



A

LEGAL & PRACTICAL GUIDE

FOR

MARYLAND SMALL BUSINESS

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*The authors*

Thomas P. Kimmitt, Jr., Esquire  
Whiteford, Taylor & Preston L.L.P.  
One West Pennsylvania Avenue  
Suite 300  
Towson, Maryland 21204-5025  
Telephone: 410-832-2032  
Facsimile: 410-832-2015  
Email - [tkimmitt@wtplaw.com](mailto:tkimmitt@wtplaw.com)  
Website - [www.wtplaw.com](http://www.wtplaw.com)

John A. Hayden, III, Esquire  
Whiteford, Taylor & Preston L.L.P.  
One West Pennsylvania Avenue  
Suite 300  
Towson, Maryland 21204-5025  
Telephone: 410-832-2074  
Facsimile: 410-832-2015  
Email - [jhayden@wtplaw.com](mailto:jhayden@wtplaw.com)  
Website - [www.wtplaw.com](http://www.wtplaw.com)

David L. Cahn, Esquire  
Whiteford, Taylor & Preston L.L.P.  
7 St. Paul Street  
Baltimore, Maryland 21202-1636  
Telephone: 410-347-9442  
Facsimile: 410-234-2312  
Email - [dcahn@wtplaw.com](mailto:dcahn@wtplaw.com)  
Website - [www.wtplaw.com](http://www.wtplaw.com)

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**NOTES**

# A LEGAL AND PRACTICAL GUIDE FOR MARYLAND SMALL BUSINESS

## I. INTRODUCTION

The purpose of this Guide Book is to discuss some of the major issues facing persons wishing to begin a business or who are involved in a small business. This Guide Book is not a replacement for the competent professional assistance of lawyers, accountants, general business advisors, bankers and other professionals regularly dealing with start-up and small to mid-size businesses.

## II. CHOICE OF BUSINESS ENTITY - ALL BUSINESSES ARE NOT CREATED EQUALLY

One of the first decisions a business person must make is which business entity is best for him. To make that decision, the business owner must understand his choices. The guiding concerns in choosing the appropriate business entity are: (1) liability; (2) ease of formation; (3) taxation; (4) suitability to a particular business; (5) plans for future expansion, and (6) ease of sale, transfer, liquidation, dissolution.

The four basic business choices that are considered by most all new businesses are: sole proprietorship, general partnership, corporation and limited liability company. There are also special subgroups and entities such as limited partnerships (which is beyond the scope of this guide book), limited liability partnerships, "close" corporations, professional corporations, S corporations, benefit corporations (which are beyond the scope of this guide book) and business trusts (which are also beyond the scope of this guide book).

A. Sole Proprietorships. A sole proprietorship is a basic form for doing business. It presumes one owner. All income and loss from the business flows directly to the owner. A sole proprietorship files no separate federal or state tax return, but rather its income and expenses are those of the individual and are reported on a Schedule C, which is a part of Form 1040 Individual Federal Income Tax Return. A sole proprietor should keep business records separate and apart from his personal records so that business expenses and income can be separately identified and accounted for accurately as associated with the business.

A sole proprietorship may be operated under any name. That said, there may be restrictions resulting from prior use or claims made by others already using the name. Trade names should be registered with the appropriate state or county agency. Maryland has central filing so trade names are registered with the Maryland State Department of Assessments and Taxation. Many other states still require the recording of trade names in the city or county where the business will be located. The sole proprietorship will have a Federal Identification Number, which in most cases will be the same as the sole proprietor's social security number. If the sole proprietor has employees, it will be required to obtain a federal identification number. The duration of the sole proprietorship can be no longer than the life of the sole proprietor.

Just as all income and expenses from the sole proprietorship flow directly to the sole proprietor, so too does all liability. All assets, business and personal, of the sole proprietor are subject to the claims of creditors of the sole proprietorship.

B. General Partnerships/Limited Liability Partnerships. A general partnership is defined as a voluntary contract (oral or written) between two or more legally competent persons to carry on a business for profit and to share profits and losses of the business. For federal and state income tax purposes and for business law purposes, a partnership is a legal entity separate and apart from its partners. A partnership may sue or be sued, buy, lease or sell property, sell and trade stocks and the like in its name. A general partnership must also file federal and state income tax returns; however, it pays no federal or state income tax. The tax returns filed by a partnership are informational returns. The income and losses generated by a partnership are distributed or deemed to have been distributed to the general partners in accordance with the terms of the Partnership Agreement, which generally will provide for a distribution of profits and losses in accordance with the percentage of ownership interest of each owner/partner.

General partnerships exist under the law until there is only one remaining owner or until one or more of the partners has left the partnership, and the partnership elects to dissolve and distribute its assets. A general partnership does not provide any liability protection for its partners. Each partner is personally liable to the extent of his or her assets for any liabilities of the partnership which cannot be satisfied by the assets of the partnership. A partnership between spouses increases their liability exposure by also subjecting their joint assets and those real estate assets owned as tenants by the entirety (often the home of the spouses) to the creditors' reach.

A statutory modification to the law of partnerships is the limited liability partnership. A limited liability partnership can actually attach to a general partnership or a limited partnership. The category of limited liability partnership results in reducing the liability of individual partners for contractual and tort obligations of the partnership and of the other partners. In Maryland, the election to be treated as a limited liability partnership requires the filing of a Certificate of Registration with the State Department of Assessments and Taxation. The Certificate must contain (i) the name of the partnership; (ii) the purpose(s) for which the partnership is formed, (iii) the principal address of the partnership which must be a physical address and (iv) the name and address of the resident agent of the partnership. A limited liability partnership is required to add the designation "Limited Liability Partnership", "L.L.P." or "LLP" after the name of the company.

C. Corporations. A corporation is a statutorily created entity, which is considered under the law to be a person separate and apart from its owners. This concept is often misunderstood, but is very important. The duration of a corporation is generally perpetual unless otherwise restricted by its Articles of Incorporation. The discussion of corporations in these materials assumes Maryland law. Different states impose different statutory requirements on corporations.

1. Basic Structure. The corporation has a structure different from sole proprietorships and general partnerships. In most instances, a corporation is managed by a Board of Directors, which must consist of at least one person. The Board of Directors as a whole manages the business making policy decisions, approving major actions and delegating day to day management. No director individually, as a director, has the authority to bind the corporation to agreements or commitments.

The owners of the corporation are its stockholders. Stockholders of a corporation are those persons (which includes individuals, trusts or entities) who have invested cash or other assets in order to acquire an ownership interest (stock) in the corporation. The stockholders of the corporation are charged with the responsibility of electing a Board of Directors and for making decisions on certain major corporate actions. Stockholders do not, except in the case of a close corporation which will be discussed later, manage the business. That job is left to the Board of Directors. No stockholder, individually, has the right to bind the corporation to agreements or commitments. The stockholders' power comes solely in official action taken in meetings and by stockholder votes.

The corporate officers of a corporation are charged with the general responsibilities for keeping the corporation in operation on a daily basis. The officers of a corporation are appointed by the Board of Directors. The officer positions must consist of a president, secretary and treasurer. Additional offices of vice president, assistant secretary, assistant treasurer, chief executive officer, chief financial officer, chief operating officer, Chairman of the Board and Vice Chairman of the Board can be created if permitted by the Bylaws of the corporation and approved by the Board of Directors.

2. Organization of a corporation.

(a) Articles of Incorporation. Unlike sole proprietorships and partnerships, corporations cannot be formed by oral agreements or the desire to engage in a business venture. In order to form a corporation "Articles of Incorporation" must be filed with an appropriate state agency. In Maryland that agency is the State Department of Assessments and Taxation. Any individual having legal capacity and of the age of majority can file Articles of Incorporation. There are a number of items which must be contained in the Articles of Incorporation including the principal address of the corporation (which must be a physical address), the number of shares of stock the corporation will have authority to issue, the powers of the Board of Directors and stockholders, and the naming of a resident agent (i.e., the person or entity who will accept service of process in the event of a law suit or other official notices sent to the corporation).

(b) Bylaws. The second step in the organizational ladder for a corporation is its Bylaws. Although often thought to be boiler plate and frequently unread until a crisis occurs, the Bylaws of the corporation are the governing document for the daily behavior of the corporation. Bylaws customarily provide the method by which meetings of stockholders and directors will be held, the general powers of the stockholders and directors, the method by which officers will be named for the corporation and the powers which those officers will have, the explanation of any indemnification which the corporation will provide for its officers, directors and employees and other such sundry matters as the parties wish to cover.

(c) Corporate Minutes. Corporate minutes, or in the alternative informal actions and consents, record actual decisions of the directors and stockholders. Generally, in order to pass any action of the corporation, it takes the vote of a majority of those in attendance at an authorized meeting of the directors or stockholders, whichever is appropriate. If the action is taken by an informal action and consent, the signature of all participants (directors or stockholders) will be required to pass the measure unless the charter (Articles of Incorporation) of the corporation provides otherwise.

(d) Stock Certificate. Each stockholder of the corporation also receives a stock certificate as evidence of the stockholder's ownership of shares in that corporation.

3. Limitation of Liability. A corporation offers as one of its primary advantages the limitation of liability to the stockholders of the corporation. Generally stockholders investing in a corporation put at risk only those assets which have been actually invested in the stock of the corporation. Also, in general, if the corporation suffers losses beyond its assets, the stockholders' personal assets are not subject to liability, so long as the corporation has properly maintained its independent status. Breaking through the corporate structure to attack its stockholders, whether they be individuals or other corporations or partnerships, is generally referred to as "piercing the corporate veil". Maryland courts generally protect the liability limitation which corporate stockholders seek. The only reported court decisions in Maryland that have allowed the "corporate veil" to be absolutely pierced have involved situations of fraud on the part of the stockholders against their creditors. Maryland Corporate Law does provide that stockholders who accept dividends or other distributions from a corporation having financial difficulty are subject to liability to the extent of such dividends or distributions.

4. Tax Considerations. Regular tax corporations (or C corporations, as they are referred to in the Internal Revenue Code) are considered for both federal and state taxing purposes to be separate entities. A corporation must file a separate tax return and pay income tax on its earnings. Any losses generated by the corporation must be held for use against either past or future taxable income earned by the corporation.

Formation of a corporation can generally be accomplished in a tax-free manner. Assuming that the initial stockholders meet certain threshold tests, they may contribute cash and assets to a newly formed corporation without incurring any personal tax liability. The issue is somewhat more complicated with regard to the incorporation of an ongoing business. The general rule for the incorporation of an ongoing business is that if the debt assumed by the corporation exceeds the value of the assets transferred to the new corporation from the ongoing business, there may be tax implications to the individuals contributing the assets in exchange for stock in the new corporation.

5. Special Corporations. Maryland State Corporation Law and Federal tax law provide for certain special corporations. In order to qualify for such treatment, it is necessary to elect by a special form, or directly in the Articles of Incorporation, the privileges of these types of corporations.

(a) Close Corporation. Maryland's General Corporation Law provides a special small corporation, called a "close" corporation. These corporations are generally used when there will only be one or at most a very limited number of stockholders. A "close" corporation gives certain advantages to its stockholders. Close corporations can elect not to have a Board of Directors, the officers of the corporation can elect not to be covered by Worker's Compensation Insurance, and a single person can hold all officer positions, and sign any document in each of those positions, even to the extent of witnessing or attesting to his or her own signature.

"Close" corporations are not without their disadvantages. The election to be a "close" corporation cannot be revoked without the unanimous consent of the stockholders. In addition, unless otherwise unanimously agreed by the stockholders, or otherwise provided by an agreement unanimously approved by the stockholders, most major actions of a "close" corporation require unanimous stockholder approval, e.g., no additional stock may be issued by the "close" corporation without the unanimous approval of stockholders.

(b) Professional corporations. Maryland's Corporation Law contains specific provisions on professional corporations. Professional corporations are those formed by certain licensed professions in the State of Maryland. There is an issue in Maryland as to the extent of the liability protection which is provided by professional corporations. It is generally clear that stockholders of professional corporations will not be shielded from personal liability for their own malpractice. With respect to certain professional corporations, it is unlikely that a court would hold that the corporation shields stockholders from liability with respect to malpractice of their fellow stockholders. The law is clear that, except for their own actions, the stockholders of the corporation will be shielded from contractual and tort liabilities of the corporation, separate and apart from professional malpractice. Except as provided, professional corporations generally operate the same as any other corporation.

(c) S Corporation. Standard corporations, "close" corporations, and professional corporations can all qualify as S Corporation. S Corporation status is a special federal taxing status given to those corporations electing to take advantage of its benefits. Those corporations electing to become S corporations, which requires the unanimous consent of its stockholders, must meet certain basic tests, such as no more than one hundred (100) stockholders, no foreign aliens as stockholders, and only certain qualified trusts as stockholders. The advantage of a S corporation is that it allows the corporation to be taxed like a partnership. An S corporation, like a partnership, files an informational return and all the income and losses generated from the operation of the S corporation are passed through to the individual

stockholders of the corporation. An S Corporation pays no federal income tax at the corporate level. This is advantageous under present tax law (i) because individual maximum tax rates are less than maximum corporate rates, and payments directly to the stockholder avoid the double taxation of a C corporation which is taxed on its income, distributes dividends to stockholders from the funds it has remaining and then the stockholders pay tax again on the dividends it receives; (ii) because in the event that the corporation is sold, the individual stockholders may receive more beneficial tax treatment, and (iii) because losses incurred in the corporation will flow through to the individual advantage of the stockholders. The disadvantage of an S Corporation is that individual stockholders must pay tax on the profits of the S corporation even if those profits are not distributed to them by the corporation. Thus, an S corporation may not be advantageous for a business that will require substantial reinvestment since the stockholders may be put in a position of having tax on earnings of the corporations without having actually received any dividends therefrom.

D. Limited Liability Companies. The Limited Liability Company Act is recognized in all fifty (50) states and offers another statutory creation for operating a business combining advantages of a partnership with the liability protection of a corporation.

1. What is an LLC? A Limited Liability Company ("LLC") is a hybrid entity combining some of the best aspects of corporations and partnerships. The LLC permits business owners to accomplish directly what they have otherwise been trying to accomplish indirectly and imperfectly through the use of limited partnerships and S-Corporations. Limited partnerships often are more complex than is required for a particular situation and S Corporations limit the number and type of owners and often do not provide the desired effects which can be critical for some businesses and/or transactions.

2. Formation. Limited Liability Companies can be formed by one or more individuals. The LLC is created by having an individual, over the age of 18, file Articles of Organization with the State Department of Assessments and Taxation and pay the appropriate filing fee. Articles of Organization are an abbreviated disclosure statement resembling certificates of limited partnership. The only required information is: (a) the name of the LLC; (b) the address of the principal office in the LLC in the State of Maryland; (c) the name and address of the resident agent; and (d) any other provision not inconsistent with the law which may include whether members may act on behalf of the LLC. Generally, more specific information with respect to the organization and operation of the LLC appear in the Operating Agreement. With limited exceptions, the LLC may exercise any of the powers of the corporation for any lawful purpose. LLC and its name must include the words "Limited Liability Company" or "L.L.C.," or "LLC, " or "L.C.," or "LC. " Aspects of reserving names, utilizing resident agents and the like are all similar to those requirements for corporations.

3. Taxation. LLC, for both federal and Maryland income tax purposes, may choose whether it wished to be taxed as a partnership or a corporation. If no election is made, the LLC will be taxed as a partnership, as discussed in Section II B of this Guide Book. For single member LLC's, federal tax law disregards the entity, and if the sole member is an individual tax filings are made on the member's Schedule C from his Individual Income Tax Return.

4. Limited Liability. Like a corporation, except in specific situations, a member in an LLC is "not personally liable for the obligations of a limited liability company. . . solely by reason of being a member." A member, however, may become liable to the LLC or its creditors for breach of an obligation to contribute capital to the LLC or for illegal distributions which were made when the LLC is not in a position to pass the solvency test. In addition, members are still liable for their own negligence or intentional acts.

5. Management and Operating Agreement. Following the pattern of a partnership rather than a corporation, the operating rules of an LLC will generally be contained in a separate operating agreement. This agreement will govern the relationship between the members in a single document rather than in a corporation's charter, bylaws and stockholders agreement. It is permissible to have an oral management agreement. Generally, however, that meets with the difficult problems of any oral agreement, especially when a dispute arises among the parties. The LLC statute is very flexible in drafting of these agreements. Without an agreement the LLC law provisions will, by default, take precedence. It is generally advisable for the members to have comprehensive discussions about how they wish to handle management and operation of the LLC so that they can reach agreement early on about appropriate conduct of all parties.

Limited Liability Companies are flexible in their management structure. They are not confined to being run solely by their members, as a partnership would be with its partners, nor are they subject to being run by a Board of Directors and by the offices of president, secretary and treasurer, although those options are available. Limited Liability Companies can operate with a Board of Directors and particular officer positions, or with a managing member, or through numerous other creations. This flexibility makes the choice of a Limited Liability Company very advantageous in many situations.

As is the case with a general partnership, members of an LLC are generally agents for the LLC unless: (a) the member has in fact no authority and the third-person knows that the member has no authority; or (b) the Articles of Organization expressly limit the members' powers.

6. Transferring Interest. Initial memberships in an LLC are effective upon formation and new members are admitted upon the unanimous consent of the then existing members, unless the operating agreement specifies otherwise. The operating agreement may also give individuals the right to assign all or part of their membership interests. Unlike a partnership, however, assignment of a member's interest does not dissolve the LLC, does not cause the assignee to become or obtain any rights of a member unless the operating agreement so provides and does not release the assignor from any liability of capital contributions or for wrongful distributions.

7. Special Acts. Special acts with respect to a Limited Liability Company are similar to those of corporations. The limited liability company may be dissolved, merged and the like.

8. Open Questions. All fifty states recognize LLC's, but there still are number of open questions about them. Compared to partnerships and corporations, LLC's are a relatively recent development in business law around the United States and as yet there are many issues which need to be worked out over time; some relating to taxation, securities laws and qualification to do business in other jurisdictions.

### **III. EXPLORING FRANCHISE OPPORTUNITIES**

#### **A. Introduction.**

Entering into a franchise arrangement is one option for the aspiring small business owner who wants to "go out on his own" yet minimize risk where possible. Although many franchises offer tried and true formulae for developing and operating a business, the prospective franchisee must be wary of the numerous franchisors who appear to offer surefire methods but, in reality, are themselves struggling to stay alive in the market. The mere fact that a business is franchised is no guarantee of success. Someone who is seriously contemplating a franchise relationship must be prepared to conduct the type of thorough due diligence and careful planning that is usually associated with start-up ventures.

B. Issues To Be Addressed Prior to Deciding on a Franchise.

Once you have determined one or two industry sectors in which you wish to operate a business you should consider several factors prior to deciding on one particular franchise operation. Indeed, investigating and closely comparing three or four franchisors will provide an idea of "norms" in the industry. This is made easier because U.S. Federal Trade Commission regulations require each franchisor to provide a Franchise Disclosure Document (or "FDD") that provides a wide variety of financial, business and legal information in a standardized format. In addition, other information about a franchise can be obtained from the franchisor itself, its active and former franchisees, and from various governmental and trade organizations. A few sources of information are set forth in Section D of this chapter.

Although, as a prospective franchisee, you should obtain as much information as possible, you should ensure that you feel comfortable with the information you obtain regarding the points set forth below. This list is far from being all-inclusive; however, it does provide an idea of key issues.

1. Franchisees are required to follow their franchisor's development and operating requirements so that the consumers of all such outlets have largely the same experience at each location. Such requirements may be all-encompassing, particularly in the case of many retail, lodging and food service franchises. Therefore, if you are highly independent and entrepreneurial person who prefers to do things your own way, you will want to carefully consider whether you will be able to operate within the strictures of a franchise.

2. Just as in any business venture, franchised businesses are subject to market fluctuations and economic trends. A thorough analysis of an area's demographics should be performed to determine if the potential location or geographic area is "prime" for such an operation. Just because a restaurant or service business is successful in California does not mean that it will enjoy the same success in Baltimore.

3. A prospective franchisee should perform a self-evaluation with respect to his readiness to operate the franchise business. How much, if any, experience do you have in the industry sector? If you do not have much experience, you must determine whether the franchisor's training program will compensate for that lack of experience. One way to determine this is by having in-depth conversations with active and recently departed franchisees about their backgrounds and their experience in learning to run the business. The franchisor is required to provide the contact information for those franchisees in its FDD.

4. Franchisees must be willing to devote a great deal of time and effort (as well as money) to the operation. Franchisors often require that the franchisee be personally involved in the day-to-day operations of the business, and personally guarantee the financial obligations of the business to the franchisor.

5. Conversely, just as the franchisor wants the franchisee involved in the day to day work, the franchisee should find out how many outlets or locations are owned by the franchisor. (That information is provided in Item 20 of the FDD.) Significant franchisor ownership may show the franchisor's confidence in its product and creates a commonality of interests between the franchisor and its franchisees.

6. New franchise operations are similar to any other start-up business in their need for start-up capital. In addition to paying the franchisor an initial franchise fee the new franchisee will be required to pay for equipment, advertising, insurance and operating capital, and for retail or food service business the costs of developing the location such as construction and furnishings. Franchisors must provide prospective franchisees with an estimate of initial investment costs in Item 7 of the FDD;

however, it is best to discuss this topic with active franchisees and work with a financial advisor to develop a plan of how much money you will need to open.

7. How many of the franchises have failed or struggled, and why? In Item 20 of the FDD the franchisor is required to provide information on this topic in a series of tables, including the number of terminations, transfers and “ceased operations” by state during the past 3 years. While less than 10% of the units being transferred during a year may indicate a healthy market for selling franchised units, a large volume of transfers is cause for concern. The franchisor is also required to provide contact information for franchisees who “left the system” during the prior fiscal year, and you should contact some of these people to determine how and why they left.

8. Last, but certainly not least, an advantage of evaluating a franchise should be obtaining information on how much money the existing outlets generate, as to gross revenue and (hopefully) some measure of profits to the owner. A franchisor is permitted, but not required, to provide information on this topic in the FDD, as a Financial Performance Representation (“FPR”) in its disclosure document. If the franchisor chooses not to provide an FPR, then it is illegal for the franchisor’s representatives to discuss these topics with you. Whether or not the franchisor provides an FPR, you should develop a list of sources of revenue and expenses for this type of business and discuss these topics with the active franchisees. Once you gather the information, you should work with an accountant or financial advisor to develop a projection (or *pro forma*) before you sign the franchise agreement.

### C. Issues Upon Entering Into a Franchise Agreement.

After narrowing down the field and deciding upon one or two franchises, the prospective franchisee should carefully scrutinize the franchise agreements. Depending upon the franchisor, the prospective franchisee may be able to successfully negotiate some of the terms of the agreement. Franchisors generally will not agree to major variations; however, the widely-held notion that franchise agreements are nonnegotiable is not true. The issues set forth below are only some of those which arise when presented with a franchise agreement. Although the issues do not arise until negotiations begin, they should be in mind for comparison reasons in the first stage of investigating franchise opportunities.

1. Determine exactly what the franchisor is providing for the money. Usually, franchisors offer two main selling points: a trademark and a marketing or business plan. With respect to the former, potential franchisees should assess the strength and image of the trademark together with the potential confusion with other trademarks; some information on this topic is provided in Item 13 of the FDD. Further, the franchise agreement should contain specific representations regarding ownership and genuineness of the trademark. Finally, the franchise agreement should obligate the franchisor to indemnify the franchisee from any claims by third parties challenging the validity or use of the trademark.

With regard to the marketing and business plan, an independent evaluation of the business strategy should be performed by the prospective franchisee bearing in mind the potential location or territory for the operation.

2. In addition to the up-front franchise fee and the ongoing royalty payments that franchisees are required to make, the potential franchisee should be aware of other costs associated with the franchise operation, such as fees for accounting and/or technology support and ongoing training fees. All of these are items required to be disclose in Item 6 of the FDD. Further, the franchisor may be receiving additional sources of revenue from the franchise arrangement such as rebates from recommended or required suppliers and that information is required to be disclosed in Item 8 of the FDD.

3. Do franchisees receive any exclusive or protected geographic territory in which to operate, and if so what is the scope of the territorial protection? For location-based franchises, will the territorial protection include control over locations in “special-purpose facilities” such as university campuses, military bases, government buildings and stadiums? For service businesses, is the “territory” merely an exclusive right to direct marketing towards people in those neighborhoods or towns, or will you be the only franchise that can provide services to customers in the territory?

4. The franchise term is also an issue which is sometimes disputed. Franchisors typically grant terms of ten to twenty years. It is important that your initial franchise term be long enough for you to establish the business and recover your capital costs. It is important that the franchise agreement require the franchisor (and the franchisee) to have some good cause to terminate the contract prior to the end of the term. Moreover, the prospective franchisee should carefully scrutinize minimum revenue or performance obligations that must be maintained to keep the franchise.

5. Finally, there are several other additional, important issues which the franchisor and franchisee will need to agree upon prior to entering into a franchise arrangement: (i) the extent and nature of ongoing services which the franchisor must provide during the term of the agreement; (ii) the franchisee's ability to continue the franchise relationship at the end of the term (or “renew”) and the terms of such a successor contract; (iii) restrictions on the franchisee’s ability to transfer, including consequences of the death or permanent disability of the franchisee; (iv) whether the franchisor will be able to sell competitive products over the Internet or through other channels of distribution; and (v) the franchise owner’s liability if he or she wants to stop operating the franchise. The ins and outs of each of the issues becomes too complicated to consider here, however, the potential franchisee should be aware that important business and legal issues arise when entering into a franchise arrangement and the potential franchisee should be prepared to consult a lawyer knowledgeable in franchise law and negotiating franchise agreements.

#### D. Sources of Information about Franchises.

Several avenues of obtaining information are available to the franchisee. If you meet the franchisor’s basic financial and other requirements for experience and background the franchisor is required to provide you with its FDD and the franchisor’s reluctance to do so should be cause for concern. Further, each franchisor seeking to sell franchises to Maryland residents is required to register with the State. That said if the franchisor is not willing to provide the FDD and proof of registration, the potential franchisee in Maryland should contact the Office of the Attorney General and request all information which they have on file regarding the franchisor. Requests and questions should be directed to: Securities Commissioner, Office of the Attorney General, 200 Saint Paul Place, Baltimore, Maryland 21202 (Telephone 410-576-6360)(website <http://www.oag.state.md.us/Securities/index.htm>).

The International Franchise Association (“IFA”), a trade organization based in Washington, D.C., has a great deal of information regarding franchise opportunities, individual franchisors and the franchising arrangement in general. The IFA makes this information available to the public through its website [www.franchise.org](http://www.franchise.org) and through publications and recordings available for purchase. The International Franchise Association’s address is 1501 K Street, N.W., Suite 350, Washington, D.C. 20005, and its telephone number is 202-628-8000.

Finally, a source of information and guidance in exploring franchise opportunities are franchise broker networks such as FranNet [www.FranNet.com](http://www.FranNet.com), The Entrepreneur’s Source [www.entrepreneursource.com](http://www.entrepreneursource.com), and FranChoice [www.FranChoice.com](http://www.FranChoice.com), each of which have qualified representatives who reside in Maryland. Please be aware that these consultants are paid only if you purchase a franchise and therefore have a bias towards you purchasing a franchise. However, they also

typically have wide experience with franchise relationships and, in the case of FranNet and The Entrepreneur's Source, are franchisees themselves.

#### IV. ASKING THE RIGHT QUESTIONS

A. Traditional Business Advisors. The business owner needs to assemble a professional group of advisors and resources upon which to call for planning or crisis management. Too often, business owners, especially new business owners, are intimidated or turned off by the prospect of contacting and dealing with lawyers, accountants, bankers and other professionals. The business owner can feel comfortable in dealing with these professionals by remembering a couple of simple points:

1. You are the Client. You pay and choose the professional and should always be treated with respect and straight forwardness in all professional matters, including billing. You are entitled to know as precisely as possible what professional costs will be and how they will be billed.

2. Follow your instincts. If you believe that you are not getting the proper advice or that you are not being treated in a professional manner, voice your concerns or seek new representation rather than closing the door and going without appropriate help.

3. Do Your Homework - Know What To Expect When You Approach A Professional. In comparing professional services, the costs can vary greatly. Important in assessing those estimated costs, however, is a comparison of the services received for that cost. As part of the legal documentation for an incorporation, for example, the business owner should receive Articles of Incorporation, Bylaws, Subscription Letters, Initial Minutes of Meetings, Stock Certificates, and Applications for various Federal Identification Numbers and State Licenses. In addition, you should receive advice on comparisons between S corporations and C corporations, close and regular corporations and the like. Knowledgeable comparison shopping is appropriate. Accounting services also vary greatly. Record keeping methods range from manual to computerized. You can obtain reviews, compilations or audits of your financial statements. Each carries with it a different cost. You should match the service needed with your new business.

4. Evaluate the Risk. You should always consider your liability if the business does not go according to plans. Ask what happens if you and your "partner" have a parting of the ways. A business separation is often accompanied by financial and emotional drains similar to those in domestic separations, and the business owner should prepare for that possibility.

B. Alternate Sources for Help. In addition to the traditional business advisors, there are a number of other places where the small business owner can turn for help.

1. Baltimore County Small Business Resource Center. The Baltimore County Small Business Resource Center is located at 102 West Pennsylvania Avenue, Towson, Maryland 21204 (telephone 410 825-6200). The purpose of the Resource Center is to assist small businesses to be more productive and effective in the County. The Resource Center can assist businesses in growing their business and becoming more productive participants in the County's economy. There are Resource Centers in a number of counties across Maryland, and each provide many of the same services, some of the most valuable of which, include the opportunity to meet with counselors without charge.

2. SCORE. The Service Corps of Retired Executives, hence, SCORE, is an organization sponsored by the U.S. Small Business Administration to assist the needs of small businesses. SCORE provides counseling, free of charge, relating to all areas of small business operations including, but not

limited to, management and record keeping. SCORE tries to match counselors with expertise in the same area of business as the organization requesting counseling services.

3. Chambers of Commerce. Many Chambers of Commerce offer assistance to small businesses through small business development councils. The State, County and Local Chambers of Commerce offer through professional employees and chamber sponsored groups and activities significant help to the small business owner.

4. Baltimore County Public Library. A number of locations of the Baltimore County Public Library providing assistance to small businesses by having sections dedicated to resources for small business.

5. Business Consultants. Independent business consultants provide an alternative to traditional business advisors. Many independent business consultants have formerly been certified public accountants and have turned their attention to specifically assisting start-up and transition businesses.

6. Trade Associations. There may be a trade association in the industry in which you intend to work which would be very helpful to you in establishing the contacts which you will need to be successful.

## V. HOW DO I LEASE SPACE?

No matter what the business, an important decision which it faces, is finding the proper location. This often means negotiating a lease.

A. Choosing the Proper Location. Before beginning negotiation on any lease, the business owner must decide upon the proper location for his business. Try to answer the following questions:

1. Do I really need to lease space or can I work out of my home or apartment? Certain businesses lend themselves very well to being operated out of a home or apartment. This certainly helps to keep costs down. It is always possible to move to a commercial lease space at a later time when the business is more financially sound. Be sure to check zoning and local regulations to be sure that operating the business out of your place of residence will not put you in violation of those laws.

2. How much space do I need? Lease space is generally paid for on a per square foot basis. It becomes very expensive therefor to lease more space than is needed for the business. A floor plan will help considerably in answering this question, but be sure to plan for possible growth.

3. Does my business have any special needs? Certain businesses require special accommodations in its space. For example, a beauty salon requires special plumbing and electric fittings. Often medical offices have special utility needs. Leasing a space already prepared for your business may be much cheaper in the long run than trying to adapt space.

4. Essential Questions. Where is it best for me to locate? How close are my competitors? Do I need to be in a shopping center, mall, office complex, or is it possible to operate the business in a more isolated location? Answering these questions will keep you from wasting time and energy looking at the "wrong" spaces.

B. The Tenant's Dictionary. In order to understand the terminology of leasing, it is helpful to have a least a basic understanding of some of the common theories and terms used in leasing.

1. Net Lease, Double Net Lease, Triple Net Lease. These three terms relate to differences which commonly occur in leases. It is not enough to compare rent to make a determination as to which of the spaces is less expensive. In addition to rent, landlords often charge tenants a variety of other expenses, including a percentage of the maintenance costs of the premises; all or a percentage of real property taxes attributable to the premises; and utilities. A lease charging or passing through one of these costs is a "net lease"; a lease charging two of these costs is a "double net" or "net, net" lease and a lease charging three of these costs is a "triple net" lease.

2. CPI Increases. Often leases which have been negotiated with fixed rentals will also include Consumer Price Index (CPI) increases. These increases are based on some percentage equivalent of the CPI. It is to allow the rents to stay current from an economic standpoint while at the same time not requiring the parties to consistently renegotiate the rent amount.

3. Percentage Rents. Often in retail industries the lease provides a percentage rent system. Percentage rent leases generally establish a basic rent and an additional rent in the event that the business meets certain thresholds of success.

C. Using a Real Estate Broker. Using real estate brokers can be extremely helpful in attempting to locate the specific type of space which you need. You want to contact an experienced broker in the particular location in which you are interested. The broker will normally be paid by the landlord. Remember in speaking with the broker, however, that he or she receives payment from the landlord, and the payment only is made if a lease is executed. You should, therefore, be guarded in disclosing your true feelings about space, negotiating strategy and the like.

## **VI. WHERE DO I GET THE MONEY?**

It is important for the small business owner to determine his financial needs. New businesses often under estimate the amount of cash which will be needed. It is a rare business that generates a sufficient cash flow from the outset, thereby avoiding the necessity of using the owner's savings or borrowing funds. The business owner must calculate his break-even point or "nut" for the week, the month and the year.

Prior to getting financing from any source, whether it be family, friends, banks, or government loan programs, it is important for the small business owner to have his financial records in good order and to have all the documents surrounding the operation of his business in good order. Especially if third party funding is being sought, the completeness of these records becomes essential to successfully obtaining the loan.

A. Sources of Funds. There are a variety of sources of funds for small businesses which should be considered:

1. Friends and relatives.
2. Commercial Banks.
3. Small Business Government Loans. With respect to government loans, there may be state and/or Federal monies available for lending in your particular business. You should check carefully with the Local, State and Federal agencies to determine whether any such funds may be available to you. Often there is a considerable amount of paper work involved in obtaining these loans, but it may be very

much worth it, since often times the interest rates or the qualification requirements for the loans are less than would be the case for a commercial bank.

4. Credit Cards. Although used by many small businesses, credit cards are an expensive way to finance the new business.

B. Type of Loans. While the following list is not all inclusive, it is an attempt to list some of the basic kinds of loans which may be discussed with a small business owner.

1. Line of Credit. A line of credit can be analogized to a credit card loan. The line of credit will generally provide the maximum amount which the borrower can borrow with repayment being required either on a monthly basis or at some point when the loan balance reaches a certain amount. After paying down the balance, the money is generally then again available to the business.

2. Purchase Money Loan. This is a loan which is granted for the specific purpose of trucks, equipment or the like, and is generally secured by the asset or assets purchased.

3. Asset Based Loan. An asset based loan is generally a secured loan which is protected by a security interest in accounts receivable and inventory. The collateral for the loan may also include equipment owned by the business.

4. Real Estate Loan. Real estate loans are generally secured loans which require the borrower to grant a mortgage or deed of trust lien to the lender securing the loan. The borrowing limit is normally could be obtained at about eighty to ninety percent (80 - 90%) of the value of the property offered as collateral.

5. Construction Loan. Construction loans are generally short-term loans offered for the construction of particular improvements. Interest only is generally paid on these loans on a monthly basis, with the principal being paid at the end of the loan by replacing the construction loan with permanent financing in the form of a real estate loan.

C. Types of Loan Documents. The following are a list of some of the basic types of loan documents which are utilized by lenders.

1. Loan Agreement. The loan agreement outlines all the terms and conditions of the loan.

2. Security Agreement. The security agreement recites the rights of the lender in the event of a default in the loan. It protects the lender by giving it an interest in the collateral which is pledged by the debtor.

3. Pledge Agreement. Pledge agreements are usually restricted to stock or other less tangible assets of the borrower. It is like a security agreement in that it grants the lender with a protected collateral interest in the particular asset.

4. Financing Statement. A financing statement is a follow-up on a security and/or pledge agreement. It is a document which is actually filed and recorded in the local recording office and/or with the State Department of Assessments and Taxation, giving the world notice that the lender has a financial interest in particular assets of the borrower.

5. Promissory Note. The promissory note creates and outlines the terms and conditions of the debt obligation.

6. Mortgage/Deed of Trust/Indemnity Deed of Trust. These three documents are all security agreements relating to real estate. They differ slightly in their terms, but their basic objective is the same, to give the lender a financial collateral interest in the particular asset covered by the agreement.

7. Guaranty. A guaranty is an attempt to have additional persons responsible for repayment of a debt. For example, if the borrower is a corporation, its stockholders are often asked, as a condition to the lender's agreement to loan any money, to give personal guarantees thereby making them liable for the full amount of the borrowed funds.

D. Understanding the Loan Process. Understanding the loan process is essential to successfully obtaining the financing. Although this Guide Book is not a comprehensive review of the loan process, understanding a couple of key concepts will be helpful to successfully negotiating a loan and understanding the loan documents referred to above.

1. Interest. Interest may be calculated in various ways. The "prime rate" is generally defined as the rate at which a particular commercial bank will loan money to its best and most risk-free customers. The new business can expect that the interest rate which it will pay will exceed the prime rate. If long term financing is sought, the new business should expect that the bank will want to have the ability to renegotiate the interest rate periodically as it assesses its risk and the cost of it borrowing the money which it has loaned to you. Both will vary over time.

2. Points and Loan Fees. A "point" is generally one percent (1%) of the amount being borrowed. Points are sometimes changed when the loan commences. Loan fees are also often charged. These loan fees generally cover the costs of the bank's counsel and other out of pocket expenses by the bank. Although the borrower pays the bank's lawyer, this does not mean that the borrower should not have his own lawyer. The lender's lawyer is not representing the interest of the borrower.

3. Penalties. Try to be sure that your loan does not include any pre-payment penalties. Commercial entities often count on certain rates of return in order to do their own business projections. They often try to lock themselves into certain rates. They do this by including penalties for early payment by a borrower.

4. Contract to Lend. Normally the "commitment letter" is the first contract between the parties outlining the terms of the loan. It will generally contain a number of conditions or contingencies and will also note a date after which the offer to loan will expire. In order to make a contractually binding commitment letter, it must be signed by both parties and state that so long as the contingencies are satisfied, that the loan will be made in accordance with the letter. After drafting the letter, many bank documents described above will be drafted.

5. Credit Worthiness. Commercial lenders will analyze the credit worthiness of the borrower. They will review recent or projected financial statements, assess the quality of the management, possibly visit the borrowers physical facilities, and review the borrower's business plans. If the small business is a corporation, it can expect that the stockholders will have to give personal guarantees of the borrowing. These should be avoided, if possible, but generally the lender will require them since they do not want the borrower to hide behind a corporate shield for any monies that are loaned. You should attempt to make the guarantees as narrow in time and scope as possible.

6. Secured versus Unsecured Transactions. A secured transaction is one for which the lender takes collateral. This collateral may come in the way of accounts receivable, inventory, equipment, land and buildings. An unsecured loan is one for which the lender has no security, wherein the lender would stand in line with the other creditors in event of a default.

7. Representations and Warranties. Lenders will generally require the borrower to make certain representations and warranties in a loan agreement. The borrower's representations and warranties allow the lender to make the loan with as much knowledge as possible. Representations of warranties are a way of shifting the burden of risk from the lender back to the borrower. Should the borrower give incomplete or inaccurate information with respect to the warranties, he could have his loan immediately declared in default.

8. Covenants. Covenants in loan agreements serve two main purposes. They describe the agreed upon constraints as to the future exercise of managerial discretion by the borrower and they specify certain agreed upon standards of acceptable financial conditions. Basically a covenant is a promise that certain things will or will not happen. A broken covenant may trigger a default in a loan.

9. Legal Opinions. Banks often ask the borrower's counsel for legal opinions. These opinions are for "comfort" of the bank. Again, this is an attempt of the bank to lend with as much information as possible so that it understands the borrower. The opinion letters however should not be insurance policies for the bank. In Maryland, the Maryland State Bar Association has adopted an accepted standard for opinion letters which should save the borrowers a considerable amount of money in legal fees, which would otherwise be spent over negotiating such letters. In the past lawyers have been asked to make representations as to factual matters, or provide assurances to a lender on matters other than legal issues. Occasionally this produced an element of tension and cost a great deal of time. It is hoped that the model opinions will avoid those difficulties in the future.

## VI. HOW DO I PROTECT MY NAME AND/OR MY PRODUCT?

Maryland State law and federal law offer a number of methods by which your name and product can be protected.

A.. Copyright. The most common ways to protect written materials or designs is through copyright law. The jurisdiction for Copyright registration is solely with the federal government. The Copyright Office in Washington has a number of publications which are very useful to the business owner in evaluating the desirability of using copyright law. The copyright law is something which is very understandable to the lay person and, in many instances, the business owner will be able to complete copyright applications on his own.

B. Trademark/Service Mark Law. Trademark law is more difficult to master. Although the concepts are not very difficult, the initial searches and prosecutions of a trademark or service mark are complicated. Federal trademark/service mark registrations offers protection to the registrant for the name of its service or product nationwide. A more restricted Maryland trademark or service mark registration could also be accomplished relatively easily and for a minimum fee. Maryland registration, however, only protects the trade or service mark within the State of Maryland and only as to trade and service marks not already then in use in the state or in interstate commerce.

C. Business Secret Agreements. Many employment agreements and even stockholder agreements contain secrecy agreements and confidentiality clauses. This is particularly true in industries where specific information, if lost, could be very damaging to the business. This type of information can include everything from chemical formulas and manufacturing processes to recipes and customer lists. It is advisable to do the best you can to protect this information by agreement. In addition, each business should take steps to protect the information internally. Such steps include: limiting access to the information; not allowing any single person to have all of the information and not allowing any employees to copy information to be taken from the premises. Should a problem occur, at least the attempt to implement these types of safeguards will be viewed favorably by the court.

The product or service and the nuances of it represent the major reason a business may be successful. The business can never be too concerned about how that information could be used by third parties.

## **VII.** **REGULATORY ACCOUNTS, LICENSES AND PERMITS**

Before opening your doors you should be sure that you have complied with all regulatory requirements for your business. The following are some of general regulatory accounts, licenses and permits of which you should be aware.

- A. Employment Accounts. Application for Maryland Employment Accounts is made on the Combined Registration Application without charge. These include income tax, withholding and unemployment insurance accounts.
- B. Maryland Sales Tax Licenses. A Maryland Sales Tax license can be applied for on the Combined Registration Application. Sales tax licenses are required for any business whether selling products retail or buying products for which it seeks a sales tax exemption.
- C. Traders License. A traders license is required for any business selling goods and merchandise. The license should be applied for from the Clerk of the Circuit Court in the jurisdiction within which the business will be operated.
- D. General Business Licenses. In addition to Traders Licenses, state regulations mandate a number of other business licenses including, but not limited to, those for restaurants, cigarettes, plumbers and gas fitters, and vending machines.
- E. Specialty Certificates and/or Licenses. The Home Improvement Commission requires a home improvement contractor's license for anyone in that business. Professional businesses from architects and barbers to lawyers and accountants require professional licenses, or at least qualifications and meeting of certain minimum requirements, before an individual may practice under those titles. You should talk to a number of people engaged in the same business in the state and in your local area to determine whether there are any licenses which you may need for your particular business.
- F. Permits. Separate and apart from the referenced licenses, Circuit Court Clerks also issue permits including but, not limited to, building, zoning, electrical, water and plumbing permits. As with licenses, it is appropriate to visit your local Clerk's Office for assistance in these matters.

## **VIII.** **CONCLUSIONS**

As we hope is obvious from a review of this Guide Book, there is much consideration and thought which should go into the formation and expansion of any business. The business owner can expect to require the services of other professionals in order to make his business successful, not only at the outset but also on a continuing basis. The initiation and development of a business is a dynamic process which takes constant planning and continuous review.

## NOTES