider maintain a continuing relationship with the service recipient? Yes ☐ No ☐
16. Does the service provider devote substantially full time to the service recipient?  
Yes ☐ No ☐
17. Does the service provider have the right to terminate the relationship at any time without incurring liability? Yes ☐ No ☐
18. Is the service provider integrated into the service recipient's business? Yes ☐ No ☐
19. Does the service provider not make his or her services available to the public on a regular and consistent basis? Yes ☐ No ☐
20. Does the service provider work only on the service recipient's property or designated location? Yes ☐ No ☐

#### Note:

- Yes answers suggest employee status. No answers suggest independent contractor status.
- More weight should be given to the first eight questions than the last twelve.
- If you answered "yes" to any of these 20 questions, proceed with caution. Consult an accountant or tax lawyer who is familiar with the problems raised by hiring individuals as independent contractors.

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*Figuring out what kind of tank to use was tricky. There were indestructible drums made of rustproof stainless steel, but those ran about \$600 a piece. That was out of our price range, to say the least.*

*Then there were yards where you could buy re-conditioned steel drums for about \$35 a piece, but those weren't approved by the FDA for drinking water. There were also FDA-approved plastic drums that had a threaded hole for a hand pump. Those were about \$60, but I wasn't convinced the lightweight plastic would stand up to a really bad storm.*

*I thought getting the drums would be the easy part. But finding ones that met FDA standards for drinking water, and were sturdy and affordable, and didn't cost \$100 each when you factored in shipping...well, that took us a while.*

In the end, it was Regine who went online and tracked down a source for heavy-duty polyethylene barrels that had formerly held flavored drinks, but had been steam-cleaned. Those were about \$50 a piece, siphon pump included. That was ideal. Better yet, the supplier was in Baton Rouge, so Tom would be able to pick them up, instead of paying a fortune to have them shipped.

The other things Tom needed were a good solid pallet, some structural lumber, some rebar and Sonotubes, and a few sacks of concrete. He and Luther figured they could do the whole job for \$350 or so, including labor. At that rate, they'd make \$200 per unit, or \$400 a day once they were up and running. But where were people going to come up with the money to pay them?

Well, the city was swarming with agencies that were supposed to help, and a lot of people still weren't asking because of the shell shock and confusion. Tom made the rounds of his neighborhood, and told people his idea. He said he was pretty sure he could get them a grant to get the tanks installed. He said he'd even get

them the paperwork, and help fill it out. That was the clincher, for most people!

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## Laws That Apply to Businesses With Employees

As your business grows, you may want to add employees. Here are some of the most common labor laws. Again, state and federal levels apply. Federal laws are the same wherever you live, but you should check with your state to make sure you're complying with their regulations as well.

### Employee regulations

There are many laws that regulate workers' rights, workplace safety, hiring practices, and so on. Here are some of the most important ones.

### Wage and hour regulations

The federal government has established a minimum wage under the Fair Labor Standards Act. Most states have adopted these requirements. There are also state and federal laws regulating child labor, overtime, breaks, and so on. You may be required to post certain rules and regulations clearly in the workplace. You should research these laws carefully, and consult with experts where necessary.

### OSHA

The Occupational Safety and Health Administration (OSHA) sets guidelines for worker safety. There are penalties for failure to comply with these regulations, but what's more important is that it makes good business sense to provide a safe and healthy workplace for your employees.

### The hiring process

Under Title VII of the Civil Rights Act of 1964, your business may not discriminate against anyone on the basis of race, color, sex, national origin, or age. Other federal and state laws can also affect the hiring process. As a general rule, it's best not to ask



any interview questions that aren't job-related. You may wish to write up a standard set of questions for interviews.

### Americans with Disabilities Act

You can't discriminate against people with disabilities in the work force, or in facilities that are open to the public. Be aware of these regulations, and familiarize yourself with the sections that apply to your business.

### Harassment

Antidiscrimination laws target workplace harassment, from unfair job placement and promotion to permitting sexual harassment to occur in the office. The best way to avoid these problems is to adopt and enforce an employee policy manual detailing behavior your company won't tolerate.

### Child labor

In many states, children age 14 through 17 must have a work permit, and there are limits on how many hours they can work. You should check with your state labor department to find out what the law is in your state.

### Responsibility for the acts of employees

Employers are usually responsible for the acts of employees while they're on the job. For instance, if your delivery driver injures someone while running an errand, your business is probably liable. This is why businesses should buy liability insurance, and—if possible—choose a form of business ownership that avoids personal liability.

### Consumer Protection Laws

Federal and state consumer protection laws affect everything from consumer credit to warranties. Your local chamber of commerce can help you learn about and comply with these regulations.

### Privacy of consumer information

The rise of e-commerce has led to concern over the use and misuse of personal data online. Since e-commerce typically happens across state lines, the laws regarding data collection in a customer's state can affect your business.

California recently passed two laws that are a good example of this. The Online Privacy Protection Act of 2003 requires commercial Websites that collect personal data from consumers in California to post a privacy statement that fully describes their policies regarding private data.

Another law, which took effect in January of 2005, states that you may need to provide California consumers with information on your sharing of their personal data with third parties for direct marketing purposes.

### Telephone solicitation

In March of 2003, the Do-Not-Call Implementation Act, which created a National Do Not Call Registry, was signed into law. Failure to obey this Act can result in substantial fines.

In addition, most states restrict telephone solicitations in a variety of ways. And of course, every state prohibits dishonesty or fraud in telephone sales. Consult your state attorney general's office, and your lawyer, before engaging in telemarketing!

### Laws Affecting Shipping and Transportation

There are many rules about what you can transport, how you can transport it, and where it can go. Some of these have to do with national security concerns, and may have been created or strengthened in the wake of the terrorist attacks of September 11, 2001. Others have to do with agriculture; hazardous materials transport; alcohol, tobacco, and firearms; and so forth.





The USPS has rules with which you should become familiar, as do commercial carriers like UPS and FedEx. If you're shipping or receiving goods internationally, you're subject to many more regulations. Your carrier can help you make sense of these rules.

## Environmental Laws

Environmental laws regulate how your business and its employees handle hazardous materials. If you are in a business that will be handling chemicals or hazardous dry goods, you should check with your state's environmental agency to make sure you're in compliance with the current regulations. Bear in mind that you don't have to be transporting high explosives to be regulated under environmental laws! Things like batteries, oil, and certain cleaning supplies and solvents legally count as hazardous materials, too.

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Tom made a list of a hundred families that said they wanted tanks, and got on the phone to City Hall. The process was long and complicated. First, he needed to apply for a micro-loan to handle his material expenses. Then, he had to find out who might cover the expenses for the individual homeowners, if anyone.

He didn't imagine that everyone would be able to get help, of course. But families with kids, and the elderly, seemed like a safe bet.

He got the forms he needed, copied them, and filled them in with his clients. He made a trip to Legal Aid to see if he qualified for free help, and they told him that any of his clients could bring in their forms to have them filled out by experts. It wasn't a matter of Tom making money, after all; it was a matter of the general population needing help with legal forms.

There were zoning issues, building codes, and public health issues to consider, too. Fortunately, though, the small size of the tanks,

and the fact that they'd be filled in response to emergencies, meant that they were exempt from a lot of the rules that might apply to larger systems.

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## Contracts and Leases

There are four elements to an enforceable contract:

- Mutual assent
- Consideration
- Capacity
- Legality

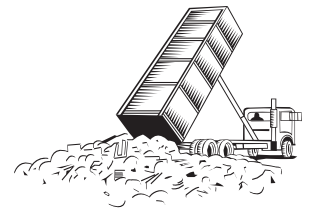
Suppose you walk into the corner grocery store where you've been shopping for 15 years, and pick up a bottle of milk. You take it to the counter and show it to the grocer, who enters the price on your account.

Although this is an informal transaction, it has all the elements of a contract. There's mutual assent, because the grocer offered the goods for sale, and you agreed to buy them at a specific price. There's consideration, because value was exchanged when you got the milk and the grocer recorded an account receivable. There's capacity, because both of you had the mental capacity to understand the terms of your agreement. And there's legality, because the sale of milk is legal.

Let's look at each of these elements in a little more detail.

### Mutual Assent

Suppose a car salesman points to a brand-new Ferrari and says, "Wouldn't you like to have one of these?" The fact that you answer "Yes" doesn't mean you've reached mutual assent!



In order to determine whether you have a deal, the first question is, have both parties agreed to the same thing? There must be a valid offer for goods or services, and an acceptance of this offer at an agreed-upon price. Also, the offer must set forth the basic terms of the contract: price, date of performance or delivery, and place of performance or delivery.

## Consideration

In a legal contract, consideration must pass between the two parties. In our grocery store example, you received the milk as consideration, and the grocer received your promise to pay.

Consideration can consist of many other kinds of value. For example, if you promise to paint the offices of a graphic-design firm, and they promise to design a logo and a business card for you, this constitutes an enforceable contract.

## Capacity

Both parties must have the mental ability to enter into a contract. For that reason, most states rule that contracts with children for unessential goods or services are unenforceable against the child. Likewise, you can't enter into a contract with a person who lacks the mental capacity to understand the transaction, regardless of his or her age (e.g., someone with Alzheimer's disease). Another example of lack of capacity is being drunk or under the influence of drugs, prescribed or otherwise.

## Legality

The terms of a contract must be legal. In most states, you can't enforce a contract based on prostitution, drug trafficking, child labor, or other illegal transactions.

## Types of Contracts

A contract can either be express or implied. An express contract is stated in words (preferably in

writing!), while an implied contract is demonstrated by conduct.

## Implied contracts

Suppose you call your office goods supplier and ask for 500 padded envelopes, and hang up without making any verbal commitment to pay for them. Even without that verbal commitment, your promise to pay is implied by the fact of your order. Such contracts are **implied-in-fact**.

If your supplier mailed you an extra 500 envelopes by mistake, and you used them but refused to pay for them, a court might find that a contract was **implied-in-law**. Though you didn't order the envelopes, the court recognizes that if you use them, you should pay for them.

## Oral contracts

Oral contracts are valid and binding, but their terms can be very hard to prove in court. Of course, it's possible to come up with a very specific and detailed oral contract...but if you're going to go to that much trouble, you may as well go ahead and put it in writing!

## Written contracts

Some types of contracts must be in writing. Examples include:

- Contracts for the sale of goods (tangible, movable personal property) for \$500 or more
- Contracts for the sale of real estate
- Contracts that, by their terms, can't be performed within one year (such as an employment agreement with a three-year term)

By committing your agreement to writing, you reduce the chance of fraud, and eliminate the risk of time-consuming legal disputes over who said what when.

### Elements of a Contract

- **Mutual assent.** Do both parties agree to the same thing?
- **Consideration.** What form of value is being exchanged?
- **Capacity.** Are both parties mentally capable of understanding the contract terms, and fulfilling them?
- **Legality.** Are the contract terms legal?

## Get Legal Advice!

If you ask your lawyer to draft a contract for you, outlining the basic terms ahead of time will save money. Look at other agreements that people in your industry have used in the past; your Chamber of Commerce may be able to put you in contact with someone in your business, or you might find relevant information at the library or on the Web.

You may want your lawyer to prepare a blank contract that you can use again and again. There are even sample contracts available on computer software, in certain business books, and on the Internet (for instance, on the NxLevel site!). However, remember that the circumstances surrounding every contract are unique, and your lawyer should review the agreement before you finalize it.

## Common Contract Issues and Terms

When you receive a contract, make sure you understand all its terms and conditions. Bear in mind that the **boilerplate** (also known as fine print, or standard clauses) found in most business agreements is extremely important. Don't assume that a printed form can't be modified. If a contract contains unacceptable boilerplate, you can cross out or change a term, initial the change, and have the other party initial it too. Remember that small print can have big consequences!

Again, you're not expected to memorize every term in this section. But the information's here if you need to refer to it down the road.

Most business contracts include the following terms:

### Performance

Performance means the things you must do according to the contract. For instance, you might be required to deliver ten desks to an office by a particular date.

### Delegation

You can usually delegate (i.e., turn over) your contractual duties to someone else, unless the contract terms forbid it. However, a duty to perform certain personal services (like singing at a wedding) can't be delegated to someone else without the other signer's consent, because the obligation is personal. The other signer bargained for that particular singer's services.

### Place of delivery

Where are the goods to be delivered? Who pays for shipment? Who bears the risk of loss while the goods are in transit? Does training on how to use the item take place in your office or theirs? Are your travel time and expenses covered? Failure to review the delivery terms of the agreement carefully can result in your profits being used to pay for these costs.

### Time to perform

You should clearly specify when performance is due, both from the delivery and payment sides of the transaction.

### Notice

Are you required to provide notice when you reach a certain production level, or even prior to beginning your performance? Whom do you notify, how often, and where? Don't ignore these questions.

### Price

Your contract should establish how many units you're to deliver, at what price, and whether the price is in U.S., Mexican, Canadian, or some other currency.

### Warranty

A warranty is a promise that the goods delivered will match the prior description of the goods. A warranty can be created by a sample or model, or by a verbal or written statement.

## Nonconforming goods

Usually, the seller must deliver exactly what the contract specifies or the buyer doesn't have to accept the goods. However, if the seller ships goods reasonably believed to be acceptable to the buyer—even if they don't exactly match the terms of the agreement—and the buyer doesn't reject those goods within a reasonable amount of time, the law recognizes the deal as complete.

## Merger clause

This clause tosses out any and all existing agreements between the two parties, and affirms that the contract terms constitute the only valid description of the agreement. Before signing a contract that contains this clause (which is also known as an integration clause), you must be sure that the contract is accurate and complete.

## Partial invalidity

If a judge or arbitrator decides that a contractual clause is invalid, a “partial invalidity” clause says that the invalid clause can be taken out of the contract, without invalidating or terminating the entire agreement.

## Alternative dispute resolution

More and more people today are using alternative dispute resolution (ADR) to settle disputes. There are three types of ADR:

- **Negotiation.** The parties try to work out their differences between themselves.
- **Mediation.** A neutral mediator helps the parties to communicate and arrive at a fair settlement
- **Arbitration.** A neutral arbitrator decides which party is right, and determines how the conflict will be resolved.

All three types of ADR tend to be faster and less expensive than going to court. Many small businesses prefer to use arbitration or mediation because of the high cost of trying to pursue a lawsuit in court. You should consider whether this is beneficial to you before specifying that ADR will apply to the contract.

## Professional fees and expenses

Most contracts provide for the winning party to recover all fees and court costs from the losing party. You should make sure that this term also covers arbitration, and other such fees and costs.

Attorney fees usually aren't recoverable in litigation or ADR. This makes going to court financially impossible for many people. That's why it's usually a good idea to have an “attorney fees” clause stating that the winner of the dispute party is entitled to an award of reasonable attorney fees.

## Indemnification clause

An indemnification clause transfers the risk of damages or loss from one party to another. If that sounds serious, it is! Certain types of indemnification clauses can make you financially responsible for damages you didn't cause. Get legal advice before agreeing to such clauses.

## Breach of Contract

A **breach of contract** occurs if either party fails to perform as promised, makes it impossible for the other party to perform, or refuses to perform. If you lose money or property because someone breaks a contract, you're usually entitled to **compensatory damages**. These may include money or property, as well as the actual value of any services you rendered, any business you lost, and so forth.

Remedies in the event of default should be clearly specified in the contract. Note that law may limit the amount of damages you can receive. For more information, seek advice from a legal professional.



• • •

Finally, Tom got a microloan for \$2,000. Etta Fulton, a woman with two young kids, lived right down the block and had the money to spend. So a week after the loan came in, Tom and Luther went to work in her backyard.

First, Tom figured out where the highest water level had been during the flood. Then, he sank four Sonotubes and filled them with concrete and rebar. They were eight feet long, and rose out of the ground four feet. On top of those, he built a flat platform on which eight 4x4s rose another four feet, with an 8x8 in the center. These were all cross-braced, and held together with heavy angle plates. And on top of those were another heavy platform, and a 55-gallon water tank secured with thick wooden up-rights and high-strength steel strapping.

*I was very, very tired and sore heading back from that first job. But I was also very, very happy. Me and Luther, we got the tubes installed in just three hours. Once they were filled and the concrete had dried, we came back with a prefab frame and put the whole thing together in another three hours.*

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## Contracts on the Internet

E-commerce contracts raise some interesting problems. Usually, consumers accept e-commerce contract terms by visiting a page that lists the terms, and clicking on a button that says “I accept” or “I decline.”

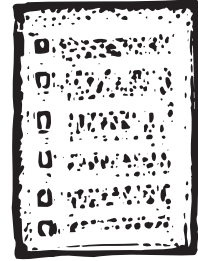
But what if the user clicks on the wrong button? The merchant would read this as acceptance, and start performing according to the contract terms!

To avoid this, online merchants require their customers to confirm their acceptance by clicking on a second button, or by agreeing to a charge on their credit card after placing the order.

Online acceptance forms should be clear and complete, and contain standard terms and conditions.

## E-mail and contracts

E-mail exchanges between a business and its customer can constitute a contract, so you should save all e-mails to and from your customers. By law, it's the final e-mail offer that, when accepted, creates a binding contract. Therefore, your final communication should set forth all the terms of the agreement. A court may look at the entire e-mail exchange in order to figure out both parties' intent, but if it finds there was no “meeting of the minds,” it will rule that no contract was formed.



### A Checklist for E-Commerce Contracts

- All terms and conditions should be clear, simple, and straightforward.
- State as a term of the agreement that the online display is the sole, exclusive, and final agreement between the parties.
- Put a system in place for capturing complete, accurate, printable records of all negotiations and agreements.
- In agreements involving transactions in goods in excess of \$500, or agreements that cannot be performed within one year, obtain a fax-back signature.

## Leases

A lease is an agreement giving one party possession of another party's land or personal property (e.g., equipment) for a stated period of time, in return for a stated amount of money. A lease differs from a sale, in that a lease transfers possession of property, while a sale transfers both possession and ownership.

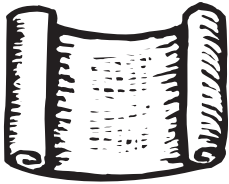
There are two main types of leases that you might have to sign: real estate leases, and equipment leases.

## Real estate leases

Real estate leases—which include leases for workspaces, studios, offices, retail spaces, and the like—are the most common type of lease. Here are some things to think about when leasing business premises.

- What area are you leasing? What is the total square footage, in what area of the building?
- How long will the lease last?
- How will the rent change over time?
- Who pays for upkeep or improvements on the building, office space, or landscaping?
- Is there enough parking? Are any spaces reserved for you or your customers?
- Are you sharing space with other tenants? If so, how are the costs for those spaces allotted between you?
- How are maintenance costs determined?
- Does your lease state that yours will be the only paint store in the complex, or can other paint stores come in and compete against you?
- Can you sublet your space?
- Can you get along with the landlord? Have other tenants had problems there?
- Are taxes paid by you or the landlord?
- Is your right to renew the lease clearly stated?
- Do you have an option to buy the property, and if so, under what terms? Do you have a first right of refusal to buy the property under the terms offered to a third party by your landlord?

The worksheets at the end of the session will help you sort out which contracts and leases you might need in your business.



## Equipment leases

Equipment leases are usually for such things as light or heavy machinery, photocopiers, and computers. When a customer can't afford to pay the entire purchase price of the equipment at once, the seller offers either to finance the purchase price through the seller or a financing company, or to put the customer in touch with a leasing company who can arrange an equipment lease. This can be a good deal, because the down payment under a lease is usually less than the down payment on a credit purchase. Also, leases usually allow you to trade old equipment for state-of-the-art equipment after a few years.

Equipment leases are similar to real-estate leases, but with two important distinctions. The first is the purchase option. Often, a leasing company will provide that the lessee has an option to purchase the equipment at the end of the lease term. Never rely on a seller's representation that you have a purchase option; make sure that you receive this commitment from the leasing company itself, and that the terms of the purchase offer are clearly set forth in the contract. The leasing company is a separate business from the seller, and will probably not be bound by any statements or promises made by the seller.

## Consignments

A consignment is neither a sale nor a lease. A consignment arrangement is one in which someone who desires to sell a product "consigns" it to a business engaged in sales of that type of product. No money exchanges hands until the product is bought by a third party (i.e., the store's customer). The consignee (the business that agreed to try to sell the product) takes a share of the purchase price and pays the rest to the consignor (the party who put the product on consignment).

The following provisions should be included in consignment contracts:

- Names and addresses of the parties to the contract
- Any provisions giving the consignee exclusive marketing rights (this should include a clause that allows termination of the contract if the consignee doesn't meet a specified level of sales)
- The dollar value of the consigned product
- The percentage of the selling price to be paid, and the date on which payment is due
- The price of the consigned product
- Any requirement that the consignee must have or buy insurance that will cover the consigned product
- The duration of the consignment
- Who pays to return unsold products?
- Who markets or promotes the work, and who pays the expenses of marketing?
- A right to inspect the books and records of the consignee relating to the consigned product

It's also very important to include a statement that the consignee holds the product and any proceeds from its sale in a trust relationship, and that the proceeds must be kept in an account separate from the general business funds of the consignee.

## Intellectual Property

Intellectual property law prevents other people from stealing your ideas, company logo, product designs, and business methods. Unlike machinery or money, these assets can't be picked up and physically handled. But they may be some of your most valuable business assets!

The worksheets that follow will help you determine which of your intellectual property rights need protection.

### Business Names

Most businesses operate under an assumed business name, sometimes signified by the phrase, "Doing Business As" or "DBA" for short.

Courts usually rule that the first business to use or register a name has the right to continue using it, so it is important that you register your business name as soon as possible! Most states provide for the registration of an assumed business name, either statewide or by county. Usually, you must file the assumed business name as soon as you begin using it.

### County vs. state registration

If your music store is named "Sax and Violins," and you reserve this name in your county, it may be available for use by a business in another county. But even if you register your name statewide, the court may allow another business to use it, provided the competing business operates in a different area and/or industry.

### Trademarks

A trademark is a word, phrase, symbol, or design that identifies and distinguishes the source of consumer goods. Trademarks are categorized by how distinctive they are. The more distinctive your trademark is, the more legal protection it has.

You don't need to register your trademark to own exclusive rights to it in your area. But state registration—or if you do business across state lines, federal registration—gives you much stronger protections. Trademark registration lasts for ten years, and can be renewed for an indefinite number of ten-year periods.

## Intent to use

Small firms that haven't yet used their mark in interstate commerce often worry that another company will begin using their mark, or register it. To prevent this, federal trademark law includes an "intent to use" provision that gives your mark a six-month period of nationwide protection.

To enjoy this protection, you must file an "intent to use" application asserting your good-faith intent to use the mark. Once this is approved, you have six months to use the mark. If you need more time, you can get a number of extensions. But if you don't use the mark within three years of filing the first application, you won't be allowed to register it.

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After they'd put in thirty tanks in the first month, Tom and Luther realized they needed a place to store materials. Luckily, a neighbor whose garage was still standing was willing to rent it to them for fifty dollars a month.

As people struggled to get back on their feet, there were lots of opportunities for barter and bootstrapping. Tom and Luther were sometimes able to get supplies and salvaged materials for a little work, and sometimes for free.

Tom and Luther were happy with the way the company was set up. They were both responsible for how things went, and the bookkeeping was all in the family. And the new sign on the truck door, that said Pritchard and Jefferson, looked terrific!

Recently, Tom read an article about methods of low-cost water purification, and this got him thinking about the possibility of rigging up a solar-powered ultraviolet bulb, to ensure that the water in the tanks could be disinfected even if it were somehow contaminated by floodwaters. He and Luther are currently working on a formal business plan for this new idea, and are feeling very excited about it. If all goes well, they may even be able to turn each storage tank into a purification system



that can produce tank after tank of drinkable water, even if the neighborhood's electricity and water is off for weeks!

*Once I started getting some recognition and respect for being an honest man who did a good job, other doors started to open to me. And it turned out there were lots of other kinds of work I could do besides working on cars. More than that, I found out that in a lot of ways, I liked working with my brains even more than I liked working with my hands.*

*All in all, I'm feeling pretty good. My work helps people, it's honest, and I make a good living at it. What more could I ask for?*

...

## Copyrights

Copyright protection applies to original works of authorship in tangible form. "Tangible" means that it can't simply be in your head; it must be physically accessible to other people.

"Original" doesn't necessarily mean the idea behind that work is original. Ideas aren't protected by copyright law. What's protected is a specific *expression* of the idea. To put it another way, the authors of this book can't stop another author from writing a book about microbusiness, but they *could* stop another author from publishing the text in this book as his or her own work.

## Works made for hire

If a copyrighted work is a work made for hire, then the hiring party is considered to be the author of the work, and owns the copyright to it. Usually, this happens through an employer/employee relationship.

## Registering copyrights

Copyright registration is not necessary to create a copyright. A copyright exists from the moment an original work of authorship is created and put in tangible form.



That said, there are several advantages to registration. You can register your copyright with the Register of Copyrights in Washington, DC. Copyright notices and registration are inexpensive and remain good for up to 50 years after your death.

## Trade Secrets

Trade secrets are the main intellectual property of most small businesses. They include private business information, methods, and processes used in your business.

A customer list may qualify for trade secret protection (but *not* for copyright or patent protection), as long as the list took much effort to develop, is valuable, and is not readily available to people inside and outside the company.

In many states, trade secrets and customer lists are protected against theft or misuse under the Uniform Trade Secrets Act, as long as you take steps to keep them secret. Even if an invention or process isn't eligible for patent registration, it may still be a protected trade secret under state law.

You don't have to be engaged in biotech or computer research to have methods or processes that are not commonly known. Who your customers are, and what and how often they order, is vital information that's worth protecting.

## Patents

Let's say you just invented a great new way to remove grass stains from clothing, and you want to make sure your competitors won't copy your product's ingredients. How do you do this? By obtaining patent protection.

A patent grants its owner the right to exclude others from making, using, offering for sale, importing, or selling the invention in the United States. Anyone, regardless of age or citizenship, may obtain and legally protect a U.S. patent.

Unfortunately, patents don't come cheap; they

can cost thousands of dollars each. You'll also need plenty of legal help from a patent attorney, to determine if your invention is patentable.

## Patent pending

The phrase "Patent Pending" serves as a warning that a patent application is in process, and that copycats should be careful because they might infringe if the patent issues. Applying the phrase "Patent Pending" to an item for which no patent application has been made is illegal, and can result in a fine.

# What You've Learned

You may feel overwhelmed by all these rules and regulations, but don't worry. Many of them will not apply to your business. And there are people who can help you understand the ones that do. For now, the important thing is to have a basic understanding of these points:

1. There are different forms of business ownership. Consider your situation carefully—and get expert advice—before choosing.
2. You need to educate yourself about the laws that apply to your type of business.
3. Tax laws affect all small businesses. You'll need professional help to deal with them.
4. Contracts are at the heart of doing business. Get them in writing, and make sure you understand every term before you sign. This applies to leases and consignments, too.
5. Intellectual property law protects your products, trademarks, inventions, and trade secrets from being used or sold by other businesses without your permission.

