STARTING A SMALL BUSINESS: FOOLS RUSH IN

by Susan A. Maslow, Esquire

As a business lawyer, I am always pleased to see a new gallery, dance studio, gift shop, graphic arts or craft business bloom in previously unoccupied commercial space. I've also found myself feeling deeply disturbed, and even somewhat guilty, when I see the same "business" closing its doors. Too often, efforts to realize artistic dreams in a business turn into lingering, painful nightmares. If you are considering starting your own small arts business, or entering into a partnership, it would appease my conscience considerably if you would consider the following:

A PLAN BY ANY OTHER NAME

Preparing a concise, realistic business plan is one of the most crucial tasks before you. The business plan will serve a variety of purposes including helping you discover issues you may otherwise not see. Problems solved on paper are much less expensive. Your plan should include a description of the management team, the products and services, the market, the competition, the marketing goals and strategies, the financial strategy, the financing goals, predictable milestones and an assessment of risks and problems. You may discover that it is too risky to proceed. Before you meet with your potential partners, banker or lawyer, prepare a rough draft of your business plan. Depending upon your true objectives and predictions, your professionals may suggest radically different strategies for assisting you. The business plan will govern (i) what type of legal entity might be appropriate for your venture; (ii) how you raise capital; and (iii) what provisions for governance are to be adopted. Your ever-changing, realistic business plan is not an end but a process which is the most important tool in focusing your initial and subsequent discussions. There are a number of excellent software packages that can help you create a business plan. Check out Inc, Magazine or PC Magazine and see what is available. You may even call on your local college business school and ask if anyone wishes to help you prepare a plan (for free) as a learning experience. In several cities the federal SBA has a group of retired executives available as a free advisory board.

GROSS PROFIT MARGIN

Three little words that can mean so much. If your Gross Profit Margin is not high enough to allow your business to form capital (as well as provide you an income), no matter what else, your business will fail. A rough definition of GPM is the ratio of Gross Sales (Revenues) minus the Cost of Goods Sold over Gross Sales (Revenues). You can never have too much working capital. Borrowed money can provide a temporary fix but ultimately lien free cash - equity contributed at the onset or generated to cover capital requirements - is essential to generate meaningful profits and a return on the investment. You can discount the value of your services (and the services of any co-venturer) at the onset but be realistic. You can't work indefinitely for nothing ... this is, after all, a business venture.

STAYING ALIVE

Although no one likes to consider the fact that a business enterprise may not be successful, during its early months, losses must be expected and plans for such losses adopted. Only by facing the realistic start-up costs can you possibly anticipate your equity and financing needs. Your business plan will help you determine how long the period before positive cash flow is generated may last. It should have a worksheet projection of income and expense, assets, liabilities and equity, month by month for at least two months prior and eighteen months after you open the doors. Refer to your worksheet time and again, making adjustments every time you have "real" numbers.

RAISING CAPITAL

If you accept investment from others, you must comply with Federal and state securities laws, no matter what form of business entity is used. These requirements are quite complex. If you need investors who will be depending on your efforts and will not be active partners, you may need a formal disclosure document, usually in the form of a private placement memorandum. This is an area to discuss in detail with a lawyer who will help you work through what capital might be available to you in your first round of financing. Any financial institution you approach will require a substantial equity contribution from the principals.

HORSE, ZEBRA OR ASS

The choice of the appropriate basic form of business entity will depend on your needs. The several forms include: (i) sole proprietorship; (ii) partnership; (iii) limited partnership; and (iv) corporation. In the corporation category, you have both "C" and "S" corporations and limited liability companies. Each alternative has specific legal characteristics and requires the creation of legal documents which memorialize all necessary transfers, financing arrangements, and the intention of what is called the "equity holders" in respective parts of the whole. One or more forms of business ownership may be completely unsuitable to your business plan. For example, the use of the sole-proprietorship is inappropriate (not to mention impossible) if there will be more than one owner. A limited partnership is similarity unsuitable if all the partners are likely to take an active role in the business.

The two classic considerations in the choice of entity are usually maximizing tax savings and limiting the liability of the owners to enterprise assets. Limited liability may, however, be illusory if your bank requires a personal guarantee from the principal owners. Consideration must also be given to the intended flow of funds back out of the business entity. Does one investor plan to get his or her money back before another? Your plan must address such expectations to alert your lawyer of the need to (i) pick a business form that permits variations in the capital structure, and (ii) document your deal.

ASSEMBLE YOUR TEAM

Ask your business savvy friends who they have used with success as a business lawyer or business accountant to be sure that you get the proper planning and consultation before entering into any business relationships. Certainly be sure you consult with counsel before you sign in any capacity under a lease, agreement of sale for real or personal property or other binding document. Do not be distracted by a landlord's or seller's insistence that they have given you their tenant/buyer friendly "form", that "no one ever has any comments", that they will accept "no revisions" or that you'll work out the "little details" later. It is the details that will cripple you from altering a course chartered for shipwreck.

START A FREQUENT BUYER CLUB

Spend time thinking about who is going to buy, what they want and what you can get them to pay. Test your market. Evaluate different incentive programs that you can implement without disastrous impact on your margins. Marketing and sales are frequently the weakest part of new management team, partly because entrepreneurs are often naive about the talent that successful marketing and sales demand. Marketing and sales may be the single most critical success variable in building a new business for, as has been said by many before me, "the best product in the world is a failure if not enough people buy it." There should be a market that will permit healthy earnings of 10 to 20 times your initial investment within 5 years. If not, you might do better in a mutual fund or other less risky investment vehicle. Remember, you can love your product and still create a sound business. Don't believe your venture's future revenues can be predicted in terms of a percentage of a market. You must determine, with specificity, the steps you will take to achieve the market penetration you are aiming for within a realistic time line.

RELATIONSHIPS

Often the people we start new businesses with are friends, family members or former colleagues - not strangers. The relationship is already defined and comes with several (unwritten) rules. This means you need to deal with each other with more formality -- not less. Partnership or Shareholder Agreements are a must - not something to think about when you have more time or a problem comes up. Who is "in control" and how equal will your equals be? Do you share underlying values? What are your respective expectations with regard to time committed, money spent, and daily operations? Who will get paid as an employee and when? How will you resolve differences of opinion and how involved can spouses or other family members be in your venture? Every relationship changes drastically when you are losing money.

Sometimes relationships change even more dramatically when ample money is being generated and one person thinks they are entitled to more than they are getting. Your best pal can become your worst enemy. When all energies should be directed to finding quick solutions to unforeseen difficulty, a divided home team can precipitate a fatal move or worse, paralysis.

<u>EMERGENCY EXIT PLAN</u>

Business ventures are not like parenthood though you may certainly feel that this project has become your "baby". You need to contemplate how you might disentangle yourself long before your only options are retirement, bankruptcy or an expensive business divorce from a partner or co-shareholder. Does the decision to close the door have to be unanimous? Are you interested in cross purchase rights, and if so, at what price? Are you willing to carry a disabled partner? Can you transfer your equity to a third party or issue additional shares or partnership interests to generate more capital without your partner's consent? Remember your decision to exit, or need to see your partner exit, may not be voluntary. If it is discussed and planned before the fact, it doesn't have to also be messy. Everything should be addressed in your Partnership/Shareholder Agreement. If you are going down this road alone, identify financial targets you will use to critically evaluate the likelihood of failure, success or the need to find a new venturer to provide you with a lucrative exit!

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