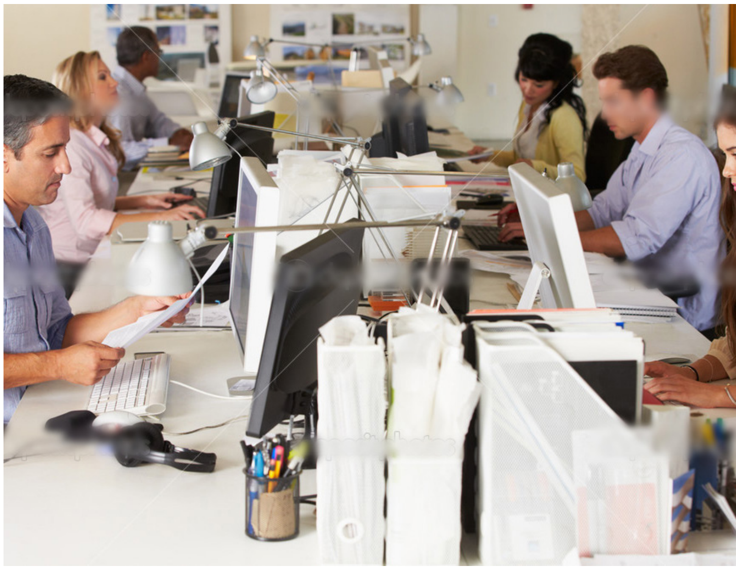
# COMMON MISTAKES BY PRIVATE COMPANIES

Legal issues arise for every business. Typically, privately owned companies do not have in-house counsel. To avoid expensive legal problems before they occur, wise business owners conduct thorough periodic reviews of policies and practices to identity and address areas that need improvement. Three common mistakes made by business owners are treating employees as independent contractors, not maintaining proper records and having no succession plan for the organization. Each of these areas are described below and include some recommendations and considerations to address when making decisions.

## TREATING EMPLOYEES AS INDEPENDENT CONTRACTORS

Treating service providers as independent contractors rather than employees is tempting. If respected, it avoids payroll withholding obligations and the obligation to include these service providers in expensive workers' compensation insurance programs and employee benefit plans. However, federal and state regulatory authorities are all too aware of these potential company benefits and have adopted multiple sets of rules to avoid abuse. From a tax perspective, the IRS has adopted rules which spell out a number of characteristics of employees, but many states have different sets of criteria that also must be complied with. The bottom line is that any person who works for you on a regular basis is likely to be either a full time or part time employee. The penalties for mischaracterizing service providers as independent contractors can be severe, so it is best to be sure that you are on firm legal ground before treating someone who regularly provides services to your company as an independent contractor.



## POOR RECORD KEEPING

Every company has legal agreements that are important to its operations. These include real estate and equipment leases, contracts with customers and suppliers, employment agreements, financing documents, etc. However, a remarkable number of companies find, when a question arises about a contract, that their file copies are unsigned or only partially signed, or they are missing important schedules or exhibits.

A similar problem often arises when a company is asked to document who owns the company. While the owners are rarely in doubt regarding company ownership, in a remarkable number of cases, they have difficulty producing the paperwork to verify ownership. Stock certificates are often lost or perhaps not even issued and subsequent transfers resulting from death or people leaving the company are often not properly documented.

This situation can go on for years, but when there is a tax audit, a bank financing or a possible sale of the company, being able to document company ownership can become critically important. Corporations should take the time to issue certificates representing their stock ownership. Each stock certificate should be numbered sequentially and the corporation should maintain a separate stock register or ledger for each class of stock, showing the name of the stockholder, date of issuance, certificate number, number of shares represented by the certificate and other relevant information (For example, was the stock issued for cash, property or services; was it originally issued by the corporation or transferred from another stockholder, etc.) Limited liability companies and partnerships are not legally required to issue certificates evidencing their equity ownership interests, but they are permitted to do so. If they chose not to, equity interests should be spelled out in a signed copy of the company's LLC operating agreement or partnership agreement as the case may be.

## NO TRANSITION PLAN

Owners approaching retirement age or suffering from a serious illness or disability can be the source of significant stress and uncertainty for both employees and customers. Under those circumstances, it is important for the owner to be able to allay concerns by assuring people that there is a well-thought-out transition plan in place. Transition plans vary but they usually include an agreement among the shareholders as to what happens to the owner's shares on death, disability or retirement and in many cases, an equity compensation plan, which results in key employees acquiring an increasing stake in the company, over time, as long as they remain employed by the company. In this regard, it is critically important to start planning for transition early. These plans and the underlying legal documentation can often take many months to develop and refine. They also require updating as circumstances change.

It is a sound practice for private companies to do a thorough periodic review to see if there are areas that should be addressed before they become expensive legal problems. If we can assist by providing you with a due diligence check list or other input, please let us know.

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