

Sink or Swim

What not to do when setting up a business or new venture

By Kyle Seeback

We've all heard the promises "Save hundreds, even thousands, in legal costs". "Be your own lawyer" "You can set up your own company". "Eliminate the hassle of lawyers". But what is the real cost of doing it yourself? Or more importantly, what is the real cost of not doing it at all?

Some legal procedures are relatively straightforward and do not necessarily require a lawyer's involvement. However, situations arise, particularly in business matters, where legal advice can literally make the difference between growing and sinking your business.

the horrible truth

The following anecdote illustrates the old adage "penny wise and pound foolish!"

Peter and Paul (not their real names) had known each other through previous business dealings. Together they invented a new type of fishing rod. Based on their discussions with a sporting goods retailer, they decided to start a business to market this new and improved fishing rod.

Since this was a new start up, Peter and Paul were concerned about money; they considered different ways that they could cut costs. They decided that hiring a lawyer was too expensive, especially because for \$20 they could buy a do-it-yourself incorporation kit. Using software provided with the kit, they prepared the necessary incorporating documents as well as the initial bylaws, resolutions and share subscriptions. They also drafted what they referred to as a partnership agreement. The new company was Fishing Poles Inc.

Unfortunately, Peter never signed the incorporation documentation. In addition, Peter and Paul's respective interest in the business, Fishing Poles Inc., was different in their agreement from their actual shareholdings. Although each had half of the shares, according to their "partnership agreement" Paul owned 55% of the business and Peter owned 45%.

then it turned sour

During the first few months, things ran smoothly for Peter and Paul and they were in the midst of negotiations with three potential wholesalers. It was not long however, before things began to turn sour. Paul decided he wanted to leave the company however; he had already begun setting up a competing business, Poles & Rods Ltd. To add salt to the wound, Paul talked one of the company's salesmen into joining him at Poles & Rods Ltd. and stole two of Fishing Poles Inc.'s major contracts.

Paul's actions forced Peter to retain a lawyer to try and salvage Fishing Poles Inc., his own future potential revenue, and prevent Paul from getting rich off their common idea. After assessing the situation, Peter's lawyer made the following observations and recommendations:

- There was no shareholders agreement in place.
- The confidential information and non-competition agreement entered into between Fishing Poles Inc. and the salesman was poorly drafted and not enforceable.
- They had never applied for a patent.
- As the incorporating documents had never been executed by Peter, the actual shareholdings in Fishing Poles Inc. were unclear.

Sink or Swim *(continued)*

useless paper trail

Peter and Paul had never formed a partnership and, therefore, the partnership agreement was the wrong contract. Peter and Paul needed a shareholders' agreement; however, even if the partnership agreement could have been construed as a shareholders' agreement, it was so poorly drafted, it was essentially useless.

Based on the conflicting documents, it was unclear who held what shares in Fishing Poles Inc., or how many. The result was that it was impossible for Peter to get authorization from Fishing Poles Inc. to commence legal action against Paul. Therefore it would be necessary to seek leave of the court to commence a derivative action against Paul and the salesman.

Although Fishing Poles Inc. had made their sales people sign a non-competition agreement, it had been poorly drafted, and like the partnership agreement was all but useless. In addition, Peter could not obtain the authorization from Fishing Poles Inc. to seek injunctive relief against Paul and the salesman to prevent them from soliciting business from customers of Fishing Poles Inc. Finally, it was unclear who had the rights to patent the new fishing pole.

The additional steps required prior to taking legal action caused delays in commencing the action against Paul, Poles & Rods Ltd. and the salesman. By the time Peter was able to pursue the action against Paul, Poles & Rods Ltd. and the salesman, the damage to Fishing Poles Inc. had already been done.

do it right the first time

This mess could have been resolved more efficiently, had Peter and Paul sought proper legal advice from the beginning. While it may be smart to cut some corners when establishing a new business or significant venture, failing to seek expert advice for such fundamental matters as incorporation, asset protection and important legal agreements can ultimately be very expensive and may actually sink your business.

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so, what's the message?

If you are embarking on a business venture, or have recently joined forces to build a business, take a moment to review all of your corporate documentation and talk to one of our lawyers if you have any doubts or concerns. This reality check can be relatively straightforward and not expensive. It can also save you tens of thousands of dollars in future potential legal costs. Even if operations are underway, step aside and initiate this review. Any of Fishing Poles Inc.'s problems could have been remedied even after it had begun operating. However, the time to fix the problems are when things are going well, not after things have fallen apart. When in doubt, please take a moment to call me. A five-minute discussion could initiate action that could save you weeks of frustration.

reality checklist

- Shareholders' agreement
- Non competition and non solicit agreements for employees
- Confidential information agreements for employees
- Copyright, trademark or patent registrations
- Intellectual property transfer agreement between the designer/inventors and the company
- Up to date corporate Minute book

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