# MINDING YOUR OWN BUSINESS

## Ropes to Skip and Ropes to Know

## In the Operation of Your Small Business

**by Don Hudspeth, Esq.**

# Table of Contents

## GENERAL DISCLAIMER

OBVIOUSLY THIS BOOK AND THE ARTICLES CONTAINED WITHIN ARE INTENDED TO PROVIDE ONLY GENERAL, EDUCATIONAL INFORMATION. THIS BOOK IS NOT INTENDED TO GIVE YOU LEGAL ADVICE ABOUT YOUR SPECIFIC CASE. EVERY SMALL CHANGE IN THE FACT PATTERN OF A CASE WILL CHANGE THE LEGAL ANALYSIS, AND THEREFORE THE LEGAL OUTCOME. AND, UNDER THE ETHICAL RULES OF THIS STATE, LAWYERS CAN AND WILL PROVIDE LEGAL SERVICES ONLY PURSUANT TO A SIGNED FEE AGREEMENT WITH DEFINED SCOPE AND TERMS OF PAYMENT.

## A NOTE FROM THE AUTHOR

This book is not an introduction to law that may apply to your business. For that take a survey course of business law at your local college or university (or buy the textbook and read it). I taught that course and could expound on general principles. But that is “basic training.” This is knowledge for “special operations.”

In this book I talk about how to deal with your business partners both to structure the deal and to minimize the negative consequences of business divorce.

You will learn how to prevent your key employee –who may be the “wolf inside your door” – from destroying your business.

We will discuss dealing with landlords, the landmines of leases and how property law can be different from other law. Think about it: When is the last time you called someone “lord?”

You will learn key “ins & outs” of buying a business, of moving from layoff or retirement to business ownership, and the ropes to skip and the

ropes to know about buying and selling your business, and many other things.

All of this is advanced stuff. Usually business owners learn this the hard way. Many never survive the lesson; some never learn. And even many lawyers do not know this because business is not their thing (These days in a business town like Phoenix it is popular to call yourself a "business lawyer") Clients tell me that some of these lawyers don't know what to do; they don't have a clue, especially about small business. I do. I was a businessman before I became a lawyer. Now I am both of these and have been for many years. You don't have to reinvent the wheel, just learn from my experience.

The bottom line is that the law, like money, is a powerful tool. Give me the law and you the money: I'll get the money. Remember that the next time you want to "forget lawyers." I appreciate the sentiment, but lawyers, like soldiers, are necessary. Ignore or forget about them at your peril.[1]

[1] I read in the bookstore about the "false assumptions" people bring into relationships. The same principle applies here. Your business is a series – a group – of relationships: with your partners, employees, vendors, your landlord, customers and advisors. One common false assumption is that you can do business without professional expertise. This is like rolling the dice on health insurance and hoping you don't get sick. Eventually, you will get sick, and if you don't have health insurance you have a serious problem. But using lawyers is not just remedial – or even also just preventative. The party with the lawyer who engages in pre- deal or pre-litigation management, "framing" (like a snapshot) how the deal or lawsuit will look can add value to the case, make it go smoother and make or save you some serious money.

# INTRODUCTION

## A BRIEF WORD ON THE LEGAL SYSTEM

The legal system is not your friend. Courts in the area of business law are not welfare agencies, but expect you to protect yourself first. If you haven't protected yourself by doing what a reasonable person would do, then your lack of due diligence may bar legal remedies.

Lawyers are not neutral; they are either for you or against you. Make certain legal mistakes and the law and legal process can become your worst nightmare.

But the law, the legal system and lawyers can serve you if you know what to do and how to do it. That is what this book is about.

The chapters of this book do not deal with business basics, but the "minefields" of business practice, where failing to the right things and to do them right can destroy your company.

These mistakes are common, ordinary and disastrous. The good news is, as I counsel my clients:

"We can identify most, and get rid of some of the landmines. Those we cannot get rid of for now, at least you know where they are."

Another self-quote: "A common result of doing business is that somebody is always unhappy with the deal. My job is to make sure that it is not you."

# CHAPTER ONE

# YOUR BUSINESS: THE BASICS

Starting a new business? Need some advice from someone who has been there? Or, if you are already in business, do you need a refresher course?

Giving advice regarding starting a new business is a little bit like the blind man describing an elephant: it depends on where you are standing. For example, a government official will focus on permits, licenses and taxes; an accountant may emphasize accounting, payroll and tax issues; and a marketing person will develop your identity, brand and unique selling proposition.

As a lawyer I consider the following items to be important in starting your business:[2]

**1. An entity:** Does a corporation make the most sense for your company? Or does a limited liability company (LLC) make the most sense? Note: You can form a corporation or an LLC from a worksheet you get online, but that will not include the Operating Agreement, Minutes or EIN number. Or the advice needed to make sure you have the correct entity, and that it has been modified, if necessary, to meet your needs. All these factors are very important. But it's fine if you want to try to do it without advice from a professional. As a plumber once said: "We like 'do it yourselfers.'" Both lawyers and plumbers make more money cleaning up the mess created by the inexperienced, and then doing the work over again correctly.

**2. Source of Capital:** Will there be investments from out of state and/or by a person not active in the management or operation of the company? Be careful. This could be a securities law violation with criminal penalties. There is a good reason you can't sell securities or investment contracts on Craigslist without getting a letter, or even a personal visit, from the Attorney

[2] This list is not intended to be exclusive or "the" list. I will add things as I go. But, for the most part this advice is not limited to Phoenix or Scottsdale, or even just to starting a business in Arizona, but would apply an any state.

General's Office. Have a clue; if you are selling interest in a business, you need an attorney. There is a way to do this right.

**3. Business Plan:** Can you fill in the blank in 25 words or less? "The reason why people should buy from me and not my competitors is _____" (If you can't answer this question reasonably well, then stop what you are doing. You are probably not ready to launch). Second test: I will survive with fewer and inferior resources than the more established and well-heeled competitors in the industry because _____ (new industry, niche market, what?). Nobody cares that you worked and saved for 25 years to open your business; customers care if you have something they want and if what you have is better, or a better value, or more convenient, than somebody else's product in the same industry.

**4. Your Team**: The newer you are to business (and usually the less you can afford it) the more you need a team of qualified professionals (lawyer, accountant, marketing expert, tech guru, etc.) not only to get financing or investment, but also to get business. Major clients, investors and bankers do "due diligence," which means they check out your legal and operational preparation, i.e., your professionalism and real-world ability to perform. They do not want to get left "holding the bag" of unfilled orders, lost money, breached contracts, unpaid loans, etc.

**5. Due Diligence:** Have you checked out the industry and the viability of your ideas on the market? Are you really the only one to have this idea of starting this new business in Arizona? Great ideas tend to happen at the same time. Is someone else launching this new business in Phoenix or Scottsdale or Flagstaff with the same idea? Is it somebody else's idea but you can do it better? That's OK, if it is. Starbucks didn't invent the coffee house, Microsoft the computer or the idea of software, etc. But they prepared and executed their product and business plan better than anyone else.

**6. StartUp Capital:** Do you have the money to build your "legal brick house" and avoid "the ten common mistakes that business owners make"? (These are titles of other articles by me.) The money for legal stuff such as

your entity to ensure limited liability, the owners' buy-sell agreement (a business pre-nuptial), a federal trademark, trade name, copyrights, lease review, key employee agreement (non-competition agreement and/or confidentiality agreement), asset protection and general advice regarding organizational engineering is *not* an expense. It is an investment in the legal foundation of your business. So invest $10,000.00 up front on your legal brickhouse, on top of the money for tables and chairs, and set up your business properly. A business is like a child: you will spend a lot of time feeding and nourishing it – and you must be there when it needs you. Your life will be much easier if you build your legal house well, starting with the foundation. One quick example: Getting a letter from an attorney telling you that you cannot use your new business name because someone in Ohio has a federal trademark on it. If you find out soon enough, this is fine. However, after you have invested $100,000 in brand and customer goodwill, it is not fine. The same point applies as well to your accounting, marketing and technology. (This being said, I am well aware of what I call the "$3,000.00 decision". In fact, I wrote a book about it entitled Inside the Firm: The Inside Story on Choosing and Using a Lawyer, available on Amazon.com. Anyway, when I was a business person, before I became a lawyer, I would have, say, $3,000.00 for my new venture. I knew I needed legal, accounting, marketing and technology help (probably just "needed help" period) but I could not get everything done for that amount of money. New business owners have this problem, only today the amount may be $10,000.00 or more. So, what to do? Answer: List the things that you have decided are important. Some things you can eliminate, e.g. if your business is at home, then you can skip the lease review. By the way, an article by another associate of this firm, Jo Ann Joy, on organizing your home office is also available on my Firm's website. Prioritize your list. Then, as soon as you have the money (and something to lose), come back and do the next thing.

I hope this partial list helps. If you need further help, you can always make an appointment with my firm. And, by the way, the appointment is free if you hire us for other work; that is, we will apply the consultation fee

(designed so I don’t wind up working all day for free) to your entity, trademark, contract, litigation, or other matter.

# CHAPTER TWO

# BUYING OR SELLING YOUR BUSINESS

I am a business attorney in Phoenix Arizona. I've seen the same things over and over during the years, and have worked up a list of general tips for buying and selling businesses. I have tailored my comments to Arizona, because that's where I practice, but these general principles should apply anywhere.

## 1. Buying a Business.

### A. Business Brokers, Pros and cons:

Business brokers are a good place to find a business. They often have good qualifications; some are attorneys or former attorneys or accountants. And they understand financial statements and doing the deal. However, brokers cannot give legal advice, and therefore avoid addressing many legal issues, leaving many matters unresolved. And, the broker has each party sign a Disclaimer stating the parties relied on themselves and each other and have no claims against the broker for any problems that arise after the deal. Business brokers take an extremely high commission right off the top (discussed below in the section on SELLING YOUR BUSINESS). Because brokers get paid only if the deal closes, they have no incentive to work with intermediaries like lawyers and accountants who might complicate or even "kill" the deal when the business' information doesn't add up. Brokers simply want to get the deal done and to get their check, which check can often exceed the down payment to the seller (see below). By all means do NOT use the broker's purchase/sale forms. They are written to please both the buyer and the seller with, typically, inadequate protection for both, and a waiver to protect the broker from the later resulting fallout. What often happens is as follows: the deal closes, then issues that should have been handled prior to the closing arise, but with no language in the contract to deal with the situation, and no liability for the broker. This leaves the buyer and seller looking at each other, asking themselves: "What did we just agree to?"

**B. Due Diligence in the Purchase of a Business**.

"Due Diligence" is the process of investigating a company to determine its financial performance, goodwill and reputation in the industry and community. Market and personal changes are often undisclosed. Usually the stated reason for selling is not the real reason, and the law will not protect those who do not protect themselves to a reasonable degree. While the seller cannot knowingly or negligently misrepresent the business, YOU have the duty to ask the right questions and to get the answers. Often this law firm confronts the situation where the buyer asks for documentation, but the seller convinces the buyer that it is not necessary, is not available, would come later, etc. Often these answers are untrue and just "stonewalling" in the hope that you will say "Never mind" and buy the business anyway. Don't do that. You may wind up, as one client did, paying $55,000.00 cash for a piece of equipment the seller did not even own; it was leased. Brokers often have "Disclosure" forms that they have the Seller prepare, but if you compare that form to the Disclosure Form a house seller must complete in Arizona, you can see how inadequate the typical broker's Disclosure form is. However, it can be a good place to start.

C. The Agreement for Your Purchase of a Business.

Whether you are buying a business in Arizona or selling a business, it is NOT a form transaction. Clients sometimes do not understand that legal representation in the purchase or sale of a business is an adversarial transaction – a zero sum game; that is, what one party gains the other loses. You will see this by comparing some examples of what the buyer wants and needs in the transaction versus what the seller wants and needs (as discussed in the next section).

For example, the buyer will want the contract to include extensive "Representations and Warranties," including provisions which state the seller has the right to sell, the sale will not breach any other contract, the company and or assets are being sold "free and clear" of all liens and encumbrances, and the sales, net profits, assets and net worth of the

company are as portrayed in the company's financial documents which the buyer reviews as part of Due Diligence. These Representations and Warranties can go on for a page and a half. In contrast, the Seller may want the contract to say the business and its assets are being sold "As Is" with no representations or warranties at all. Obviously, this is a huge conflict and helps explain why hiring one attorney to represent both sides, -- or just using a "form" -- is a recipe for disaster (I put quotation marks around "form" because to quote myself: "there are form documents only to non-attorneys"). In the real world "one size does not fit all" and the contract must be tailored to the facts and circumstances of the deal. Frequently the contract reads fine because what is in there is agreeable. It is what is not included, and should be, that frequently causes the problems later.

The buyer will also want a non-compete. I had a client who came to me (after the sale) where the hair salon seller packed up and moved across the parking lot and opened a new salon. It turned out the business sales contract did not prohibit that. The customers walked across the lot to the seller's business, and so the buyers got next to nothing for their money. These are just a few of many examples. Bottom line: buying or selling a business is one of the more important events of your life and needs to be treated as such.

## 2. Selling a Business.

When you are selling a business the same considerations apply (as those discussed above) except in reverse.

### A. The Business Broker.

In addition to the dangers and considerations mentioned above, some key points for the Seller in using a business broker are determining the purchase price and commission. Brokers sell businesses, and typically they know what they are doing. For example, the typical small business has a relatively low net profit, for reasons which include the following: high owner salaries (e.g. paying oneself a $100,000.00 salary when you could hire a manager for $60,000.00), use of company funds like credit cards for quasi-personal expenses (like cars, art on the wall, etc.). The business

broker knows this and will help you add back a fair portion of these expenses to obtain a true picture of the company's earning power and cash flow. Then, the broker may use a multiple – based on industry standards – of this adjusted net profit or cash flow to determine the company's "fair market value" (whether it is fair or not is the buyer's job to determine in Due Diligence). This fair market value becomes the "list price" or "asking price" of the company. This "add back" process is good because it adds value to the seller. A negative point to the seller for using a business broker is the commission, which is typically 12%! And, typically the broker takes this commission right off the top. So, for example, say you are selling a business for $100,000.00. Because you need to transfer the business and/or its assets free and clear of liens this means that you must use the sales proceeds to pay off company debt. Let's assume the company has $60,000.00 owed to the bank, $10,000.00 on credit cards and open accounts with vendors of $20,000.00. This adds up to $90,000.00. So this would leave a $10,000.00 profit to the Seller (of course a real company may have more or less in value versus debt). EXCEPT that the broker would get 12% or $12,000.00 off the top. This means, in this example, the Seller would get nothing, but instead would have to come up with $2,000.00 out of pocket to close the deal. This is the "catch 22" that sellers face when using a broker: They may not be able to afford to use the broker; but also may not be able to afford not to. Sometimes, brokers will negotiate pay out of commission as money is received, but do not count on it, and they won't typically be generous because problems often arise later as mentioned above under Buying a Business in Arizona. They would prefer to "take the money and run.'

### B. Due Diligence in the Sale of a Business for the Seller.

Selling a business – or buying a business – requires some work. For the Seller, "Due Diligence" means producing information for the potential Buyer to review. This can be dangerous because the potential Buyer may simply be a "wolf in sheep's clothing" who wants to learn your trade secrets and steal them. To help protect yourself you will need one or more of the following: (1) a Non-Disclosure Agreement, saying they can't use or disclose the information, with legal remedies stated, and (2) a Letter of

Intent, including, among other things, confidentiality provisions. You as the business seller also need to protect yourself from unintended representations. Material misstatements or omissions are legally actionable. Suits based on alleged fraud or negligent misrepresentation are common outcomes in the purchase or sale of a business, especially where the contract has strong "Representations and Warranties" in favor of the Buyer, as discussed above. As a general rule "hiding the ball' or "delaying the game" by withholding information or holding back its production in the hope the Buyer will buy anyway is a strong signal to the Buyer that the Seller is not trustworthy. Chances are slim to none that a Buyer represented by a business lawyer would allow the sale to continue until the information was furnished and evaluated, or in the alternative, stipulations made. This is just one of the many advantages of having a business attorney who practices business law on your team. But, Buyers are often anxious, and if unrepresented by business legal counsel, may make hasty deals. This may result in litigation, which can be a life altering event for both the Buyer and the Seller.

### C. The Sales Agreement for the Sale of a Business.

As we discussed above, the Seller would like to sell their small business or owner-operated business without any – or as few as possible – representations and warranties. This probably will not happen. The reason for this is that, in many ways, what the Buyer is buying is the "legal stuff," e.g. the representation that the business is free and clear of liens, that the Seller owns it, that the stated financial performance is real and that the Seller will not compete for the same clients, in the same trade area, and/or in the same type of business, etc. So, careful negotiation of these points is necessary. Also very important for the Seller are the "loan documents." By "loan documents" I mean the promissory note, security agreement and, perhaps, personal guaranty that the Buyer will sign if the Seller finances the deal. Generally, wherever possible, the Seller should attempt to avoid financing the deal – at least no more than necessary, because what happens in the common event of a dispute is that the Buyer just stops paying. Obviously, the buyer could not do this if it borrowed the money from a bank rather than you. But, for small businesses or owner-operated

business it is common for the Seller to carry back part of the loan. In this case the ability to collect the amounts due is only as good as the loan documents. It is very important that the Seller have a business attorney draft or review these documents.

These are just some of the things you need to know about the purchase of a business or the sale of a business. As stated above, these statements are based on Arizona law. You would do well to seek local legal representation and advice for your particular matter.

# CHAPTER THREE

# MANAGING THE TRANSITION: FROM LAYOFF AND RETIREMENT TO OWNING A SMALL BUSINESS

## 1. The Crisis of Opportunity.

We are told that crisis and opportunity share the same Chinese symbol. So it is that a layoff or a forced retirement can lead to a new life owning and operating your own small business. But the interplay between crisis and opportunity can work both ways: you can make a bad situation worse if you start a business for the wrong reasons, or run it in the wrong way.

Business attracts active, self-reliant people. The worst thing that can happen to an active person is to sit at home with no reason to get up in the morning. The prospect of retirement does not sit well. Therefore, owning a business can seem like a dream can true. And, it can be, but here are some "rules of the road" for taking that path;

## 2. Don't Buy a Business Just Because You Are Bored.

As my father told me "You really have to have what it takes in order to succeed in business." If you don't love the prospect of constant challenges and work, it isn't for you. In many ways business is war; can you live on your wits? Direction followers usually don't make good independent business persons, although they may work well in the structure of a franchise organization. In addition to having a good skill set, an entrepreneur needs to be self motivating and is always solving problems. These qualities are essential for actualizing a dream.

## 3. Buy Into The Reality, Not The Dream.

I sold a business to a woman who had the idea in her mind of having tea with her friends and discussing her fashion business. She had no more aptitude or attitude for business than I do for having tea. I sold to her her own dream. I asked her: "What do want from a business?" She said: "X, Y and Z." I said, in effect: "Imagine that. One neat thing about this business is

(you guessed it) ‘X, Y and Z.” And, so she bought the business. When she awoke from the dream and confronted the problems of payroll, staffing, customer relations, taxes and other joys of business, she was miserable. The business closed not too long after that.

**4. Don’t Be In Too Big Of A Hurry.**

An essential process in buying a business is “due diligence.” As I say elsewhere in this book, courts are not social welfare agencies. In business cases the courts hold you to the reasonable person standard; that is, you are expected to do the investigation and/or seek and get the expert advice a reasonable person would when making an important decision such as buying a business.

What happens – I know because I have been there – is that two or three months go by and the psychological need to “get busy” becomes almost overwhelming. It is a little like not having a date for a while; a lot more people start to look good. I have never seen a deal entered into hastily that turned out well.

**5. Realize What You Would Be Getting Yourself Into.**

Starting a business is like having a baby. When it cries you have to be there. Having a baby at 50 would not work for everyone. The days are long and at first the money is not good. Your key employee will quit the night before your first vacation in five years. Like a jealous lover, your spouse may complain about the business as the “gigolo” or “mistress” of your life: the business takes much of your time and passion away from your relationship.

**6. Beware the Business Broker; Use Neutral Advisors.**

The good news about business brokers is that they usually have many good businesses for sale. And, they usually know a lot about the process and can explain it to you.

The bad news is that when a broker works for a commission -- a percentage of the sale -- a broker always works for the seller, i.e., if the

business doesn't sell, the broker doesn't get paid. So, brokers help the seller 'restate' the earnings (I'll talk about this more below) to make the deal look better to the buyer. The result is a higher sale price, and therefore a bigger percentage for the broker. Brokers want to make their 12% commission bigger, and even when the profit is small for the seller, the result is that often half or more of the profit of the deal goes to the broker.

"Restating the earnings" from above means adding back discretionary expenses to the net profits upon which the purchase price is typically based. Examples of this are expenses for art on the wall, car expenses, meals, vacations booked as business trips, etc. Business owners often do this – it is one of the benefits of owning your own business – but you can see that it could be overdone, and make the overall business expenses look greater than they really are. As a consequence, the purchase price of the business could be overstated.

As I said, the broker is paid on commission, which of course he/she does not receive unless the deal closes. A commission of 12% can create a powerful conflict of interest, and not just to close the deal, but to jack up the price as well. A commission of $24,000.00 on $200,000.00 is even better for the broker than a commission of $12,000.00 on $100,000.00, right? Who cares if the true value of the business is $100,000.00? The broker has his commission, and a release, signed by you, to prevent you from suing him. So the broker is a salesperson, not a neutral advisor. He/she has no incentive to raise practical or legal issues such as your emotional readiness for this endeavor or obvious conflicts between the seller and the buyer. For this reason, neutral advisors such as attorneys and accountants you hire yourself are preferable: they are paid to be critical, and get paid whether the deal closes or not. Even experienced businesspersons use their team of lawyers, accountants and valuation experts to get the best deal. We are paid by the hour and so get paid whether you do the deal or not. A large part of a law firm's practice is return business over time. If we help your business stay viable from the beginning, we can look forward to performing your legal services far into the future. And not only do we have no incentive to mislead you, we have a State-enforced duty to represent you to the best of our abilities.

Elsewhere in this book you will have read my “skyscraper speech:” As I look out my office window I see the high rises. They are filled with lawyers and accountants. People use them, not because they like them, but because they bring value to the deal.”

## 7. Conclusion.

Rational thought and objective advice can help you make the successful transfer from lay-off or retirement to success in your small business. Just take your time, do it right and good luck!

# CHAPTER FOUR

# WORKING BEYOND YOUR MEANS

## 1. Character as Destiny: Sometimes That's Not Good.

Ralph Waldo Emerson, who wrote the essays *Self Reliance* and *Compensation*, among others, would have loved my law firm clients who, just to name a few of their good character traits, tend to be hard-working, self-reliant, persevering and intelligent. In short, they have "character." Too often, however, these good character traits cause them to fail. "How can this be?" you may ask. The purpose of this chapter is to answer that question.

We'll start with the general proposition that our assets can often be our liabilities. For example, single-minded focus can become tunnel vision. Consensus building can become pleasing. Strong values can become rigidity. Spontaneity can become lack of discipline.[3]

## 2. Skill Sets, Value Propositions and the Importance of Having Structure.

We'll add a second basic observation that none of us are good at everything. In business this can work this way: Tony is a friendly, out-going, service station owner in his standard issue grease-stained blue coveralls with the red rag in his back pocket. He pumps gas and fixes cars for the residents of his neighborhood. He does well because people like him and trust him and he is nice to talk to. So, Tony succeeds and prospers. He then decides to open a second service station in another neighborhood across town, and does so.

What just happened? A lot of things, including logistical challenges, but the issue we address now is that of growing beyond one's expertise. Tony built his business on his personality and good service. However,

[3] For fun I gave my ASU students a five-question personality test to determine the characteristics. Whether or not you accept the results, i.e. your personality, the indisputable truth is that we process the "data of the world" differently. Same world, but different.

Tony now has to work through others (and also must establish onsite management). This is a vastly different organization than the one Tony built at first. And this may become an example of the so-called "Peter Principle": the process of growing beyond one's successful skill set.

What Tony did will take him away from his "skill set". He has shifted away from the business core strengths and the character the customer has come to expect (the "value proposition"). Even if we assume Tony has an MBA in management and so could handle the expanded management challenges, the fact would remain that he built his business on the value proposition of personality and personal service. Tony cannot be in two places at once, and so cannot offer that value set as well with multiple locations. From a marketing point of view, the "Unique Selling Proposition", he has changed the deal.

### 3. On Acting Your Size.

Another aspect of the consequences of growth is the structural change mandated by the change in size. As shown by Tony's service station hypothetical, a change in size can cause a change in organizational structure.[4] J.B.S. Haldane in his essay "On Being the Right Size" pointed out that living things, whether elephants or insects, work at the size they are and would not function if shrunk or expanded. A fly, for example, would be crushed under its own weight if it were the size of an elephant. Haldane explained that, under the laws of physics, as we double the size of an organism, its volume weight increases by the cube. This is one reason why business costs can so easily get out of hand (but that is the subject of another article). Here, the point is that as a business grows, like an organism and other living things, it not only grows *quantitatively*, but *qualitatively* as well; that is, as it grows, its structure must change. And, if the structure does not change, then the organization, like the organism, will fail. Witness what happened to Tony's business in the example above. It might not do as well at twice the size.

[4] In the above example we used a second service station to represent the increased size because it makes the point easily understandable. But, the same issues of "skill set" and "value proposition" would hold true if Tony's one service station became a mega-station with 14 pumps, a supermarket and a gift store. He would no longer be running the business (as much) based on his personality and personal service.

## 4. Over-Reliance on Character as a Cause of Business Failure

All of which brings us back to some of the reasons why my business owner clients fail in spite of their Character:

A. They over-rely on their Character strengths until they become a liability.
B. They expand beyond their skill set without adapting.
C. They grow beyond their original value proposition to their customers (e.g. become too "corporate," e.g. chain stores).
D. They don't become "corporate" enough in dealing with the structural changes required as a result of company growth.

The business must add "Structure" to deal with growth. By "Structure" I mean adopted company objectives, job descriptions, policies and procedures – what I colloquially call "Roles, Goals and Controls." Bottom line: The business must implement structure to replace Character.

In my experience many entrepreneurial companies, especially founder-created, owner-controlled organizations, still operate as if they were sole proprietorships; that is, the founder-owner calls the shots. A primary cause of this may be that the founder has, or had, Character. The company may be a "Character-based" company. Depending on the owner's skill set, this will work for a while. But eventually, like the "elephant-sized fly" the business may crush under its own weight due to the lack of supporting structure. One example of this "crush" is internal dissension. For example, my firm handles many disputes between and among business owners. Whether the owners are members of a limited liability company or shareholders in a corporation these disagreements generally fall under the rubric of a "partnership dispute."

One form of partnership dispute is where the company founder makes all significant decisions. For a sole owner, of course, this works. But often what happens is that as the company has, or adds, 'partners,' who expect to have some say along with their investment. And, as the business grows the breadth (i.e. across disciplines, e.g. accounting, marketing, management, engineering, etc.) and depth (money at stake and

other consequences) of the decisions grows and can become vastly more important to the company's viability and success. Yet, the company founder, say our friend Tony, may still be making all the decisions. The company may still be "Character based."

This causes some obvious problems in addition to the ones discussed above, including (i) the role of the minority owner, and (ii) corruption. Over and over again I see the founder treat other owners of the company, whose ownership percentages may be, say, 30% or more, as if they were just passengers along for the ride. In the founder's mind they have no real say in where the company is going and/or how to get there. But, except under the highly unusual legal circumstance of (what I call) "King Tut" authority under an LLC Operating Agreement it is *legally wrong* for the founder-majority owner to refuse or ignore the input of the company's co-owners. In fact, among other things, the majority owner(s) owe a fiduciary duty to the minority owners; that is, the highest duty of loyalty, honesty, trust, integrity, etc. This is a "big f**king deal" as Vice President Biden would say.

Worse, the system, or lack thereof, may lead to corruption (defined here as "inappropriate decision making procedures"). For example, a star salesperson, who may or may not be an owner, goes to the founder and asks for a car. The founder agrees. Whether or not the salesperson deserved or needed the car is not the issue; the issue is how the matter was handled. Buying a car for the salesperson may be $20-$30,000.00 out of the pockets of the owners, who with an LLC would have been paid their share of this money as a part of their K-1 distribution. Now that money is gone and they had no input into the decision.

And this is but one example: In my practice variations include payments to other businesses owned by the founder, compensation for duplicate wives and families, mistresses, condos, faith healers, drugs – you name it. So, at its worst, character based decisions can become a function

of “old friendships,” “ass kissing,” good mood, whim, etc. instead of what it should be a function of: standard operating procedures.[5]

On behalf on my clients, the forgotten owners, I attempt to present policies, procedures and job descriptions. If the company is an LLC I can do this in the Operating Agreement by specifying who has what authority and how decisions outside of the ordinary course of business (after defining that) will be made. This modest and reasonable, though usually resented and initially- rejected approach, is a setup. The setup is that if the founding character rejects the implementation of Structure then my letter, and the attached memo of proposed “Standard Operating Procedures” become “Exhibit A” in a lawsuit including possible claims of negligence (mismanagement), breach of fiduciary duty, perhaps misappropriation, etc. The founder, or dominant owner, is then forced to defend against our request to run the business as a normal business is run.

## 5. The Right Way to “Go Corporate.”

Some companies “rue the day” when they have to become corporate, e.g. Ben & Jerry’s Ice Cream, who had to make dollar-decisions in favor of their hedge fund shareholders which they would never have made before – and legally they had to. But, this is not really what we are talking about. Here, we are talking about having internal controls, including the hiring of persons whose job it is to do “X” and who is held accountable for that. There is a saying that: “If everyone is responsible no one is responsible.” A corollary to this principle might be: “If the founder is responsible for everything the organization can only grow so far as the founder can meet the organization’s geometrically increasing need for different – and increasingly specialized – skill sets ( a good personality and personal service can only take the business so far. In fact, the old paradigm of a “shoe shine and a smile, i.e. building relationships over time, may be completely ineffective in the Internet world (As much as I like ‘Julie’ at Neiman Marcus it may be faster, much more convenient, and even cheaper just to buy online).

[5] A case I guess of absolute Character corrupting absolutely.

When I was a young man there was a band called the Pott (short for Pottawatomie or something like that) County Pork & Bean band. They looked and sounded a lot like the Grateful Dead. They wore overalls and had hand-painted speakers of black and fire engine red. And they talked in a “down home” manner of speaking. But all of the guys were college grads and all of them bought and paid for farms or made other sizeable investments from their earnings.

One day I was looking at their equipment and realized that behind the humble façade the band had the best and most sophisticated instruments and equipment available. The point I learned: be as sophisticated and “uptown” as possible behind the scenes (i.e. internally) and as downhome (i.e. down to earth, easy to talk and relate to) externally. In a nutshell, going corporate inside does not mean you have to go corporate outside.

## 6. Conclusion.

But, going back to Character and the trouble it can cause you and your owner-operated business: If you, as a small business, don’t add the “Structure” of Goals, Roles and Controls internally to support the volume weight of growth, then the business will either be crushed by the weight of organizational problems and internal dissension or it will “max out’ at the level of skill and time contributable by the owner.

I see it all the time: The company may grow rapidly from nothing to $4-5,000,000.00 based on its owner’s character, skill set and value proposition, then will stop growing as the founder still tries to do and decide everything. Sometimes the founder acts or reacts “jealously” over power, or greedily over money (because the company is “my baby”); sometimes the founder or dominant owner acts “valiantly” (because, the founder feels, “Nobody can do it as well or cares like I do”, which may be true up to a point). But, even the valiant founder will stifle the organization’s growth and success if structure does not augment character.

Whatever the reason the failure to add structure to character will stifle, if not destroy, the company.

# CHAPTER FIVE

# ENFORCING (OR ESCAPING) COVENANTS NOT TO COMPETE[6]

The "Great Recession" has brought to the forefront the issue of the enforceability of confidentiality or non-competition agreements, especially in the realm of sales and even more particularly in computer and software services. The most common, but not the only scenario, is employee noncompete agreements. The employer may need to lay off a good employee who has information valuable to a competitor. Even without a layoff, the employee may fear job loss or have suffered a cut in pay or benefits, so may be looking for greener pastures. Actually, the problem can get much worse for the employee. A prospective new employer may not hire an employee who is subject to non-compete; the former employer may not release the employee from the non-compete because it keeps the employee off the market during the non-compete period. This scenario is especially likely where the employee leaves under unfavorable circumstances. Unfortunately, "dirty pool" can be the rule in business.

## 1. Types of Non-competition Agreements and Where They Are Used.

Non-competition and confidentiality issues also arise in the context of business "partnerships" (by which I mean a business which has two or more owners). Partnerships often do not work out, and not just because of obvious problems of greed, but also due to differences of opinion, values, management style and money earned. A common fallacy of the business startup is the idea that if the owners have the ideas and money to *start* the business then they will each earn enough to make a living. That doesn't follow: Putting $100,000.00 into a business does not mean that you can each pull out $100,000.00 – or even $50,000.00 – or even anything, for a while. So, often somebody stays and somebody goes. Generally, this

[6] This chapter is written under Arizona law. Some states, like California, are reputedly more hostile to non-competition agreements. Some, like Illinois, are more liberal – at least in some contexts, like a business sale. So the reader is strongly advised to see a local lawyer for specific advice and **not** to use and apply the general information of this or any other chapter of this book except to ask questions.

problem falls under the rubric of “partnership dispute,” but it often leads to what we at the Law Offices of Donald W. Hudspeth PC call “business divorce.” Business divorce raises many issues, many of them similar to a personal divorce. Someone may “act out” by changing locks, seizing bank accounts or customers, etc one of the immediate issues is the right to compete.

Non-competition and the duty of confidentiality can be especially troublesome in the event of business divorce, i.e. where one or more “partners” leave. Not only may the partners (i.e. owners) be subject to a non-competition provision in an employment agreement, LLC Operating Agreement or Buy-Sell Agreement but even if not they are, for as long as the departing members are still owners of the business, they cannot lawfully compete with the business. The reason for this is the “fiduciary duty,” or, at minimum, the duty of loyalty,\ the business owners owe to each other and to the business. A fiduciary duty is the highest duty imposed at law. It is the same level of duty that a trustee has over the assets and income of a disabled person: that is, the duty of absolute loyalty, honesty, trustworthiness, and integrity.  This is one reason why the “buy-sell” agreement is so important. A buy-sell agreement is like a business “pre-nuptial:” It specifies the events, such as divorce, disability, dissociation or death under which the company, or other owners, may or will buy the ownership interests of the departing owners, and sets the price (or formula for determining same) and terms of purchase. This saves a lot of time which would otherwise be spent on arguments and money spent on attorneys’ fees to resolve the issue.

But, non-competition issues in the business divorce setting are beyond the scope of this article except where the departing owner is subject to such “restrictive covenants,” as they are called in a written agreement (again, for example, a confidentiality and non-compete agreement, an employment agreement including same, an operating agreement, or a buy-sell agreement).  In this case, again, you have a business on one side and the departing owner or employee on the other.

And, we here at the Law Offices of Donald W. Hudspeth PC get questions from both sides of the confidentiality and non-compete issue.[7]

## 2. Elements of An Enforceable Non-compete Agreement[8]

So, in general, what makes a non-competition agreement enforceable? First, we need to deal with a common misunderstanding that non-competition agreements in Arizona are not enforceable at all. This was true, or more true, ten or fifteen years ago when the typical agreement was so badly written that more often than not they were not enforceable. But that is not true now. Today most non-competition or confidentiality agreements that I see are enforceable because they have been drafted by an attorney and because attorneys know that in many states, like Arizona, the court will no longer re-write and enforce a non-compete agreement on weaker terms (the rule under which courts would do this was called the "blue pencil rule"). Instead the court will say "yes or no," which means that the agreement must be more conservatively written to be enforceable.

To be enforceable in Arizona, and in most states, a non-competition agreement (aka "non-compete") needs to satisfy three criteria:

### A. "Consideration"

Payment of some kind is given in return for infringing on the employee's liberty to work where and how he or she pleases. The best way to do this is to say the agreement is made in return for "good and valuable consideration, which the parties acknowledge to be adequate," and to attach the Compensation and Benefits as an exhibit to the agreement (or

[7] There is also the issue of the enforceability of a covenant not to compete related to the sale of a business. Here public policy supports reasonable restrictions on the seller's right to compete because, arguably, the business purchased would have little or no value were the seller allowed to compete. But still, there is no "blank check" of enforceability.

[8] Strictly speaking, in general, a "non-competition agreement" prohibits not only the solicitation of service but also any contact with and or provision of service to a customer while a "non-solicitation" agreement (or non-competition agreement written as such) prohibits only proactive sales activity. This difference can be important in this high tech age where employees may be allowed to use their personal cell phones and laptops in company business. In that case the employer must have a non-competition agreement, not just a non-solicitation agreement. But the greater the restrictions the more the courts will scrutinize the provisions. As stated above in the general disclaimer all of the articles on this site are intended to be general information. One fact can change the entire analysis. So, "Don't try this at home," Have a qualified and experienced *business* attorney review the document. The cost is low and the stakes are high.

otherwise state the form of payment in the agreement). This way the same agreement, except for the monies and benefits paid, can be used for each employee.

**B. It must be ancillary to a broader agreement**

The confidentiality and/or non-competition pledge is related to another agreement. A good way to do this is to, again, have the "restrictive covenants," as non-compete and confidentiality agreements are called, be part of the employment agreement. (By "employment" agreement I am including what could be contracts with bona fide independent contractors.). And,

**C. It must not violate public policy**

That is, it must be reasonable in geographic area and time so that we do not have doctors working at Starbucks because they signed a non-compete. That is an outcome that would violate public policy.

This latter requirement, i.e. reasonableness of time and scope, is where non-competition agreements commonly failed in the past. Businesses would incorrectly assume that if they got the employee or partner to sign the agreement, then it would be enforceable as a signed contract, like most other contracts. But, that assumption was not true in this case because of the strong public policy to protect workers' right to work, earn a living, and practice the trade for which they are most suited. An educated, trained and skilled worker working in the areas of his or her knowledge and experience benefitted both the worker and society. So, many of the early agreements got thrown in the trash, legally speaking, because they were not reasonable. "Back when" a contract *might prohibit a departing engineer from working in the State* of Arizona for *ten years.* Today, the same agreement more likely would be drafted to prohibit the departing employee or partner from working in the industry within *ten (10) miles* of the business for a period of *six months to a year*.

### 3. The Enforceability Pyramid.

The validity and enforceability of the covenant is a function of what the restrictive covenant seeks to prevent. This can be explained by what I called the pyramid of enforceability. At the bottom of the pyramid of enforceability is a blanket prohibition of the employee from working in the industry, e.g. prohibiting a doctor from practicing medicine in a certain area for a certain length of time. Obviously, this prohibition raises public policy issues. It is not good for the doctor or society for the doctor not to be able to practice medicine. We need a careful balancing between the interests of – and potential harm to – the medical clinic where the doctor worked and the harm to the doctor and his or her patients.

A. **Choice:** First, the consumer, here the patient, has the absolute right to choose and use the doctor of his or her choice. Generally, the patient's rights trump that of the clinic. So, usually, it is not really a question of whether the doctor can see the patient; the doctor can. The question is whether the clinic has an interest in the monies which the doctor earns from that patient. But, as a practical matter, if the doctor cannot earn money from seeing the patient, then he or she probably will not do so.

**B. Right to work**: In Arizona, in deciding the issue of the doctor's right to practice medicine (not with old patients, but in general) within the former employer clinic's trade area, the court essentially asked the question "How often does a patient see a doctor?" Six months? Then, it decided that six months was the time period for which the restrictive covenant of practicing medicine in the trade territory would apply. Recovery time, or how long it would take for the business to recover from the loss of the departing partner or employee seems to be another consideration in this right to work analysis. So, beyond the six month recovery period the doctor could practice medicine even in the old trade area.

However, Arizona has a "wrinkle" on the employment restriction. Not only can the employer prohibit the former employee from working in the industry and trade area for some period, which may be up to a year, but also the employer may prohibit the former employee from working for

"major competitors". Thus, it is that a major chain store mattress sales person could not work for another major chain mattress seller (defined as doing more than 50% of its business in selling of springs and mattresses) for a while, so would up selling mattresses at Sears.

**C. Confidentiality and Trade Secrecy**: The next level up on the pyramid is confidentiality; that is, the enforceability of confidentiality provisions. Confidentiality provisions protect proprietary information of the business, e.g. its clients, what they buy and when, marketing plans, financial performance, etc. This would include intellectual property like patents and inventions, as well as secret formulas, e.g. for Coke.

In this case the public policy presumption shifts to be in favor of the business. In fact, confidential information is protected even without a written contract because there are "trade secret" statutes in every state that protect such information as a matter of state policy. The business may have worked for years to develop its product and clientele and is therefore entitled to the benefits of its labors. In this case as long as the information is truly secret and treated as such (e.g. under lock and key or password protected, etc.) and is not commonly known in the trade (being in the phone book does not equal commonly known as a buyer of product or service X), then the business will have a right to prevent a former owner or employee from distributing such information.

It is not uncommon for agreements to have no time limit on the confidentiality restrictions, but the better rule, and Arizona law, is that there should be some reasonable time limit. Again, it probably depends what it is. A secret formula would probably be protected by patent, and be if protected by patent would protected for the life of the patent (typically, 20 years); a special process may only be protected as long as it is truly still used and still secret. (Industry has a way of adopting similar processes across the board.) But, in any case, the time period of protection for confidential information can be longer than the restriction against working in the industry. In most circumstances two years would probably not be outrageous.

**D. Non-Solicitation of Clients and Employees**. The next and highest level of the pyramid is shared by the restrictive covenant prohibiting the solicitation of clients and employees. Again, public policy supports the business; “inside information” regarding clients is highly protected. For example, there is an old Arizona case in which an insurance representative took client information from his former employer: the types of policies purchased, premiums paid, age and birth dates, time periods and renewal dates, etc. This would be confidential information under the previous level of analysis, but also a breach of the non-solicitation covenant if the agent called on the clients using the old firm’s client list.

Note: In today’s world, technology “upsets the apple cart”. If the employee or partner is allowed to use his or her personal computer or cell phone for operations then the “non-solicitation” provision may become a moot point. After a partner or agent leaves, clients may call the former partner or agent on his or her cell phone as they have always done, and their accounts are thereby transferred to the agent or partner’s business does on with the new business without breach of any non-solicitation provision. Similarly, if confidential information is on a personal computer or cell phone, the claim to secrecy may be lost. So, as a practice pointer, the business should issue the owners and employees company equipment and have same returned when the person leaves the business. This is still not a perfect solution, but unless the business has at least done this, it may have no chance of bringing a sustainable claim on the grounds of breach of the restrictive covenant.

**E. Remedies**: Assuming there is an enforceable restrictive covenant, then what are the remedies available to the business and faced by the ex employee or partner? Generally, the injured party can obtain a temporary restraining order (“TRO”) and preliminary and permanent injunction against the breach. The breach party will face damages equal to the monies earned as a result of the breach, e.g. all monies earned from the wrongfully solicited customer. (Sometimes the damages are specified in advance under what is called a “liquidated damages” clause). Also, there can be claims for (what is called) “tortious interference with contract or business expectancy” which means that the breaching party knowing, intentionally

and improperly interfered with an established contract or relationship with a business client or employee in breach of the non-competition agreement.

Note: where a breach of the non-competition or confidentiality provision is shown, a subsequent employer or business can be liable as well. The breach of the non-compete provisions makes the new employer's act of selling improper for purposes of the tortuous interference claim. Punitive damages are awarded on this claim. A related claim is "civil conspiracy," where the employee and new employer may be liable for the act of making the sale that neither one could do without the help of the other. It is because the subsequent employer or business may face such claims that without the release the departing partner or employee may find him or herself "sitting on the bench" during the non-compete period. Strictly speaking, the partner or employee should e able to work for new clients (i.e. not with the old firm) and in new areas (i.e. not job description of old job) but these are what I call "arguments, not conclusions." By this I mean that arguments imply issues and issues imply legal fees and legal fees in any dispute are almost never less than $10,000.00. And, if the departing partner or employee did actually breach the non-compete, then the damage could be huge. So, because the new business may not want to take the risk, an employee with a 100% winning argument may still "ride the bench" during the term of the restrictive covenants.

# CHAPTER SIX

# HOW YOUR SMALL BUSINESS CAN SURVIVE AND SUCCEED IN TOUGH ECONOMIC TIMES[9]

## 1. INTRODUCTION.

We business owners are groomed and have a mental mind set to grow, to add, refine and prosper. Down-sizing, quitting something, letting people or things go is not part of our vocabulary. "Winners never quit and quitters never win." That's our attitude. And it serves us well, most of the time. But downturns are different. We have to play our game backwards, to function on rewind. Many of us are not very good at that. But, one thing the experts tell us – actually, two related things: (1) Many successful people, who are household names, have experienced failure and even bankruptcy (Henry Ford for one I believe) and this was at a time when bankruptcy was considered "morally wrong," not a strategic option, as it is today. And, (2) we can learn more, or at least as much, about our business on the way down than during a growth phase because bad times "magnify" our practices. For example, during this recent downturn in my law firm I learned that our time and billing procedures were leaking "money like a sieve," which was not apparent when times were good.

So here are some hints l have learned during this "Great Recession."[10]

## 2. DENIAL AS A FRAME OF MIND.

First and foremost, success during hard times is not so much a matter of knowledge, or skill – or even character – as it is acceptance. What I have seen in both myself and others is: *denial*. Here, by "denial" I mean not seeing, processing and taking the dramatic actions needed to

[9] You do not have to be in dire straits to benefit from this article. Any small or medium sized business ("SMB") or owner-operated business can benefit by learning from others' mistakes. Knowledge is power and understanding where you can go, if you must, is useful knowledge. .

[10] This article is not intended to be complete or all-inclusive. It is not even intended to be the opinion of an expert, which I am not. I am only sharing information as part of a "conversation." Take any and all of this – as with all of my articles Online – for what they are worth.

deal with the situation – in a word “coasting.” What happens is that each day creeps in its petty pace into the next. The assumption or ‘method’ as Scarlet O’Hara said is that “tomorrow is another day.” Well, it is another day, but nothing new is done. So, as Einstein, among others, said (to paraphrase): “Only a fool repeats the same things and expects the outcome to be different.” So, denial makes fools of us all. For example, back when I had a tremendously successful retail store. I opened a second one. I should have closed it in six weeks. But I kept it open; thereby experiencing $150,000 in operating losses before closing it. Thus, I still took the investment loss, i.e. capital loss on the store and lease buy-out on top of the operating losses. I made a bad thing worse by “hanging in there.” I am not saying that we should “bail early,” but that we should know when to bail. To quote Kenny Rogers: “To know when to hold ‘em and know when to fold ‘em.” I was raised to “have what it takes,” but I learned the hard way that “having what it takes” does not mean ‘banging your head against a wall,” in the same old way; it allows for a change of strategy and course of action.

What to do: time and again in my consultations re business formation, or operating agreements, or partnership disputes I tell my clients that “You may not have been in this *business* situation before but you may have been in several, and several *kinds* of, *personal* relationships. You can apply what you know from your personal life to this situation. For example, lack of customers is a relationship failure. When we have a personal relationship failure what do we do? We think about how we can do better; we talk to trusted friends for objective advice; we may seek counseling; we may call a lawyer. So, here, do the same things you would do in a personal relationship and (but) do it early. Because of the “denial problem,” described above, often what I see is that the “patient is dead in every way but pronouncement” by the time the business comes to me. This will not work.

The cure for denial is "*proactivity."* And, here is some incentive for you. Instead of the “emergency operation” *initial* fee of $10,000 *to* start or defend litigation, the cost of early consultation and advice may be a little as

$500.00. And, you can proceed with a plan (instead of your head in the sand).

## 3. ACTION: THINGS TO DO.

OK, let's hope that I have convinced you to act proactively and to start early in your response to hard times. What are some of the things that you can do? General rule of thumb: If it is counter-intuitive and you really don't want to do it, so want to put it off, then that is probably it (or one of the "its''). Here are some examples:

### A. CASH FLOW MONITORING (down and dirty)

1. Calculate your breakeven point. How many dollars you have to take in (cash in hand) to pay bills.
2. Watch your cash: Monitor your cash *daily.* My first and best accounting system, taught to me on my first day of business by a bookkeeper:

Beginning cash,

+ Cash in (sales or receivables paid)

-Cash out (refunds, bills paid, payroll, expenses, etc)

End cash.

3. Take the steps necessary to keep cash positive. (SEE B. DECISIVE ACTION Below).*

Follow this simple system and keep your cash above zero and you will never go broke.

### B. *DECISIVE ACTION

If you are like many businesses, especially those completely caught off-guard by the size and swiftness of the recent economic downturn, by the time you realize how bad things are, you may barely have enough cash to cover payroll, let alone to pay rent and other expenses. But, knowing your breakeven point and daily cash balance will tell you what to do next.

Obviously, you need to increase sales and/or cut expenses. But probably, you have already tried things on the sales side (e.g. in house incentives and special "package pricing" for customers) and such actions were not sufficient to turn things around. This leaves the hard stuff, i.e. cutting expenses.

What do you cut? Well, what are the big dollar items? Most likely, payroll, rent, and for some businesses equipment or advertising. Scrutinize these areas.

1. PAYROLL: Often growing businesses pay a number of well paid sales people. You may need to reduce sales staff, e.g. to have only one or two sales persons working on a lower commission but making about the same money (or at least an acceptable amount) instead of three or four sales persons all of whom are starving. (Hopefully, as part of your "Legal Brick House," i.e. legal organization, you will have non-competition agreements in place that at least keep your talented, but superfluous, sale person from stealing your clients. [11] If not, call your business lawyer for a consultation.

There are at least three cases where a business lawyer is really valuable:

a. Formation,

b. On the way up and

c. On the way down.[12] If I were to name one overriding fault that I see business owners make (that keeps them small) it is the underuse of professional expertise. Larger businesses use and take it for granted that

[11] This is but one example where "$1,000.00" upfront in legal costs can literally be worth $1,000,000.00 in lost sales later (I have seen in happen to just that extent). Think about that then call your business lawyer to do things right, i.e. smart, i.e. "brain >> brawn."

[12] This is what I call my "skyscraper speech." The high rise office buildings around my office are filled with accountants, lawyers and marketing people, among other experts. The buildings are filled with lawyers and other experts because people use us. And, they don't use us because they like us – or even because they want to – but because we bring value to the deal.

they need to use lawyers, accountants and other experts. Small businesses don't (they would rather buy a boat).[13]

Notice that I mentioned both cutting the number of personnel and their pay. If you want to see capitalism and the instinct for survival at its best then terminate fixed pay for any income producer and pay only a commission of what is both sold (billed) *and collected.* Instead of having to nag the lawyers or others to get their time in, bills reviewed, monies collected, etc. the commission workers will now be "right there" with both their time and the money. It is a beautiful thing to see. Notice that it helps both sales and collection and goes right to the bottom line as cash flow.

2. RENT. If the business is in a downturn, not only may it be necessary and proper to cut personnel and payroll, but also to reduce space rented. This means talking to the landlord. (And, again, consultations with your accountant and lawyer re cash flow and the terms of the lease are advisable.)

Clients often forget that, while their problem may be unique to them, i.e. first time, only time, to us, i.e. the law firm or accountant, the problem may not be unique. We may be handling a number of clients with similar problems. Thus, we may have some valuable knowledge and experience, not just in general, but based on the *same circumstances* as you have.) For example, during most times, especially good times, and except for a proven non-performing space (like bad location), landlords were extremely hesitant to re-write the terms of the lease, especially where, in a popular location, the landlord had a stack of other applicants wanting to be in the mall, office building or industrial center. Thus, in good times our negotiation strategy with the landlord was to negotiate a buy-out of the lease. This worked because the landlord could get, say, 2-4 months' rent as a buy-out of the lease and re-rent the premises the next month. I am exaggerating but the point is that the landlord could make money in a buy-out.

[13] Excuse me for being grumpy but it gets a little old to see the same serious, *life-altering,* and simply-avoided mistakes made over and over again.

Today, in these economic times, what we lawyers have learned, and the client may not realize, is that due to the hard times new potential tenants are NOT lined up to take the space. New tenants, especially, at the old rent level, may be nowhere to be seen. Thus, a buy-out may not be easy to do because even with a favorable buy-out the landlord still faces the negative prospect of the space just sitting there empty for a year or more. So, no matter how good the buy-out, the landlord may rather have the tenant and have more incentive to sue to get the rent to the end of the term. (In the buy-out discussed above the landlord has a duty to mitigate damages by attempting to release the premises. This duty prevents the landlord from just sitting on re-leasable space to collect rent from a good tenant.)[14] But, during bad times the landlord can list and advertise the premises with no takers; thus, the duty to mitigate does not prevent the landlord from demanding rent to the end of the term or, at least, for a longer buy-out period.

In an economic period like we have now the landlord may be inflexible as to termination of lease but very flexible as to renegotiation of lease. In this economy market rents are off 30 to 40% so the landlord faces a reduction of rent whether it is paid by you or by a new tenant. And, you are here and certain; the new tenant is not. For these reasons it is not unusual to negotiate a *rent reduction* (i.e. reduced price paid per square foot of space), say $20.00 per sq. ft to $16.00 per sq ft.) and a *space reduction* (cut back in the number of square feet of space rent reduction. I have seen rent reduced to less than half of the amount due under the present lease. Landlords are hurting too and cash is king. Many commercial landlords would rather have "$4000 a month instead of $6000" than "$00.00 instead of $6000," especially where the space may sit empty for years. (Rental space is like an airline seat. Better to sell a $300 seat for $100 than not sell it at all.).

[14] The landlord will always demand or sue for the "$120,000.00," or whatever amount is due on the lease but as a matter of law the landlord has the duty to avoid unnecessary damages (aka the "duty to mitigate damages") by actively marketing and attempting to re-lease the premises. And, during good times these steps are usually successful, so the landlord knows that it can re-lease the remises after a few months.

**3. WORKOUT PLAN**. By ”workout plan” I am talking about a non-bankruptcy negotiation with creditors based on the (i) timing of payment and the (ii) percentage of payment. Like a Chapter 11 reorganization bankruptcy debts can be paid in classes. For example, creditors who are will to take, say, 15% of the amount due as full payment will be paid “immediately,” in, say, 20 days, while creditors who want full payment will be moved to the end of the line with payment in, say, six or nine months (therefore they have a much greater risk of getting zero.)

Of course, the creditors know they can ignore the plan and just sue, but this would create the proverbial “race to the courthouse” where the first to sue gets paid and everyone else gets nothing. And, litigation may be questionable under a “cost benefit” analysis because the creditor may incur substantial attorneys fees and costs for little or no return. Even where the firm uses a collection attorney who works on a percentage of recovery (“contingency”) the numbers still have to work. The law firm will hesitate to do $30,000 worth of work “on the come” where the expected recovery is less than that. All of which means that if the recovery looks relatively certain and “reasonable” under the circumstances (likelihood of recovery and cost to recover, time period, etc.) the creditor may accept payment under the workout plan.

The above is the “good news.” The ‘bad news” is that work out plans are relatively expensive, say $5,000 and up, so can cost more than a Chapter 7 or 13 bankruptcy. For this reason work out plans are often not an option because the client has exhausted its economic resources and is not in a position to pay these fees. But, where the client is not “so far gone” the workout plan has some major advantages, including avoiding bankruptcy, which can hang around on the credit record for ten years, the possibility of bankruptcy in the future (which for a Chapter 7 is typically prohibited for seven years once a chapter seven has been filed), a better credit record and perhaps on-going relationships with critical vendors who could be lost in lawsuits or bankruptcy.

## 4. CONCLUSION.

The above is just a list and discussion of some atypical things you can do. Obviously, there are others, which you may have thought of and tried. The two main points here are:

A. Avoid denial; that is, recognize that you must take drastic action and

B. Use experts because they have "been here" many times before with other clients and may have options that you would not think of (for one reason because you have not been here before.

Your chances of survival and success may be much better than you realize. So, don't give up, and call your business lawyer. [15]

[15] Unfortunately, you may need to call and interview more than one. Clients tell me that they went to a "business lawyer" who didn't know what to do. In my humble and biased opinion if they do not have a background in business before becoming an attorney, especially in small business, they may just not "get it." (A lawyer for a big corporation can be practically worthless for a small business owner.)

# CHAPTER SEVEN

# PREPARING FOR THE GOOD TIMES IN THE OPERATION OF YOUR SMALL BUSINESS[16]

## 1. Spring Cleaning for Business.

Once a year we may have a medical examination. When Spring comes we may clean or fix up the place. We may change the air conditioner filters and inspect the house and property to see what's needed. Now that the economy appears to be doing better (e.g. a news report today discussed the shortage of trucks to haul freight; freight being a leading indicator of economic activity) it is a good time to take a look at your business in the same way. Virtually every day – every *half* day really – I deal with another bone-headed play by a client, e.g. yesterday afternoon the client who called because she has entered into a major contract with a Fortune 500 company who is not performing under the contract (and the client got screwed anyway) because, among other things the client's logo is not on the box. And, by the way, the product in question is very similar to a product on which someone else has the patent. (*This reminds me of the line: "We couldn't write stuff this good – or unbelievable.*) What does the client say? "I know. I'm stupid." I get that a lot. But, I use this as an example of an *opportunity*. With a little legal work we can reconstitute the product, patent it, redo the contract, get the logo on the box and make more money on the product. This is what I mean by "Spring Cleaning" in this article: Doing or re-doing things as they should have been done in the first place.

## 2. The Decision Rules for Legal Work.

You may be thinking that legal counsel is expensive so that you want to avoid the expense. I advise my clients to use at least three criteria (or stages) to analyze and determine whether to hire legal counsel:

[16] I always hesitate to use the word "small" when what we mean is "owner operated." And what is "small" anyway. By federal definitional standards it means under $50,000,000. Give me a break. No wonder we have such a disparity and disconnect between Wall Street and Main Street.

**A. Is the money available**? The first question of course is Do you have the money?" Legal work is like an operation. If you don't have the money, then you don't get the operation. If the injury or illness is fatal and you don't have the money, then you die. This is a brutal reality of our legal system. Going back to the definition of "small" mentioned in footnote below the legal system works well for those who can afford it. (Just today parts of the Enron and Conrad Black convictions were overturned. If you have money you can almost always optimize your final outcome. A friend of mine sent me a card: It says: "Everything will be Ok in the end. If it's not okay, it's not the end." This is a great operating principle – a code to live by. But, I am not sure that the outcome will be "as OK,' where one is not rich or a major corporation. Many of my middle and even upper class clients run out of money in major litigation.

Fortunately, "Spring cleaning" is not major litigation and the cost for "preventative maintenance" or even "legal repair" is not great outside of the courtroom. So, for most of my clients and for the matters discussed here, money should not be a problem – at least to get started.

**B. Does the potential benefit justify the cost (the cost-benefit analysis)?** The second criterion is the cost-benefit analysis. Except perhaps in wage case where attorneys fees are mandatory and there is a high likelihood of recovery, it is typically not a good idea to spend $10,000.00 to recover $10,000.00 in a litigation case.[17] But, the good thing about *transactional work* like we are talking about here (in contrast to litigation), is that it is relatively inexpensive and can have huge benefits both in value and asset- (and quality of life-) protection. With transactional work, the cost of the service is relatively very small, e.g. less than $1,000 or so, while the benefit can be huge (what is the value of the coca cola

[17] This unfortunately is another problem of litigation. A case is not necessarily easier or less legally complex because the dollar amounts are small. I have seen justice court cases with complex fact patterns. Also, the rules of procedure require certain pleadings be filed within certain time periods and by certain dates, so the work is not optional. Moreover, the duty of competence (and avoiding malpractice claims) requires that lawyers, like doctors, do everything reasonably necessary to advance or defend the claim, e.g. depositions, the hiring of experts, etc., all of which makes any case, large or small, expensive – and small cases unaffordable under a cost-benefit analysis. There are alternatives, like arbitration which can be court required or agreed to in advance by contract, but these options can also be expensive and have their own costs and benefits – which means they are the subject of another article.

trademark?). Some examples of the legal "spring cleaning" are discussed below in the section on the "Legal Brick House." And, the third criterion for proceeding with legal work is:

**C. How will I feel, what can happen, if I don't do anything (– or if I do?)** The third question in evaluating an expenditure of legal fees is whether one may have afterthoughts or regrets later. Where the client does nothing now, but walks away from the claim, it leaves open the possibility of "what if" thinking later, perhaps after the statute of limitations on the claim has run, the witnesses were readily available, etc. Sometimes clients are sitting on legal matters which they do not know whether to pursue**.** To reduce or avoid the possibility of later regret often the client will decide to budget certain fees to have us at least work up the deal or the claim, e.g. a legal memo, to see what it looks like. Resolving these questions can be part of the "Legal Spring Cleaning." Often clients are not sure whether they want to pursue the deal, or a legal claim in litigation, but they are thinking about it. In that case – as we would probably do anyway –we may propose the deal or do a demand letter of the claims for response and analysis. Then, based on the response – both factual and legal – we can better advise the client whether to proceed.

On the other hand, sometimes the client is simply not emotionally able – (or for other reasons is not in a place) to pursue legal claims even where the first two elements of the analysis (i.e. money and cost-benefit work). For example, I still remember the case where my clients had a very strong legal claim for substantial legal damages. But, the husband was in chemotherapy (for reasons unrelated to the legal claim) so not strong or feeling well and the wife was literally on the verge of, if not already in the middle of, a nervous breakdown. They decided – and for them I agreed – they simply were not mentally and physically able to endure the extreme emotional and physical stress and strain of litigation. So, we did not pursue the case, which otherwise would have been a good one to pursue.

### 3. Items for Your Legal Spring Cleaning.

So, what kinds of things are good to give legal consideration as part of your "Legal Spring Cleaning?" As mentioned above, one is addressing a "deal done wrong" to see if it can be redone to do it right. Another is collections. Can some receivables be collected by turning them over to any attorney? Other things to do may be to do what I call a "legal audit" of how you do business and your legal brick house. This legal audit of your small business might include a review and update, or creation of:

**A. Employment handbook, policies and procedures**. Is the Employee Handbook current and enforceable under recent law? Are your current policies procedures lawful and understood by everyone in the business?

**B. Review and update of your contracts**. These contracts include your invoices, agreements and documentation used with your customers, your employees and contractors, your landlord, and your vendors. Even if originally well drafted the contracts now may be less effective than they could be because they do not cover situations: For example, interest and storage fees in invoices and reminder notices, and the right to repossess and of "peaceful entry" to do so in sales contracts. Also, the law may have changed. The law is dynamic. Any contract more than a few years old may have been rendered questionable or unenforceable by changes in the law, whether by changes in governing statutes or by new case decisions. For example, do you have a key employee agreement (formerly called a "key man" agreement)? Anyone who can hurt you if he or she leaves and competes is a potential "wolf" inside your door and you need to protect the business by having a well drafted confidentiality and non-competition agreement. For example, the firm had a client who lost $1,116,000.00 in sales *in six months* to a former key employee because the contract in place had expired and was "under-written, i.e. not very well drafted, in the first

place. A legal audit would have revealed this problem before the employee left.[18]

**C. New product related documentation**. Launching a new product? What does the marketing contract look like? – the manufacturing agreement? Non-disclosure, non-competition and non-*circumvention* agreements with manufacturers are critical because at my level of owner-operated businesses it is common for the manufacturer to take the idea, via reverse engineering or otherwise, then to manufacture the product or a similar one for itself or other companies. So, you need to prevent this theft of production. You also want to prevent the manufacturing company – or anyone else – from bypassing you to buy components of the final good thereby competing not only at the retail level but at the supply level. These are just a few examples.

**D. Your entity and its use**. Is the corporation or limited liability company ("LLC") properly formed and in good standing? If the company is an LLC is there an Operating Agreement, as required by Rule 704 of the Internal Revenue Code? Failure to have this Agreement in place (a common mistake of legal do-it-yourselfers) can cause some limited liability issues. Also, unless the company is owned only by a sole owner or husband and wife it is important to document the ownership and method of control of the limited liability entity.

It is amazing that multi-millionaire clients can file improperly completed do-it-yourself legal documents which can cost, literally hundreds of thousands of dollars to argue about and fix later. When the document was filed the client may have had no money, but by the time one owns land next to the Super Bowl stadium under construction it would have been a good time for the legal audit. If your business has grown since "back when," then it might be a good time to have a lawyer look at your organizational documents

[18] Besides documenting the deal and achieving a legally enforceable agreement on its terms, an often overlooked but important reason for contract negotiation is to determine the other person's agenda. Here, the employee might have been unwilling to sign a new, improved non-competition agreement, but "forewarned is forearmed," as the saying goes. So, knowing that unwillingness, the company would have had notice of a problem and the opportunity to decide what to do to protect itself and mitigate the harm.

before a legal problem (outside or inside) arises. Again, “an ounce of prevention is worth a pound of cure,” as the saying goes.

And, if the entity is properly formed and maintained, is the “INC.” or “LLC” or similar designation on ALL of the corporate paper work? “Use it or lose (the limited liability benefit of) it” is the rule in the use of the corporate or limited liability company designation. This is true for a couple of reasons under at least two areas of law, which your attorney can explain to you in a consultation.

**E. The Lease**. Is it coming up for renewal? Is the rent fair under current market conditions? Do you know what the lease says? Has anyone ever reviewed it? The lease is “the tail that wags the business dog. Leases may make the business unsalable – a sad fact to find out after 20 years and you have a pending retirement and or sale of the business. Some reasons why the business may be unsalable under the lease include not just the rent, but the “assignability qualification” requirements or “sharing of assignment proceeds” provisions. The landlord’s say into the person who buys your business and takes over the lease needs to be negotiated. Otherwise the landlord will typically set the bar high (“the “equal to or better than you” standard), which can be a deal breaker. Typically, if the buyer were equal to or better than you they would not be buying your business but the one that you intend to buy. And, the lease needs to be drafted so that while the landlord may have a claim for increased *rent* that results from the assignment, it would have no claim to share any of the *proceeds of the purchase* price of your business. This distinction is not always clear in the document. And, there are leases where the landlord could, upon the tenant’s request to transfer the premises, just elect to terminate the lease and take back the property. Worse, I have seen leases where the landlord had the right to buy the business at a price far below market upon the tenant’s request to transfer the business and the lease or where the lease says that upon sale of the business the tenant would owe the landlord X dollars. As I tell my clients: “Look who you are dealing with: A land *lord*. Who else have you called “lord” lately? This area of law goes back to feudalism when the landowners were kind and the tenants were former

serfs. So, it is difficult to overestimate the importance of having a lawyer look at your lease.

This leads to what I call my “landmines speech.” The lease will be filled with provisions adverse to you. Otherwise, the 40 page lease would be three pages. And, even with legal counsel, the typical tenant does not have the bargaining power to negotiate away all of the adverse items. But, we are usually able to focus on select terms and conditions and to negotiate them to a favorable resolution. And the client after consultation with the lawyer will know the provisions that can be “lying in wait” to harm them. So, at the end of the day the client will be rid of some landmines and will know where the rest of them are. When the lease comes up for renewal then we can take another crack at ridding the lease of other adverse provisions. For example, the typical lease says that the landlord has no duty to insure the building is zoned for tenant’s business or even complies with applicable law (try that as a tenant!). This can lead to the following situation, variations of which I have seen more than once:

The tenant operated a cotillion for the “coming out” parties of Hispanic girls at the age of 13 or so. These are huge affairs and $10,000 and up is a typical cost for such events. My client rented an auditorium for this purpose and was very successful – until the City closed down the business for lack of proper zoning. The client turned to the landlord and said “It is your property. Call your lawyer and get the property properly zoned – or release me from the lease because obviously I cannot do business on these premises.”

The landlord responded: “We did not represent that this property is suitable for your business, zoning or otherwise, so it is not a breach of the lease by the landlord that you cannot do business. Moreover, under the terms of the lease it is the *tenant’s* obligation to fix the premises so that the business is legal; this would include rezoning to comply with applicable law. Moreover, it will constitute a breach (lawyers like terms like “constitute”) of the lease for which we can sue you for all rent due to the end of the term.” – I.e. a $500,000.00 or so (have a nice day).

The tenant logically replied (perhaps unaware that the famous Supreme Court jurist, Oliver Wendell Holmes in his book "The Common Law" said: "The life of the law is not logic but experience"): "I'm shut down. How am I supposed to have the money to rezone the property?" To which the landlord, in a perhaps unknowing affirmation of Holmes, said, in effect: "Too bad, so sad."

"Catch 22's" like this are not unusual in legal experience --another good reason for your "legal audit."

**F. "Partnership Documentation."** In addition to the Operating Agreement or corporate Bylaws, is there a "Buy-Sell Agreement" between or among the owners? This is like a business pre-nuptial agreement under which the owners determine, in advance, when a partner will leave and/or if he or she leaves what the consequences will be in terms of buy-out, price terms, etc. Obviously, this can be an important agreement because, as discussed in my article on "Partnerships Disputes and Business Divorce," business breakups are not only hard to do but very expensive. Legal fees of $100,000.00+ are typical, especially where there is no Buy-Sell Agreement in place to streamline the process.

I could go on but by now I think you get the idea why your "Legal Spring Cleaning" can be very beneficial.

## 4. Online Information, Legal Forms and the Difference Between A Contract and a Form, and Information and Advice.

You may be thinking: "All of this sounds like a good idea. I'll go Online and see what I can find in the way of updated forms and information." And, you probably already know that I am going to tell you that is not a good idea. Here are two reasons why: A. There is a difference between a *form* and a *contract* (even a form contract is not a contract in the proactive sense of the term). And, B. There is a difference between *information* and *advice*.

**A. Forms are not contracts.** A form is a document that was prepared by somebody else for somebody else. It may or may not be

complete (usually not) and it may or may not suit your situation (typically not). Not only may it be inadequate for your circumstances because it omits *terms important to your interest*, (if it is not to serve your interest then why are you doing this?) but also it may have even been negotiated from the point of view of the *opposing party*. (By now you should know that a lease is not just a lease it is a business weapon.) I am sure you know this but just in case you don't: Neither a lawyer nor a document is neutral. A contract or other legal document is a "business tool." Often it is a weapon. It can be an instrument of slavery (which a bad deal or contract can be). As the Mafia rule puts it: If you don't know who the patsy in the room is, it's you. If you are using a form, or you have not had the contract reviewed by your own lawyer, then *you* are the patsy. Why? Because a legal document is a negotiated – often a long, hard and fiercely negotiated document. If you do not negotiate the document – or worse, just adopt somebody else's form, this is not just legal malpractice (which it would be for an attorney, but it is *business malpractice (by you).* To quote myself: "There are form documents only to non-lawyers." What a lawyer thinks when you use or ask about a "form" is that "You're an idiot." A *contract* worthy of the name is the result of an active, proactive negotiated, give and take process, preferably between attorneys for the reasons stated below in discussing legal advice. It is not something printed off the internet and used without question.

**B. Information is not Advice.** Internet sites, like LawGuru, can be a good source of information about legal matters. By "information" I mean general principles of law. But the law is complex. "General principles' have exceptions and may or not apply depending on the facts. Change one fact and you may change the applicable law and completely change the outcome. For example, McDonald's was held liable for giving and working its employees too much overtime, even where the employee *volunteered*, when an employee left, and because tired and sleepy ran into and killed another driver. Why in God's name, you might ask, would the *employer* be responsible for the employee's free choice? Are we turning into a paternalistic society where the business must 'stick its nose into the private affairs of its workers? Must the business ask: "Have you been out a lot?" "Are you sleeping well?" "What medication are you taking?" Etc. You may

be wondering: How does this case make any sense? The answer turns on one key fact, which changes everything. Know what the answer is? (It's in the footnote below.[19])

My point is that general information may just get you in trouble, so a little information can be more harmful that none at all. This leads to my next point:

Information is not advice. *Advice* connotes brain power expended by a highly trained professional with knowledge and experience in the area. Legal "a*dvice*" is given by an attorney after document review, discussion of the facts and circumstances of your case, legal research for the current law in the area, thought and analysis. For difficult cases, this process can take days or weeks. As shown above, *one fact* may change the analysis and the perceived likely outcome(s) – which may go back and forth in the attorney's mind. *Advice* is tailored to you and your case. It applies general principles of law and the myriad number of variations and exceptions developed and cited in the case law to your specific facts. And, often, the facts do not come out or become clear all at once because the client does not remember them or realize that a fact is legally significant. This is why in litigation we require the client to do a chronology of events – i.e. to aid the client's complete recall of the events as they occurred. The same process may apply to an important contract negotiation, which is another reason why a form is not a contract. This leads to what I call my "yellow pad speech:" If you are like me, often you will think of something important relating to a matter while you are doing something else, like driving for coffee, taking a shower, going to bed, etc. For this reason I keep a yellow pad or notebook nearby so that I can write down things as they occur to me. You can do the same. Then when you have a list of things (not one at a time unless you want to lose your lawyer) you can forward the list to your attorney for his or her review and consideration.

I need to say a brief word about knowledge and experience. Another way to say is "Don't be this dumb." Recently, popular articles and books have talked about many hours of work (10,000 hours) as the substitute for

[19] The employee was a school aged minor. Different rules for minors.

genius. This may be a misstatement of this exact premise, but the point was that top level performance can result from concentrated hours of work and dedication. Thinking about this on my way to work this Saturday morning I calculated that with my business and legal experience combined I have about 100,000 hours of dedicated work experience. This is because I started early and have never succeeded at much, or been much interested in anything, except work. Well put yourself in my shoes – or in your own shoes for what you do – how would you feel about do-it-yourselfers? Would you think that don't have a clue?

Hopefully, this brief discussion brings to light and makes obvious the true and terrible difference between forms and contracts and information and advice. Forms and general information are legal "wannabees." They masquerade as legal documents and advice but can ruin your life.

Everybody wants legal advice and a lawyer. Fewer persons want to pay for one. But what we have been talking about; that is, your "Legal Spring Cleaning," is not expensive and its benefits can be tremendous. You do not have to be the one who calls and says " I'm stupid, " to which we could answer or think, but never do: "I know."

# CHAPTER EIGHT

## PARTNERSHIP DISPUTES AKA "BUSINESS DIVORCE"

### 1. Business Disputes as "Partnership Disputes" and "Business Divorce."

Regardless of the form of business, i.e. whether it is a corporation, or limited liability company or general partnership, the business owners are both colloquially, and often at law, referred to as "partners." Disputes between and among the business owners are referred to as "partnership disputes." And where the dispute leads to separation of ownership, then the matter is often called a "business divorce." In fact business owner disputes can have many of the same kinds of transactions and occurrences ("acting out") that a personal divorce does, e.g. the wrongful seizure of space, money or property.

### 2. Causes of Partnership Disputes and Business Divorce.

Partnership disputes can occur for a number of reasons, including lack of money, false expectations, personality conflicts, or differences of style and vision. Where the company was founded by one majority owner, often that founder can be so dominant in terms of operational control that the practical and legal rights of other owners, even of significant owners, can be ignored.[20] This is particularly bound to occur where the minority owners come later in the company growth curve. The problem with "founder dominance" is that (1) it may ignore and violate the rights of the other owners to be informed and have input into company governance and (2) it may result in a "sole proprietor" (i.e. single owner) management style being imposed on, say, a $5,000,000.00 company. More than once I have seen a company experience rapid growth from virtually nothing only to implode internally due to the lack of policies, procedures and job descriptions (i.e. standard operating procedures) which are essential if the company is going to continue its upward projectory. For one thing the lack of policies and procedures encourages cronyism, which in turn causes

[20] This is what I call the "mini-van" problem. The founder is in the driver's seat; everyone else is in the back.

resentment for favoritism and, again, the lack of input by parties who are affected by the decision but were not given the chance to provide input before the decision was made.

**3. Operating, "Shareholder's" or Buy-Sell Agreements.**

In the event of a partnership dispute, especially one leading to a business divorce, where an owner is leaving the company, it is good to have an agreement that tells the parties what happens in that event. Continuing the marriage analogy, the purpose of this agreement is to serve as a "business prenuptial." It sets forth the events which will, or can, trigger a buy-out of the departing owner's ownership interest in the business, the price or method to determine the price, and the terms upon which payment of the purchase price can be made. Buy-outs may occur in the event of divorce where the departing spouse agrees in advance to sell his or her shares to the company and/or to other owners. This rids the company of an angry and often non-productive spouse and the spouse gets money in return for the interest.

Buy-sell provisions like the above can be in the Operating Agreement of a limited liability company ("LLC"), a "Shareholders' Agreement" among the owners of a corporation, or in a document simply entitled the "Buy-Sell" Agreement. Often death events are funded by insurance; non-death events may be funded by payment terms written into the agreement.

Obviously, one major issue for a buy-out is the price. Often "buy-sell agreements call for the price to be determined annually (does not happen) or by appraisal (a lawsuit waiting to happen). Sometimes the buy-out occurs according to an "earn out" where the departing owner receives what he or she would have received as a dividend or distribution on his or her interest for and over a certain time period, say five-to-seven years. Even where imperfect the Buy-Sell Agreement is instrumental in avoiding some major problems which can occur without it.

## 4. Business Divorce in the Absence of a "Buy-Sell" Agreement.

The key point to know here is that, absent the "business pre-nuptial" or some agreement to buy, as discussed above, neither the company nor the remaining owners have any duty to buy out the ownership interest of a departing "partner." This means that a year or more can be spent operating under one or both of the following scenarios: The angry "ex-spouse" or the "free ride."

**A. The Angry Spouse**. "Angry ex-wife" (or "ex-husband") describes the scenario where the departing owner has no offer to buy his or her shares, so must proceed by making the company and its owners so miserable that they want to buy his or her shares. This can be done by reminding the company through legal counsel that until the buy-out occurs, the partner is still an owner of the company (they are still "married"); thus, by statute (and case law in Arizona) the absent owner has a legal right to all of the company's books and records and to a "seat at the table" for major business decisions. And, of course, not working in the business every day the "newly departed, but still alive" partner (hereinafter "departed partner") wants to have regular meetings and feedback. Psychologically, this is hard on the remaining owners who want to forget the one who's gone and run the business. So, this is a strategy to be bought out.

**B. The Free Ride**. In this situation the departed owner is not necessarily confrontational but rather can simply remind the company and remaining owners that, until he or she is bought out, then the departed partner is still an owner of the company. And, as with the value of any other investment, the value of that interest does not depend on the owner being there, but on the appreciation in the value of the shares of stock, or membership interest, caused by the time and efforts of the remaining owners. In short the one who has left may actually or in effect announce that "I'm going to Tahiti for five years. I'll check in on the value of my ownership interest when I get back. (Thank you very much.)."

This scenario is about as bad on the non-confrontational side as the "ex-spouse" confrontational approach was on the other. And, as stated, the

approaches are not necessarily mutually exclusive. The departed one may be on the beach while his or he attorneys keep the former partners busy with requests for information, etc. So, while the company and its remaining owners have no duty to buy out the departing partner they often do to avoid these outcomes.

**5. Legal Claims.**

One could write a book about the legal claims that surround business divorce. The claims, among others, include breach of contract, "squeeze out," and sometimes conversion (civil theft) of assets. A breach of contract claim would occur where, for example, one was fired from company employment without cause or in some other manner not in conformance with the company agreements.

"Squeeze out" refers to the situation where an owner, usually a minority owner, invests in the business with the anticipation of owning, having management input and drawing a salary from the company but the owner finds him- or her-self with little or no input into the company operations and usually without employment. Often all or most of this owner's net worth is invested in the company. And, in many cases having been a victim of this scheme the wronged party has no financial means to afford the attorneys to right the wrong.

But a corporate squeeze out is a form of breach of fiduciary duty and a fiduciary duty is the highest duty imposed at law; it is the duty of highest loyalty, honesty and trustworthiness. And, each partner of a business owes the others this duty. Where it is breached punitive damages may be awarded.

Conversely, because the departed owner is still an owner until a court or a purchase and/or settlement agreement says he or she is not, the departed partner may not work for a competitor until the buy-out occurs. This is one reason for the "ex-spouse" stratagem discussed above. So, not only may the departing owner have a breach fiduciary duty claim against the company and its remaining owners but also the company may have a claim against the one who has left. The rationale is that one cannot be

“married” to the company and cheat. In this regard corporate law is more “prudish” than domestic relations law.

A conversion claim may occur where one owner makes a grab for company property, like the funds in the bank account. This would be a crime as well. But in many states, like Arizona, the police or other law enforcement officials typically will not handle claims where the party has a “civil remedy;” that is, can hire his or her own lawyer and sue.

**6. Great Frustrations.**

The interplay between the wrongful conduct and legal claims in the partnership dispute and business divorce situation can be maddening to the client. For example, some questions and answers:

A. “Does the fact the business is “blowing off” or “stonewalling” the departed partner by being totally non-responsive, say, to a request for a buyout and at a fair price or to establish a procedure for determining same, allow the “departed partner” to compete by starting his or her own company or working for a competitor? *

Answer: probably not. Even on these facts the competing partner still owes a fiduciary duty to the company, even if he was kicked out of the company. In general the fiduciary duty would prohibit any kind of “disloyal” behavior, like working in the industry in the territory. (There may be counter-arguments for wrong-doing by the company, but the essential point here is that there are no clear answers, everything is an issue, and arguing and negotiating the legal issues costs time and money.) This provides the company with the opportunity to act with impunity, subject to the hassle of the ex spouse scenario or unpalatable nature of the freed ride.

* Of course, if there is a duty to buy under a buy-sell agreement, then the situation might be managed to come out differently. Still, you would start with a situation of offsetting claims and no clear, risk-free course of action.

B. If the departing partner “acts out” by taking money, computers, equipment or client files (collectively, “misconduct”) does the business still have to buy out the departed partner to turn the partner into an ex-partner?

Answer, probably yes. The purchase price might be reduced, especially if there is a buy-sell agreement which contemplates a reduction in price for misconduct. But the partner who has left may be able to sue for specific performance and seek summary judgment (i.e. earlier judgment without trial) to enforce the duty to buy under a buy-sell agreement while the company’s claim for conversion (civil theft) and misconduct might have to go to trial, which could be six-nine months later (all claims do not have to be adjudicated at once).

If the departing partner uses the client files to solicit clients, then the company may be able to obtain a restraining order to prevent that.

C. If the departed partner engaged in misconduct and is stonewalling the company in response to buy-out offers may the company simply dissolve the company and pay the ex-partner his or her share of the proceeds?

Answer, probably not. Courts will generally not dissolve a profitable company. (One reason for this is that the liquidation value of a company – i.e. basically an asset sale of tables and chairs, etc -- may be one/tenth the price of the company as an operating company. (Think of a company with a million dollars in sales with $40,000 in hard assets) So, in that case an action for a judicial dissolution will typically fail. The remedy is buy-out, which of course the company has already tried to do.

D. Can the company not even file for judicial dissolution (which is a court lawsuit) but unilaterally dissolve by just filling out the paperwork at the Corporation Commission (takes about five minutes)?

Answer: No. The reason depends on the ownership stake of the departed partner and any governing documents. But, in the common case of 50/50 owners the answer is “No” because there is deadlock. And, both in that 50/50 ownership case and even where the departed partner is a

minority owner, the answer is No, not without facing substantial legal claims (for damages and punitive damages). The majority owners owe a fiduciary duty to the departed minority owner, and assets or revenues into a new company would be fraudulent transfer, etc. Thus, the company would face compensatory damages equal to the ex-partners share of the new company plus punitive damages for doing the liquidation and starting over.

## 7. Conclusion.

These are just some of the joys associated with a business break up in Arizona. The best way to deal with a partnership dispute or business divorce is to contemplate and prepare for it in advance – like, say, Donald Trump might with his wives – by using a business "pre-nuptial." (More than that, choose your future "business spouse" wisely because, to quote the song, "Breaking up Is Hard to Do.")

With or without the buy-sell agreement in place I counsel my clients, and remind the other side, that there are two ways to handle a business divorce: the relatively short, easy way or the long, hard way. The short, easier way is to agree on a method to proceed: For example, a buy-out with a neutral appraiser used to determine purchase price and a negotiation of the payment terms.

The long way is to go through litigation; that is, pleadings, experts, depositions and other manifestations of Hell on earth. This process may be more thorough but, as implied, between angry ex-partners it can be as emotionally draining, time-consuming and expensive as a hostile personal divorce. Sometimes the two (personal and business divorce) go together. Be thankful if that is not you.

# CHAPTER NINE

# ON BEING BRILLIANCE AND MAKING MISTAKES IN OPERATING YOUR BUSINESS

## 1. Introduction.

In my chapter entitled “Working Beyond Your Means” I discuss the ironic result that many business owners fail, not because they lack intelligence, perseverance, and resourcefulness, but because do. In this Note I want to discuss this problem as it relates to the use of legal services.

## 2. The Need for Standard Operating Procedures for Sustainable Growth.

In my practice I see small business owners fail – or fail to grow past a certain level - because they do not implement “standard operating procedures;” that is formal policies, procedures and job descriptions. As a result everything becomes a decision of the owner. This in turn can lead to decisions made on the basis of fiat and favoritism rather than input and rules. It is not too much of an overstatement to say that standard operating procedures are a precondition of growth and success, and that the failure to adopt and implement them is a major cause of business failure. Operating without standard operating procedures is what I call the “ingrown owner” stage.

## 3. Using Experts to Avoid Self-Destruction.

Another cause of business failure is the failure to use experts. (In fact, if I were asked to name one main reason why small businesses stay small it would be this problem.) I have mentioned elsewhere what I call my “skyscraper speech/” I n this I state that the nearby high rise buildings are filled with lawyers, accountants and marketing experts which businesses use, not because they like lawyers (or accountants or marketing people) but because these experts bring value to the business. “Second stage” businesses, by which I mean businesses that have grown beyond the

"ingrown owner" stage use these experts and so have the expertise to continue growth.

### 4. Do It Yourselfers and the Path to Self Destruction.

With regards to the use of lawyers, time and again I have seen established businesses have major legal problems, e.g. with intellectual property, use of name or logo, landlords, former employees, manufacturers, suppliers, banks, etc., that may be *life-altering* (by which I mean they put the business, its employees, and the owners at risk to lose everything). Due to prior neglect these problems may now be *extremely expensive* to cure – if they are curable at all.[21] Yet, these same problems may have been prevented or made much more manageable at minimal cost by the use of a business law firm in the formation and organizational stages of the business. What I am referring to here is the organizational engineering that should go into starting your business. This work could or should include your entity, trademark, trade name, intellectual property protection, lease review, buy-sell agreement by and among owners, non-competition agreements for employees, etc. (what I call the "legal brick house."). Rarely, are all of these needed at the same time and if they are needed all at once, then it is because the business failed to do what should have been done earlier.

I give a lecture at a local University and to business owners entitled "Ten Common Mistakes that Business Owners" make, but the students and attendees call it the "Scared Straight" lecture. I hear the groans in the audience by business owners who have made these (frankly dumb and easily preventable) mistakes. And, after twenty years of practice, I can get positively grumpy about seeing the same easily-preventable-at-low-cost mistakes being made over and over again by small businesses.

[21] This is one of those topics where I say "Don't get me started." For example, the business without a key person employment agreement whose key person left and did $1,116,000.00 in six months with the firm client; the lease that makes it virtually impossible to sell the business (not good to find out 20 years later that the lease is the "tail that wags the business dog."); the loss of a million dollar brand name and customer good will due to the failure to have the name and logo protected; personal liability by improper formation and use of an entity (clients often form their own entity but do so improperly or use them improperly so are still personally liable).

Why do business owners make these mistakes, because they are stupid? No. Well, maybe some of them are, but anyone who can succeed in small business has got to have what it takes in “character and fitness,” so to speak. It seems to me that the problem is *the opposite*; that is, many business owners are brilliant; they are too smart and resourceful for their own good*. So, t*hey attempt to handle all aspects of their business from sales to accounting to legal, etc. by themselves.

But specialized areas, like law, do not lend themselves to “do it your selfers.” As the saying goes “He who would be his own lawyer has a fool for a client.” This is true, even for lawyers. (I do not do my own legal work because I lack objectivity. Non-lawyers lack both knowledge and objectivity). Moreover, no matter how brilliant you are, there comes a time when you cannot do everything, especially at the same time; therefore, you outgrow your skill and time-set. This is when the business starts to fail.

But more than outgrowing your ability to learn and do everything (that was a point of my “Working Beyond Your Means” article) my point here is that “do it your-selfers fail because they simply do not have the training and experience to do their own legal work. They both do not know all of the things that need to be done and to do them well. For example, how many of you have reviewed, maybe revised, and signed a legal document without giving it to a lawyer? Or, downloaded and used a “form” document without having a lawyer review it? And what is wrong with that?

Well, first of all (to quote myself) “There are form documents only for non-attorneys.” Attorneys know that contracts are written to serve the client – to exaggerate they are an instrument of war. Only to the uninitiated is a contract a neutral agent. So, right out of the box is a fundamental mistake of paradigm, i.e. the idea that the agreement that has served another serves you.

Another thing wrong with using un-reviewed documents is what I call the “the documents look OK to me fallacy.” The fallacy is in thinking that reviewing the document is enough. I had a multi-millionaire client who was selling his very successful business for a substantial price. Because he was

smart he was negotiating the deal and the revisions to the legal contracts himself. After *nine drafts* he came into me in the middle of the afternoon and said (as many clients do):"Could you take a quick look at this? We want to sign this tomorrow morning."

A. Common "Do It Yourself" Fallacies.

There are at least two major (dare I say really "boneheaded") mistakes here:

1. When I review a legal document I outline it line by line, page by page. This takes hours of time to do. So, what I tell people who want a "quick review" is that they want a priest, not a lawyer. They want me to do a sign of the cross over the document. That is, they want me to "bless" the document. But that is not my job and in any case I can't do that on the spot.

2. While the client had revised the language *on the pages,* he failed to realize *(because he did not have the legal training to know this)* that the contract had none of the necessary representations and warranties from the buyer, too many and unfairly burdensome representations and warranties by the seller (I joke that a good contract by me is one where you breach it when you sign it. This contract was like that.) and inadequate security for the carryback portions of the purchase price. In other words the client did not realize all of the important and necessary language that *was not in the document*. The client could review and revise what was there, but he did not have the legal education, knowledge and experience to know what was missing – which any experienced business lawyer would realize.

So, two common mistakes are the "you want a priest not a lawyer" and the "documents look OK to me" fallacies. But there are about as many mistakes as there are clients who do not use lawyers. These are just some examples. As the saying goes, "Don't get me started."

## 5. Being Penny-Wise and Pound Foolish.

In addition to being smart and resourceful (yet stupid : ) another reason why business owners do not use lawyers and other experts as they should is "the cost." Lawyers are expensive. So, particularly because they do not know what they do not know (the "unknown unknowns" to quote Donald Rumsfeld) they have little incentive to spend the money. Two things in response to this:

A. The cost of building your "legal brick house is relatively small and extremely cost-effective (think doctors office visit versus hospital or emergency room surgery). For example, most of the work that I have mentioned costs only about $1,000.00+/- each. And,

B. From a cost-benefit analysis point of view the expense is a no brainer. To quote myself: "You can have a business legal brick house on the hill" (i.e. all of the above) for less than the initial advance fee required by this firm for one litigation matter. So, from a cost-benefit analysis building a legal brick house is a "no-brainer." [22]

## Conclusion.

Two points that you can take away from this article:

1. Business do it yourselfers limit their business growth. And,

2. Business owners who attempt to do it themselves as to legal work may lose a lifetime of work and investment by making simple, obvious business mistakes that any business lawyer could prevent with minimal time, cost and effort.

A last word: My Intake Paralegal, Tom, mentioned that I am being incredibly altruistic in writing books and articles like this because as long as clients make these mistakes we can charge:

[22] Here is an example from five minutes ago. The bank tells our potential welding business client that he needs a waiver. So, he downloaded one but called us because he did not know how to complete the language in the document. What the client did not know is that the waiver could be so much better and than for $250.00 we could draft a waiver that would also limit damage claims to defined damages, limit recovery to the amount paid for the welding services and not damages to or by third parties, etc. So, for $250.00 we could prevent a $100,000.00 claim later.

(i) to fix the problem and then
(ii) to draft the documents that would have helped prevent or mitigate the problem in the first place.

He said, like plumbers, we should “love do it yourselfers.” Maybe he’s right.

# CHAPTER TEN

# ESSENTIALS OF INTERNATIONAL BUSINESS LAW

Some years ago a client wanted to do business with a Chinese company for the supply of movie-related action figures. The firm did not feel qualified to handle this matter, so we looked for legal counsel who could handle the matter. What we found is that, even though Phoenix is the fifth largest US City (just passed Philadelphia) and sophisticated in business and legal matters (talent comes west) we had no clear choice, especially when it came to international tax issues. Because of that problem we decided to "bone up" on International law and handle such matters ourselves. We added to our firm library materials on both international law and international contracts. But, in receiving the library reference materials, the China section was missing; i.e. not yet completed.

I mention the above anecdote to demonstrate the precarious nature – still – of doing business internationally. You face differences in culture, business practices, and law. What is expected in terms of dress and behavior in South America would be outrageous (and might get you thrown in jail) in the Middle East. For example, sexy dress in South America is common and expected, not in Iraq. Bribes are accepted and expected in some countries, but are illegal to pay under US law, the Foreign Corrupt Practices Act. So, one cannot just "barge in" to do international business. Without a little education and finesse you may not only be the "Ugly American," but also the "Ugly and *Stupid* American." But, there are some "legal absolutes" (not many of those in law) that I can tell you now.

First, in international contracts, even with a "friendly" nation like the United Kingdom, it is imperative to specify the law which applies. For "goods" (basically, manufactured goods moveable at the time of the transaction), the paradigm examples of which are furniture, fixtures and equipment, this would be the Contract for the international Sale of Goods (commonly referred to as the "CISG"). The CISG is much like the Uniform

Commercial Code except that it follows the traditional, more rigorous standards for contract formation. [23]

Second, it is essential to specify the forum (i.e. the country and "courthouse" so to speak') where disputes will be heard. Typically this will be arbitration in London or Geneva under the UN Convention. Some of the forums are the International Court of Arbitration ("ICC") headquartered in Paris and the London Court of International Arbitration (LCIA), headquartered in London, which handles many commercial disputes.[24]

Third, you would do well to specify the *language* in which the proceedings may occur. Although English has taken hold as the "*lingua franca*" i.e. language of choice, for international business, the language to be used could become an issue, among other issues, in international dispute resolution.

While contracts between companies in the US *may* specify the forum law and state, e.g. "this contract will be governed by Arizona law with forum and jurisdiction in Maricopa County, Arizona," (and it is a good idea to do this) it is *not* a legal requirement to do so. In the United States we have statutes and case law to tell us where the case should be brought, e.g. where one of the parties resides, the contract arose, the property is located, etc. The above is not the case in and with international contracts. In an international agreement you must meet the following requirements, as outlined above:

A. State the controlling law. This can be US law, even US state law if agreed.

[23] The uniform commercial code ("UCC") in the US makes contracts easier to form and be enforceable because it recognizes a contract as formed where we have the parties, subject matter and quantity. Other terms like price, delivery etc. can be determined by looking at what is reasonable in the marketplace and trade custom. For example, price of 1957 Chevy – what AutoTrader or the equivalent market reference shows a fair price to be. In contrast, for contracts not for the sale of goods, e.g. services and real property, the US follows the "mirror image rule," which requires not only the parties, subject matter and quantity to be specified, but also the price, payments terms, delivery terms and performance times. The CISG, used in international contracts for the sale of goods, is unlike the US UCC because it follows the mirror image rule.

[24] There are others, but my point is here is not to provide an education in international law, but to point out some "legal landmines," which can cause you considerable grief.

B. Specify the forum, e.g. LCIA, although this can be the federal or state courts of the US, if agreed, and

C. Agree on the governing language.

Please understand that if you fail to meet these requirements then in the case of dispute you are in legal “nowhere” or “never never” land. You cannot just look up where to file your case and do it or trot down to the local court house, because there isn’t one.

Last word, if like many businesses these days you do business online and by video or tele-conference, then you need to incorporate the above elements into your communications. For example, you could include same into the “boilerplate” of your Purchase Orders and/or Invoices by adding a section stating that:

“In the event of a contract with a company which is not a resident of the United States, then unless otherwise specified in a superseding agreement, then the governing law, forum and language shall be ____. “

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[1] I read in the bookstore about the “false assumptions” people bring into relationships. The same principle applies here. Your business is a series – a group – of relationships: with your partners, employees, vendors, your landlord, customers and advisors. One common false assumption is that you can do business without professional expertise. This is like rolling the dice on health insurance and hoping you don’t get sick. Eventually, you will (get sick) and if you don’t have health insurance you have a serious problem. But using lawyers is not just remedial –or even also just preventative. The party with the lawyer who engages in pre- deal or pre-litigation management, “framing” (like a snapshot) how the deal or lawsuit will look can add value to the case, make it go smoother and make or save you some serious money.