



TEN COMMON MISTAKES THAT BUSINESS OWNERS MAKE

By Donald W. Hudspeth

The following is an outline of a lecture I have given to the Edson Institute at Arizona State University in Tempe, Arizona as well as the Arizona Small Business Development Center and the students of my business law class at ASU in Glendale, Arizona.

I am hoping this summary report will be sufficient to trigger action on the issues discussed and to cause the reader to obtain some professional advice regarding same. I hasten to add that the problem of intelligent, self-reliant business owners working beyond their skill set is a common problem and one that can cause life-altering harm to the do-it-yourselfer.

Take-home motto: “Don’t operate on yourself and don’t do your own legal work.”

TEN COMMON MISTAKES THAT BUSINESS OWNERS MAKE

1. Not Using the Corporate or Limited Liability Designation.

Newco, Inc.
WE, Corporation
Newco, LLC
Professions, PLLC

“Use it or lose it.” Virtually every day I see clients who form a corporation or LLC but who fail to add the designation “Inc,” or “Corporation,” to their name. This might save you money on business cards, letterhead and marketing materials, but when you get named personally in a lawsuit because the plaintiff did not know (or claims to not know) that you are doing business as an entity, you will get religion. Exaggerating to make a point: You can walk away from a failed corporation but you can’t walk away from yourself. Personal liability is one of the worst things that can happen to anyone and it is easily avoided. So, form an entity and use it in and on everything you provide to your clients and vendors.

2. Not Putting Your Assets into the Entity.

After you form the entity and use the name, e.g. “Newco, Inc.” or “Newco, LLC,” you must be sure to put all assets that you intend to belong to the business into the business. Think of the corporation or limited liability company as a *bowl*. Without assets the entity is just a shell; hence, the name “shell company.” If you buy furniture, fixtures or equipment, or sign leases, or hire employees, etc. you want to do so in the name of the company. (You may have to sign a personal guarantee for credit, but for asset protection, business and tax purposes, the assets need to be in the entity.

The most common mistake is the failure to put existing assets into the entity. This is done by means of a bill of sale for goods, like furniture, fixtures and equipment (“FF&E”), an assignment for intangible property, like an interest in another company, or intellectual property like contracts, a trade name, trademark or copyright, or by deed for real property like a building or land. These documents are short, easy to prepare and important.

But, they are often overlooked. So, the assets you thought you had in the business and protected are often still held personally. This can be a problem, not just for asset protection but also for tax purposes and for the future sale of the company or asset.

3. Failing to Register Trademarks, Trade Names, Copyrights and Other Intellectual Property.

Registered Trademark ®
Trademark ™
Service Mark ™
© Copyright
pat. pend. - Patent Pending

Once your business is “up and running” one of the first things you should do is to register your name, logo, slogan and marketing materials. Think about the two sides of a coin: Underneath the coin is your customer *goodwill*, your customer franchise, i.e. the customers that come to your business. Above the coin is your *brand* – your identity in the marketplace (what you sell if you sell the business). Think: “McDonalds” as a trade name and the “Golden Arches” as the trademark (logo).

Before the rise of the Internet you could probably run your business in Phoenix without someone out of state, say in Pittsburgh, knowing you were both doing business under the same name. But today,

a website is an essential tool for any business – if not for marketing, and then at least to provide information about location, hours open for business, etc. With the internet comes visibility. So, it is not uncommon for clients to come in with a letter from an out of state law firm demanding that my potential client “cease and desist” from using the other company’s name, logo or copy, especially because they have the federal registrations and my client does not.

Losing your trade name or trademark *after* you are in business can be a catastrophe. Because a “federal trademark trumps domain name,” overnight you may lose both your company identity and the way for potential and actual customers to find you.

Moral of the story: Register your intellectual property as soon as your business is operating.

Actually, we do it at the same time we form the corporation or LLC to avoid forming the company under a name that we cannot have because it is already in use and to avoid wasting time and money by having to start over later after the business has been in operation.

4. Just Signing a Real Property Lease.

One of the most common mistakes that I see new business owners make is to just sign the lease without having an attorney review and revise it. Clients treat the lease as an after-thought, but in reality the premises lease is the “tail that wags the business dog.” Exaggerating again (but not much) a lease *could* be four pages, but usually it is more like 44 pages long. The reason for the extra pages: to protect the landlord. And, by the way, speaking of the “landlord”; when is the last time you called somebody “Lord?” that should tell you something.

The *typical* premises lease will retain for the landlord the right to qualify any assignee of your space. In plain English this means that you cannot sell your business to a buyer unless the buyer –as the lease assignee – is approved by the landlord. Sometimes this right is absolute; sometimes the landlord sets qualification criteria, e.g. that the new tenant would have financial status, background and experience commensurate with you and your company. But, if the new tenant has the same financial and business background as you do, then why are they buying your business? So, this can be a “Catch 22.”

The typical lease requires the landlord’s consent to make improvements inside the space – generally if the item is physically attached or added to the landlord’s space, like build-outs or “tenant improvements,” this can trigger a long procedure of architect, design, submittal, negotiation and approval. So, before long you may wonder if you are working for the landlord (often “Yes”).

Moral of the story: Have an attorney review and revise your lease.

As I say to my clients: It is a matter of “landmines.” (By “landmines” I mean unfavorable terms or terms the inadvertent breach of which could have serious consequences.) Due to lack of bargaining power for many clients we may not be able to rid the lease of all its negative aspects, but we can identify its important aspects to the client and the lawyer – and by going over the lease, at least the client will know what the rest of the “landmines” are.

5. Not Calculating the Interest Rate and Total Interest Paid (and Failure to Escape Same in Equipment Leases).

Equipment leases, e.g. for your computer, copier or other office or shop equipment, typically have both high interest rates and non-cancellable terms. This means that if you want to pay off the lease early *you still have to pay the full interest amount as if the equipment were financed and the lender's (lessor's) money were used and at risk for the full amount of the term.* Do you want to re-read the last sentence? Let me give you an example of that this means:

Let's say a leasing company pays the copier dealer for your copier, then leases it to you for, say three years at \$500.00 a month (or \$6,000.00 a year). Thus, the total dollars paid over the three year term will be \$18,000.00.

Then let's say that the cash price of the copier from the dealer is or would have been \$12,000.00. This calculates to \$6,000.00 in interest (\$18,000 paid less \$12,000 copier cost) over three years or \$2,000.00 in interest per year. That comes out to roughly 16.7% per year. (In real life this rate and the interest paid could be higher.)

Now, let's assume that your "ship comes in" and three months after you start the copier lease you want to just pay off the balance due. On most loans typically there would be no prepayment penalty (or least not a formidable one) and you would not pay interest (rent) on the money beyond the term of actual use. In this example, the yearly interest was \$2,000.00, the term of actual use was three months (i.e. $\frac{1}{4}$ of a year), so the interest would be \$500.00, plus the balance due on the copier. Right?

Wrong. For equipment leases: *After the lease is signed the full amount of interest for the full term is due.* (You want to re-read that?). This means the leasing company will say to you (roughly): "Sure you can pay off the lease early. The balance due is \$18,000.00 (that is, the same amount as if you had used the leasing company's money for the entire three years.

The effective interest rate? (\$6,000 in interest for three months equals \$6,000.00 times four quarters equals \$24,000.00 in interest for the use of the \$12,000.00,) an effective interest rate of 200%! (I hasten to add that not every lease may be like this and that I am not a mathematician, so my apologies if the form and fact of my calculations are not exactly correct. But, the legal conclusion is correct: With this kind of lease you can really get screwed ("screwed" of course being a legal term of art meaning "not a real good deal.")

I had a client who was a Howard Hughes heir and could have borrowed money at 5%. But, he was stuck with a 53% early pay off rate until his big guns discovered the lender was underpaying its lender by misstating the terms of the lease – a different issue entirely. But, this took a client whose advisors fly in and out in Lear jets. Most of us do not have that kind of clout.

6. Forgetting about Credit Card Machines.

A variation of the above is the credit card machine that you will need for your business. Here, again you may have a lease like the one above. So, you need to be aware of its terms.

But you may also have some other things, like:

- A. A disappearing broker and
- B. A failure to remember this little piece of equipment.

As you may know, credit card business advisors are as “thick as flies” when they want you to sign up with their company and use their program. But, later when you have a problem, the guy you talked to may be long gone – the *company* you talked to may be gone. Who’s left? Who remains is the lender who financed the credit card processing equipment and receives the monthly check for same.

What sometimes happens is that, if the business closes, or is sold, no one remembers the fact and existence of that humble credit card processing machine; it may not even be mentioned in the purchase/sale documents between subsequent owners. But, the lease goes on. And, often such leases are personally guaranteed. So, if it happens (as it does) that the business closes and the premises “go dark,” the lease liability is still there and increasing. It may even relate back to a previous owner or guarantor who has not been around for years and did not in fact cause the breach but who is still legally responsible for it.¹ So, what you have is a legal claim, arguments about responsibility and real money spent on attorneys fees that seems surreal in that it relates to “nothing.”

This may be more a case of aggravation than money, but the parties tend to be genuinely angry – even more so in some larger, more important cases.

7. Forgetting about Zoning: The “Shady” or Willfully Blind Seller or Landlord.

This firm does not practice all forms of real estate law, but occasionally we wind up with real estate law issues relating to the operation of a business. Two examples of this come to mind:

- A. The house which the seller sells as a business and says is zoned as such, but it isn’t. And,
- B. The premises leased to a business for a purpose which is stated in the lease (so the seller knows the purpose) but for which purpose the property is not properly zoned.

The result in either of these scenarios is that, unless the business buyer or tenant is careful in its due diligence going in and/or hires legal counsel to look into such matters beforehand, the buyer may be in the terrible “Catch 22” of needing the business open to pay the bank or landlord,² but not being able to open the business until the zoning issue is cured. And, frequently this leads to the second “Catch 22” of not having the money to hire zoning lawyers and/or contractors to fix the zoning defect without having the business open (which the City has ordered closed due to the defect.).

What can happen? The lender (or seller if the seller carries back the loan, e.g. under a contract for sale) or landlord will probably sue you for the balance due. So, you not only lose the business and your investment in the business, but you may owe the loan amount or lease as well. This amount, of course, can be hundreds of thousands of dollars. (With a contract for sale or lease the seller or landlord has a duty to mitigate damages but this will require legal representation and possibly a lawsuit to resolve.

So, this would obviously be a case of things not going well.

Moral of the story: Be sure the intended purpose of the business is lawful for you and for the premises.

¹ Guarantees are nasty: they can live past this loan to attach to the next loan at the bank. Or, if never revoked, one may face suit 15 years and hundreds of thousands of dollars in breach later. I have had it happen.

² One of the “landmines” of a lease can be that the tenant must fix the building to conform to zoning. This firm attempts to strike or modify such clauses.

8. Not Knowing the Difference Between an Asset Sale or a Stock (or LLC Membership Interest) Sale.

An easy way to sell a business is to just sell the “bowl,” i.e. the entity that I referred to in example #1 above. But, generally, this is not a good idea because the buyer has no way of knowing -- and sometimes the selling stock or interest owner(s) does not even know -- about undeclared (by the IRS) tax liability, e.g. 941 payroll taxes.

First, some general principles of applicable law:

- A. Business owners are personally liable for unpaid payroll taxes.
- B. Such liability is typically not dischargeable by the business in bankruptcy, and
- C. Such personal liability for which the business owner is vicariously liable as a matter of law is typically not dischargeable in bankruptcy.

Legal result: You’re “screwed” (see definition above).

As I implied above, sometimes even the business and the business owners do not know of the tax claim. The reason for this is that such claims tend to arise a few years after they IRS says they arose. They are what in law we might call “springing claims,” that is, they come out of nowhere, years after the fact. For example, the typical IRS Notice and letter might say that you failed to pay \$13,200.00 for the second quarter of 2007, so now with principal and interest you owe \$32,000.00! (This may be an exaggeration but not by much). For many businesses the actual numbers could be much larger.

Moral of the story: Undisclosed tax liabilities can be a business “giant killer.”

So usually we at least discuss this point before doing a stock purchase transaction. Lawyers often like asset purchase/sale agreements under which only the “contents of the bowl” are sold, but sometimes tax considerations raised by the accountant will be important as well.

Second moral: Get advice from an accountant and lawyer, not just one or the other.

(I do not mean to pick on accountants but because they often focus on taxes and tax preparation only, their advice may not address liability issues. Note: Lawsuits can cost more than taxes. Unless you have been in litigation, you may have no idea.)

9. Calling Employees “Independent Contractors” to Avoid Payroll Tax.

Many small business owners must drink from the same well of logic or advice when it comes to treating their employees as independent contractors. The logic seems to be something like this: Collecting payroll taxes, including state and federal income taxes, insurance and unemployment tax and social security, is expensive (because we have to match some of same) and because we have to pay someone to keep the books and do the paperwork, so let’s just skip all that and call the employee an “independent contractor.” OK?

This topic could be an essay in itself, but in this short version know two things:

- A. Generally, someone is not an independent contractor unless they have their own clients. It is not just where they work and who controls the work, the common test. And, if they have their

own clients then they should have a name, location, LLC, business license, tax ID number. You get the idea. In other words they would be to you like this law firm would be to you – *independent*.

- B. The first disgruntled employee that calls the labor board or IRS, saying I wasn't really an independent contractor – is going to trigger an audit of every employee and contractor you ever had. And, the disgruntled employee who triggered the audit may say: "By the way I think I/we worked 60 hours a week." So, you face a claim *per employee* of say \$10,000.00 to \$100,000.00. Worse, many attorneys will take the case on contingency because wage claims are favored by the law and some claims have punitive damages and/or mandatory attorneys fees.

Moral of the story: Calling an **employee an independent contractor** gives that employee the **power to destroy you**. They hold the switch to a nuclear bomb – and you gave it to them. So, like the doctor says when you say it hurts to raise your arm: **"Don't do that."**

10. Not Having a Non-Compete Agreement with Your Key Employees.

Public policy favors the employee's right to work in the field of his or her training or choice. We do not want doctors working at Starbucks because they signed a non-compete agreement. But, when it comes to confidential information or customers and employees, the public policy switches to favor the business. Trade secrets are protected by most state statutes, provided that you treat the information as confidential by having it password protected or under lock and key – or at least saying so and perhaps stamping it as "Confidential." But, if you want to keep your customers and employees, then the burden is on you to prevent the departing employee(s) from soliciting and diverting same away from your business.

Again, this could be a long story, but under this short version, the way to do this is by a well drafted (according to the laws of your state) Non-Competition and Confidentiality Agreement. Ideally, depending on the state, this agreement will prevent the employee from "two-timing" while working for you and prevent them from doing business with your customers or hiring your employees for a period, say, one year after leaving your employ.

Sometimes, the employee can even be prohibited from working in the same *industry* or for a major competitor for a short period. This can be very advantageous because it can keep your employee from going to work for your competitor. And, the future employer may face a legal claim by you if they allow the employee to breach your Agreement by hiring that person.

Usually, the employee is willing and able to do the most damage to your company right after he or she leaves, so a "restrictive period" can be very favorable to your business. But again, the only way to get this restrictive period is a well-drafted employment agreement. Because, in the old days, most such agreements were not reasonable in terms of territory or term they were junk and could be ignored. But, these days, employers – and their lawyers – have got religion; so, the agreement stands a good chance of being enforced. And, the difference can be huge. For example, one of my printing company clients lost \$1,116,000.00 in six months when his key employee left and went after "her" (really the company's) clients. This firm charges a \$1,000.00 or so for a complete employment agreement. \$1,000 versus \$1,000,000.00: You decide.

Moral of the story: Have your **key employees sign a non-compete agreement**.

CONCLUSION

Moral of morals: Be diligent, knowledgeable and wise. Owning a business is not for the fainthearted, nor for the lazy, ignorant and tight. **Use a business lawyer** for these organizational issues.³ The **cost is minimal and the benefits are huge.**

As a Phoenix collection lawyer I know says: *"If I am not collecting for ya, I may be collecting from ya."* I would paraphrase this to say: "If I am not working for your business, I may be working against your business." And, in the latter case you better be damn sure your organizational documents – what I call the "legal brick house" – are in order.

Have a comment on this article? Email: TheFirm@azbuslaw.com



Donald W. Hudspeth was a business owner before he became an attorney. Don owned a chain of businesses in Kansas and Arizona before attending law school at age 36. A 1988 graduate of The Sandra Day O'Connor College of Law at Arizona State University, Don has more than twenty years experience practicing corporate and business law. After working for a large firm representing corporate clients, Don founded the Law Offices of Donald W. Hudspeth, P.C. in 1993 with the motto *"The Business of our Firm is Business."* The firm's practice areas are business law and commercial litigation: from entity formation and business planning to business dissolution and disputes resolution, and all the transactions in between, including intellectual property - trademarks and copyrights, contracts – non-compete and purchase/sale agreements, mergers and acquisitions and franchises.

Don taught business law at Arizona State University and American Institute; has conducted classes and given lectures at a number of educational institutions and business organizations, including the Edson Institute at Arizona State University, Phoenix College, the Maricopa Community Colleges Small Business Development Center and the Arizona Small Business Association.

Among articles and books, Don authored, [Getting Past Thompson v. Harris, A New Standard of Constructive Eviction in Arizona](#), 1997, Arizona Attorney Magazine; [Inside the Firm: The Inside Story Of Choosing and Using a Lawyer](#), 1999 (copy purchased by Langdell Hall, Harvard Law Library) and most recently, [Minding Your Own Business, Ropes to Skip and Ropes to Know In the Operation of Your Small Business](#), 2010.

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³ There are others, e.g. a buy-sell agreement – like a business pre-nuptial – between the business owners to avoid one of the nastiest and most expensive business-related suits, i.e. the partnership dispute or business divorce.