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I WANT TO INCORPORATE

Often the first thing I hear from a new business client is “I want to incorporate”. Many times that is what we end up doing. But usually what the client really wants is to start a new business and—the instincts are good here—to minimize personal liability.

Surprisingly often, after hearing the plans for a budding business, my best advice is that needed capital can be better used for something other than paying a lawyer to set up a corporation, at least at first.

Sometimes, after talking to the client and usually with his accountant, another form of business entity such as a limited liability company is recommended. But that is another discussion.

Everyone has heard scare stories about the high number of startup businesses that fail in the first few years, and no one wants to deplete their savings or retirement funds to pay debts of a failed business. But it should be kept in mind that the liability protection of a corporation or other limited liability alternatives is of no help when the owner or owners voluntarily guarantee loans of the business. And it is rare that a bank or other experienced lender will miss that one. Even a savvy trade creditor will often be unwilling to supply much in the way of equipment or inventory without a personal guaranty.

Getting back to the basic purpose of minimizing liability (and the new catchphrase is “asset protection”) my first advice to a new business is to buy as much liability insurance as is affordable. A small retail or service business that does not provide much risk to the customer can get by on fairly low commercial liability premiums and can save the costs of setting up and maintaining a corporation. It should not be forgotten that a corporation or limited liability company requires certain formalities in its operation, which means ongoing accounting advice and usually another set of tax returns every year.

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However, if your business poses certain risks to customers and the public which cannot be affordably or fully insured, the initial and ongoing costs of setting up a corporation or other limited liability business entity are well worth it. Even for a less risky business, if the capital investment and amount of money expected to be handled by the company is substantial, costs of organizing and maintaining a corporate or similar structure are worthwhile on a relative basis. For a more complicated business, the built-in organizational structure provided by corporation laws and similar statutes are beneficial.

If the business will have more than one owner (perhaps excluding husband and wife), a corporate or similar structure is generally advised in order to provide a structure for sharing profits and losses as well as exit provisions.

As in every important business change, good communication among the business owner and an attorney and accountant familiar with the business can lead to the best decision.

-Dennis O'Toole