This unit on dealing with legal issues in a small business, the ninth in a series of 18 modules, is on the second level of the revised PACE (Program for Acquiring Competence in Entrepreneurship) comprehensive curriculum. Geared to advanced secondary and beginning postsecondary or adult students, the modules provide an opportunity to learn about and try out entrepreneurship ideas so that students can make a preliminary assessment of how these ideas relate to personal needs. The units on this level contain detailed explanations of small business principles, suggestions on how to find information and use techniques, and encouragement for creating a future business. Students completing this unit should be able to perform these competencies: (1) describe the major legal issues faced by entrepreneurs; (2) determine when and how to obtain assistance with legal issues; (3) identify major types of contracts used by entrepreneurs; (4) identify the major rights and responsibilities of lessees and lessors; and (5) identify special contracts used by entrepreneurs, such as mortgages, deeds of trust, credit sales contracts, and long-term sales contracts. The unit is organized into five sections. Following a preliminary section on how to use the unit (with vocabulary and a review of the objectives for this topic on level 1), the unit's information is presented in question-and-answer format. Individual and group activities, an assessment to be completed with the teacher, and sources used to develop the unit follow. A list of the modules of Revised PACE, Level 2 completes the unit. (KC)
Dealing with Legal Issues

Developed by M. Catherine Ashmore and Sandra G. Pritz

You will be able to:

- Describe the major legal issues faced by entrepreneurs.
- Determine when and how to obtain assistance with legal issues.
- Identify major types of contracts used by entrepreneurs.
- Identify the major rights and responsibilities of lessees and lessors.
- Identify special contracts used by entrepreneurs (mortgage vs. deed of trust, credit sales contract, and long-term sales contract).
BEFORE YOU BEGIN...

1. Consult the Resource Guide for instructions if this is your first PACE unit.

2. Read the Unit Objectives on the front cover. If you think you can meet these objectives now, consult your instructor.

3. These objectives were met at Level 1:
   - Describe why a basic understanding of legal issues is important to the owner of a small business
   - Define the term “contract”
   - Identify the conditions that call for a written contract
   - Name and describe the five essential components of a contract
   If you feel unsure about any of these topics, ask your instructor for materials to review them.

4. Look for these business terms as you read this unit. If you need help with their meanings, turn to the Glossary in the Resource Guide.

   conveyance
   guarantee
   warranty
DEALING WITH LEGAL ISSUES

What is this unit about?

In the process of organizing and operating a small business, the owner deals with a variety of legal issues. Some of these issues are obtaining patents for a product, purchasing items for the business, and paying on a mortgage. You should not deal with these issues without proper information.

Professional assistance from an attorney is very helpful in dealing with legal issues. In fact, the small business entrepreneur may find that it is necessary to obtain advice from a qualified attorney in order to deal effectively with legal issues.

Even when legal counsel is used, the owner of a small business is the prime negotiator for the firm. In fact, the owner/manager is the final decision maker in all basic business transactions.

In order to negotiate business transactions effectively, you will need to know how to obtain information about basic issues. In addition, you will need some grasp of the basic legal issues involved in each transaction.

The advice of an attorney can assist you in identifying basic legal issues related to each transaction. Because the advice of an attorney can be helpful in dealing with legal issues, you also need to know how to obtain this professional assistance. Such assistance can help in identifying the legal implications of a particular issue.

This unit is designed to assist you in learning more about the legal issues involved in operating a small business. This information will help you in negotiating transactions. The unit will focus on the major legal issues that entrepreneurs face. In addition, the major types of contracts will be discussed. Rights and responsibilities of lessees and lessors will also be explored.
Legal questions appear when any of the following problems or conditions arise:

- Form of organization (sole proprietorship, partnership, corporation)
- Taxes
- Leases
- Real estate
- Delinquent accounts, insurance contracts, estates and wills, purchase agreements
- Sales contracts
- General contracts and agreements
- Formal litigation

Daily transactions with customers, suppliers, employees, and the general public expose entrepreneurs to many legal risks. Therefore, they must be aware of local, state, and federal laws and regulations that apply to business activities.

The owner of a small business should also be aware of the legal problems related to the company's size, trade, and geographical location. Ignorance of the law is not accepted as an excuse, and even licensed attorneys are not always sure of certain provisions of the law and their interpretation by the courts.

To avoid law suits (litigation)—particularly unwarranted suits—the owner of a small business should know exactly the extent and limit of personal and business responsibilities to suppliers, customers, employees, and others. Necessary legal documents should be prepared in such a way as to limit the owner/manager's exposure to liability. This takes great care, as well as the time of the principals (important persons involved) and the services of a skilled attorney.

In addition, it may be helpful for the owner to be familiar with some of the sources of legal problems. The sources of legal problems have been identified in the Small Business Administration publication, Managing for Profits, and are listed in figure 1.
| Acquisitions | Government—Federal, State, and local |
| Advertising—copy packaging | Insurance contracts |
| Agents and brokers | Interstate transportation |
| Antitrust matters | Inventions |
| Arbitration—role in disputes | Labeling |
| Bankruptcy | Licenses |
| Board of directors | Mergers |
| Brand names | Misrepresentations |
| Buying and selling—terms and conditions | Multiple corporations |
| Checks—forgeries, frauds | Negligence |
| Contracts and agreements | Negotiable instruments |
| Competitors stealing employees | Order acknowledgement and confirmation |
| Corporate form | Patents |
| Employer and employee responsibilities | Permits |
| Employment agreements | Price discrimination |
| Franchises | Profit sharing |
| Product liability | Records, legal |
| | Retirement pensions |
| | Slander and libel |
| | Stock options |
| | Stock voting rights |
| | Stockholders |
| | Taxes |
| | Tie-in sales |
| | Trade secrets |
| | Trademarks |
| | Unfair competition |
| | Verbal agreements |
| | Wills |
| | Worker’s compensation |
| | Zoning |

Figure 1. Sources of legal problems.


You may wish to have the assistance of an attorney in order to deal with these or other issues. The services of an attorney may be helpful on other occasions. For example, an attorney can assist you when you purchase your business and establish the type of ownership. The attorney can advise you of the legal consequences of each type of ownership.

Your need for an attorney will depend upon the business that you are in. Highly regulated industries and businesses that use a number of contracts may need legal assistance on a daily basis. Other business firms may only need assistance occasionally. Some people recommend that legal advice be used before any business agreement is made. You—the small business owner—must determine when you need an attorney. Your decision will be based on your individual business and its particular needs.

How do you locate a competent attorney? One technique that is often used is reference from others. Relatives, friends, and neighbors may have been satisfied with a particular attorney. If so, they may be more than happy to recommend that individual to you. You may wish to get the names of several lawyers so you don’t limit your choice.

Another effective way of locating an attorney is to talk with the owners of small businesses that are similar to yours. If you do this, you may wish to ask entrepreneurs who are not direct competitors. Find out which attorneys they use and if they are satisfied with the services they have received.
There are other ways to locate a competent attorney. You may wish to talk with people who teach small business management, or to law professors. A local judge may be able to recommend your attorney. On the other hand, you may obtain referrals from the local or state bar association. Members of the Service Corps of Retired Executives (SCORE) may help you to identify prospective attorneys for your business.

Another source of names of attorneys is *The Martindale-Hubbell Law Directory*. This directory provides a listing of attorneys. Specific information about these attorneys is also provided, showing how other attorneys view their level of competence and integrity. This publication is available in law libraries, through local bar associations, and in some banks or legal offices.

Once you have identified several attorneys who might offer assistance to your business, make an appointment with each. You can tell them that you are interested in a meeting because you are starting a new business and want competent professional help. Find out if there is a charge for this preliminary meeting. Some lawyers won't charge for the initial meeting. Others charge a very small fee.

At the preliminary meeting, you will want to discuss your plans for the business. Find out what services the lawyer will perform for what fee. If the fee seems too high, you may wish to shop for another attorney. The Supreme Court has said that it is illegal for bar associations to fix minimum fee schedules for attorneys. So, you have every right to shop for legal fees that you can afford.

Some of the other things that you may wish to do in the preliminary meeting include discussing the questions that you consider important. Be sure that you are clear about the kind of information that you need. Try to develop a positive relationship with your attorney so that you can work together to benefit your business.
Almost daily, entrepreneurs are involved in establishing contracts. 

What is a contract? A contract is a mutual agreement made between two or more persons that is valid and enforceable by law.

The two most common types of contracts are lease contracts and sales contracts. At this point in time, you will have an opportunity to learn more about lease and sales contracts.

As you start your business, you will probably lease the site for your business rather than buy it. For this reason, it is important for you to become acquainted with leases and their terms.

After you become acquainted with lease terms, you will have an opportunity to take a closer look at sales contracts. Sales contracts are probably the most common type of contract. For this reason, it is important for the small business owner/manager to understand the nature of sales contract agreements. This information will follow our discussion of lease terms.

A lease is a special contract that establishes a relationship between a property owner and a tenant. A tenant (lessee) has possession of the real property of the property owner (lessor). Rent is the payment given by the tenant to the property owner. Many states have laws or statutes regarding leases. In some states, if the leasing period is to be a year or longer, the contract must be written to be enforceable.
There are various types of leases that a business can sign. Selecting the “right” lease depends on the circumstances, type of business, and common leasing practices within the industry. There are four types of leases:

- **Tenancy for years**: site is leased for a definite period of time. Lease can last six months, one year, five years, or ninety-nine years.
- **Tenancy from month to month**: site is leased month by month, and rent is paid by the month.
- **Periodic tenancy**: site is leased for an indefinite period of time, with rent due at specified intervals.
- **Tenancy at will**: site is leased for an indefinite period of time. Lease can be continued indefinitely, or can be terminated by either party.

In a lease agreement, both tenant and property owner assume certain responsibilities and rights. Some cities, counties, and municipalities have established rules and regulations with which both parties must comply. Therefore, you should check with the local government office responsible for regulating lease agreements in your community to be sure you know the exact duties and the rights of tenants and property owners. A general listing of the responsibilities of each party follows.

Normally, the duties and rights of the tenant (lessee) include:

- **Payment of rent**: the rent can be paid with money, services, or products, as long as both parties agree on the method of payment. Sometimes a security deposit is required prior to rental. This security deposit is refunded when the lease is terminated if the property is not damaged and is left in the same condition as it was when the lease was signed.

- **Use of the property**: the lease often specifies how the property is to be used. For example, if the property is leased as farm land, it cannot be used for mining.

- **Repair and alterations**: the tenant must make reasonable repairs to the property unless the property owner has agreed to make them. The property must be maintained in the same condition as when the tenant moved in. The tenant must also take reasonable action to prevent damage. In other words, if the roof leaks, the tenant should inform the property owner of the leak before a major problem develops.

- **Liability and injury to a third party**: the tenant is in exclusive control of the property. Under certain conditions the tenant can be held responsible for what happens on the property. For example, if ice forms on the steps or in the
entrance to the property, the tenant, not the property owner, is responsible for removing the ice. If anyone falls due to the negligence of the tenant, it is the tenant who is responsible.

**Assignment and subletting:** If a tenant subleases the property to a third party, the third party is liable for rent and other conditions of the original lease. However, if the third party fails to pay the rent, the original tenant is liable and must pay. Many lease agreements do not have sublease provisions. Normally, if subleasing is allowed, the property owner must approve of the sublease.

Property owners (lessors) also assume rights and responsibilities. Their rights and duties normally involve the following:

- **The right to collect and agreed rent:** if the tenant does not pay the rent when due, the property owner has the right to sue and/or evict the tenant. Eviction means the legal right to force the tenant off the property. Eviction laws vary from city to city. You will need to check your local rules and regulations concerning eviction.

- **Inspection:** the property owner does not have the right to enter the property at any time. However, the property owner can establish in the lease the right to enter the property to do whatever is necessary to protect it. The property owner can also show the property to prospective tenants at reasonable times. Again, be sure to check your local laws regarding inspection of property by the property owner. Some communities have very specific rules and regulations.

- **Condition of the premises:** unless agreed upon, the property owner does not have to keep the premises repaired and is not liable for injuries to a third party caused by neglected conditions of the property. In some states, human habitation
WHAT SHOULD A LEASE INCLUDE?

codes have been established. Such codes can provide for the following conditions:

- Protected (not exposed) wiring
- Sealed (not leaky) roof
- Easy-to-clean walls and ceiling that are free of loose plaster and wallpaper
- Screens on outside doors and windows
- Private bathrooms in each dwelling place
- Taxes: Unless otherwise stated, the property owner pays the property tax.
- Fixtures: If the tenant installs fixtures, they become a part of the property and belong to the property owner. To avoid problems, both parties should reach an agreement before the tenant installs fixtures.

Since a lease is a legal document, it is important that certain precautions be observed before the lease is signed. Examine the property thoroughly to make sure that it suits the purposes for which it is to be used. Make sure that the signatures are properly witnessed. Examine the lease thoroughly to make sure that it contains the following:

- No narrow restrictions on merchandise that may be sold or services that may be provided
- Statements of the duration of the lease, the amount of rent, the date on which the rent is to be paid, and the penalty for late or nonpayment
- Arrangements for subleasing, subletting, and assignment to another merchant
- Provisions in case of fire or other hazards
- Explanation of mutual obligations concerning major and minor repairs
- Options and renewal arrangements

WHY LEASE EQUIPMENT?

Often businesses lease more than the firm's premises. Even though leasing rates are usually higher than rates charged for purchasing the equipment on credit, many small firms lease equipment. Manufacturers very often lease machine tools and heavy equipment, including trucks. It is not uncommon to find service, wholesale, retail, and manufacturing firms leasing data processing equipment, photocopying equipment, and company cars.
Leasing has some definite advantages. These include—

- It does not tie up capital.
- It eliminates the need for some types of insurance protection.
- It saves taxes. Lease payments are tax-deductible.
- It eliminates possession of outdated equipment. When new models become available, most lease agreements allow the lessee to exchange the equipment for the new models.
- It saves on maintenance costs, since these costs are usually included in the terms of the lease.

The most common type of contract is a sales contract. A sale is the transfer of ownership or title of goods from the seller to the buyer for a consideration (price). The sales contract can be written, oral, or implied. For example, in an implied contract, if a buyer takes a product from the store shelf, the implication is that the buyer will pay for it.

A distinction must be made between a sales contract and a contract to sell. The Uniform Commercial Code (UCC) states, “Contract for sale includes both a present sale of goods and a contract to sell goods at a future time. A sale consists in passing the title from the seller to the buyer for a price.” A contract to sell means that the title for the goods is to pass to another at a later time.

Sales contracts are written using a distinct terminology or vocabulary. If you read a number of sales contracts you will encounter the same set of terms to describe the persons and places involved. A merchant is the person who regularly purchases and sells goods. The casual seller only sells occasionally. Goods are tangible, movable personal property. A conveyance is a transfer of a title of real property from a seller to buyer.

Sales cannot involve illegal acts and there are laws to prevent certain types of sales. For example, one must have a prescription to buy drugs, and the pharmacist selling prescription drugs is required to have a license to sell them.

There are also laws that prevent the sale of certain items on Sundays or holidays. Other laws require that certain goods be packaged and labeled in a specified manner.

The Uniform Commercial Code (UCC) relates to commercial or business transactions involving personal property and contracts. It is a good guide; it contains detailed rules of conduct for business persons. Since it covers appropriate methods of doing business, you need to become familiar with the code.

Each state modifies the UCC to fit its needs. The code is also interpreted by the courts. However, if you have a specific question or
WHAT DO WE MEAN BY THE TERMS WARRANTY AND GUARANTEE?

A warranty is a promise or a representation made by the seller that an article will operate in a specified manner. A warranty does not exist when goods are sold "as is."

Generally, warranties are expressed or implied. When an expressed warranty exists, the buyer gets a formal statement by the seller. This is usually in the form of a written guarantee about service or performance.

A guarantee is a pledge or assurance that something is as represented and will be replaced if it does not meet specifications. A guarantee is a positive assurance that something will be done in the manner specified.

A seller makes implied warranties every time a sale is made. With each sale, the seller warrants several things:

- The seller has the right to convey title.
- The merchandise will conform to the sample.
- The merchandise being sold will be fit for use.
- The merchandise is fit for human consumption.
- The merchandise is marketable.

These are implied warranties that exist with each sale.
WHAT ARE CREDIT SALES?

A business arrangement by which a customer may purchase goods and services and pay for them within a specified future period is known as a charge or credit sale. As an entrepreneur, you will work with credit sales in several ways. For example, you may purchase goods and services for your business using credit. You may also offer goods or services for sale to others on credit.

When you purchase goods on credit, your credit sales contract can be sold. A buyer can buy goods, sign a contract, and send payments to the seller/creditor. Sometimes a seller/creditor transfers contractual rights to others. This means the seller/creditor sells the contract to another party for a small fee. This is called an assignment. Contract assignments are legal as long as they do not materially change the original contract price.

For example, Mr. Jones buys a refrigerator from E-Z Appliance. However, a month later, the firm decides it needs more cash to take advantage of a sale, and it sells Mr. Jones’ contract to the White Finance Company. There is no change in the amount due.

Mr. Jones is confused. How can he owe money to White Finance Company when he purchased the refrigerator from E-Z Appliance Store? E-Z Appliance has sold Mr. Jones’ credit sales contract to White Finance Company. By law, Mr. Jones is obligated to pay White Finance Company.

WHAT IS A CONDITIONAL CONTRACT?

There are two essential characteristics to a conditional sales contract.

- The seller (creditor) retains the title to the goods.
- The buyer (debtor) is given possession and use of the goods. The buyer is subject to making regular payments.
With a conditional sales contract, the buyer has the right of possession, the use, and the enjoyment of the goods. The buyer also has the right of controlling the goods as long as regular payments are made. In addition, the buyer must pay for any licenses for the goods and for any taxes. The buyer also bears the risk of loss of goods by fire, theft, or other misfortune.

This is what happens with a conditional sales contract. The merchandise is delivered to the buyer. The title to the merchandise remains with the seller. The buyer and the seller agree on the conditions by which the title will pass from the seller to the buyer. Usually, the merchandise may not be moved or sold to another without the consent of the seller.

The seller may repossess the merchandise in the event the buyer fails to fulfill the conditions of the contract. If the buyer misses one payment, the seller can repossess the merchandise.

Because conditional sales contracts are usually extended over a long time period, they may be called long-term sales contracts.

Before signing a long-term sales contract, you may wish to have it checked by your attorney. Such a contract could be financially disastrous to your firm if, for example, economic conditions were to change or competition were to develop new products.

In times of recession, some businesses have found themselves unable to fulfill a specific long-term sales contract profitably. To guard against this some people advise you to consider including a price renegotiation clause in a long-term sales contract. It may help to protect both parties to the contract.

**WHAT IS A MORTGAGE?**

In a mortgage agreement, a mortgagor temporarily or conditionally pledges his or her property to a mortgagee as security for a loan. The mortgagee collects loan repayments as well as interest for the duration of the mortgage agreement.
Although state laws vary, all mortgages usually have these characteristics:

- If the debt is not paid on schedule, the mortgagee has the right to take recourse under the prevailing state laws. Usually the mortgagee can sell the property by court order to get his or her money back. In some states, property being sold by the mortgagee to regain losses must be sold at a public auction to the highest bidder.

- The mortgagor has the right to regain the property by paying what is due in a limited time after default. In some states, even after the court has sold the property, the mortgagor can regain the property by paying the mortgage in full—usually within one year.

- Once the money is paid in full and the mortgagee gets his or her money plus interest, the mortgagor owns the property free and clear.

If an entrepreneur needs to borrow money and is using real property as collateral, a mortgage instead of a deed of trust should be secured. Unlike a mortgage, the holder of a trust (the one who loans the money) has the power to sell the property if payment is not made, and the borrower has no right to get the property back.
ACTIVITIES

The following activities are designed to help you deal with legal issues.

INDIVIDUAL ACTIVITY

Review the types of legal issues that entrepreneurs face. Use this information as a guide to develop a list of the legal questions that you might face in your own business.

INDIVIDUAL ACTIVITY

Conduct some independent research regarding a type of small business to find the following information:

- What licenses are necessary to do business?
- What statutes apply to your business?
- Will your operations be subject to interstate commerce regulations? If so, which ones?

INDIVIDUAL ACTIVITY

Identify the provisions that you desire in a lease.

INDIVIDUAL ACTIVITY

Draft a sales contract that might be used in your business.

GROUP ACTIVITY

Divide into small groups of three or four people who are interested in the same type of business. Then, perform the following activities, using the material from the individual activities.

- Discuss the types of legal issues that you might face in your business. Have you included all sources of problems?
- Pool the results of your independent research. Were the results the same or different? If the results were different, why were they different?
- Examine each other's desired lease provisions. Are all factors covered? If not, what is missing?
- Examine each sales contract in the group. Are all factors covered? If not, what is missing? How could each contract be improved?

CASE STUDY

Tom Garcia is planning to start his own business. He has decided that he will open a sporting goods shop in one of the local shopping centers. Tom's shop is the only one in the general shopping center area that deals with sports equipment.

Tom is in the process of negotiating a lease agreement. The lessor has offered several options, including tenancy for years, tenancy from month to month, periodic tenancy, or tenancy at will.

The lessor has suggested that the lessee pay the rent with services rather than with money for a time period. The services are tennis lessons for each of the five members of the lessor's family for a period of at least six months.
The lessor has indicated that Tom must make reasonable repairs on the building. In addition, only minor alterations may be made to the building.

Tom is responsible for any liability or injury to a third party, and he cannot sublet the property. If he installs any fixtures, they become a part of the property. In addition, Tom will have to get the owner's approval before installing such fixtures.

Answer the following questions on a separate piece of paper:

1. In your opinion, should Tom continue to negotiate this contract? Why or why not?

2. What type of lease would be best for Tom?

3. Should Tom try to get other provisions written into the lease? If so, what are these provisions?
ASSESSMENT

Directions: Read the following questions to check your knowledge of these topics. When you feel prepared, ask your instructor to test your competency on them.

1. Identify the major legal issues faced by entrepreneurs.

2. Identify the two major types of contracts used by entrepreneurs.

3. Identify the four types of leases.

4. Identify the major rights and responsibilities of lessees and lessors.

5. Describe the Uniform Commercial Code.

6. Identify special contracts used by entrepreneurs (credit sales contract, long-term sales contract, mortgage, and deed of trust).
NOTES


We thank the above authors for permission to reprint from their work.

SOURCES USED TO DEVELOP THIS UNIT


For further information, consult the lists of additional sources in the Resource Guide.
Level 2

Unit 1. Understanding the Nature of Small Business
Unit 2. Determining Your Potential as an Entrepreneur
Unit 3. Developing the Business Plan
Unit 4. Obtaining Technical Assistance
Unit 5. Choosing the Type of Ownership
Unit 6. Planning the Marketing Strategy
Unit 7. Locating the Business
Unit 8. Financing the Business

Unit 9. Dealing with Legal Issues
Unit 10. Complying with Government Regulations
Unit 11. Managing the Business
Unit 12. Managing Human Resources
Unit 13. Promoting the Business
Unit 14. Managing Sales Efforts
Unit 15. Keeping the Business Records
Unit 16. Managing the Finances
Unit 17. Managing Customer Credit and Collections
Unit 18. Protecting the Business

Resource Guide
Instructors' Guide

Units on the above entrepreneurship topics are available at the following three levels:

- Level 1 helps you understand the creation and operation of a business
- Level 2 prepares you to plan for a business in your future
- Level 3 guides you in starting and managing your own business

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