

THE TOP 10 LEGAL MISTAKES MADE BY BUSINESSES and how to prevent them

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Legal mistakes can be costly to a business. They often lead to litigation, damage goodwill, and create time-wasting distractions. For a large firm, a legal mistake can seriously effect the bottom line; for a small business, it can be fatal. The good news is, with proper planning, most business-related legal mistakes can be prevented.

In our highly-regulated business environment, legal mistakes can take thousands of forms. Nevertheless, business lawyers and advisors agree, certain mistakes seem to be more problematic, both in terms of frequency and in consequences. Thus, if those mistakes are prevented, the legal risks of doing business will be greatly reduced.

What follows, then, is a discussion of the “top 10” legal mistakes and strategies on how to prevent them. These mistakes span the spectrum of business law and involve business organizations, contracts, employment, trade secrets, and taxation, and are grouped together accordingly. To make this a useful reference, much of the information is presented in a “bullet point” format. Please bear in mind this is only general information and not intended, nor should it be relied upon, as legal advice. Whenever possible, seek professional help with your particular situation.

Business Organization Mistakes

1. No Personal Insulation from Business Liabilities. California businesses can operate in many different entity forms. Some shield their owners from personal liability (e.g., corporations and LLC’s) and others provide no liability protection (e.g., sole proprietorships and general partnerships). In the latter case, personal assets of the owners can be used to satisfy debts of the business (an owner could lose their home).

Understanding Liability. The word liability is a broad legal term and generally refers to any type of debt or obligation. Such debts or obligations arise in various contexts and include the following:

Contractual Liability. A party to a contract is generally liable for the damages resulting from that party’s breach of the contract. For example, breach of the terms of an office lease can result in contractual liability for unpaid rent.

Tort Liability. Tort liabilities result from the violation of a duty arising by operation of law (not from contract). Examples in the business context include the negligent maintenance of a business premises resulting in personal injury to a customer and injury caused by a defective product.

Vicarious Liability. Vicarious liability results when the actions of one party are imputed upon another party. This commonly arises in the employer-employee relationship. Generally, employers are liable for the bad acts of their employees.

When Is Liability Personal? Sole proprietors and general partners have personal liability for business contracts, torts, and from vicarious sources. The owners of a properly formed and maintained corporation or LLC are not liable for business debts arising from contract, tort, or vicarious sources unless they have either personally guaranteed the contract or personally committed the tort. In other words, in the tort context, if you personally injure somebody you will still be liable even if your business is incorporated.

Strategies for Protecting Business Owners from Personal Liability.

- Select a liability-limiting entity with which to operate the business.
- Observe the legal formalities required to maintain that entity (e.g., properly capitalize the business, hold meetings and document actions (in resolutions) as necessary, don't commingle personal and business funds, and sign all contracts as an agent of the entity).
- Avoid giving personal guarantees.
- Maintain liability insurance appropriate to the risks of the business.

2. Not Researching and Protecting Trade Names Before Use. Incorporating with a particular name or filing a fictitious name statement does not give a business the right to market its products or services under that name. Prior use of the name, or one similar to it, by another may bar a business from using their own name under state and federal trademark laws and may expose the company to liability for "unfair competition." This mistake is often not discovered until after the "new" business has spent large sums of money developing a brand they cannot use.

Federal trademark law (the Lanham Act, 15 USC § 1502, et seq.) and the California statutes modeled after it (Business and Professions Code §§14200-14342) were enacted to protect the public so it may buy a product bearing a particular mark or name knowing it will get the product it wants. They also protect the holder of the trademark from misappropriation by others seeking to capitalize on the goodwill of an established mark. Even unregistered marks are protected under California "common law" legal theories.

What are Trademarks, Service Marks, and Trade Names?

Trademarks and Service Marks. Trademarks and service marks may be words, names, symbols, devices or combinations thereof used to identify and distinguish a business' goods (in the case of trademarks) or services (in the case of service marks) from those sold by others and to indicate their source. However, words in common use, descriptive terms, and geographical names cannot be protected as trademarks. A mark may be registered federally, with the United States Patent and Trademark Office (www.uspto.gov), or in California, with the office of the Secretary of State (www.ss.ca.gov). Registration is advantageous because, among other things, it creates a presumption of the owner's right to use the mark.

Trade Names. A trade name is the name used by a person or business entity to identify their business. The same name may identify their goods/services and thus, may also be a trade or service mark. Subject to prior use or registration by another, trade names are generally protected in

California by either filing a fictitious business name statement, in the counties in which the user does business, or filing articles with the Secretary of State creating a specific business entity.

Infringement. Use of the same or a “confusingly similar” name to market similar goods or services can lead to an action for infringement or “unfair competition.” Remedies for infringement can be harsh and may include an injunction barring further use of the trade name or trademark, treble damages, confiscation of counterfeit goods, and recovery of attorney’s fees.

Strategies for Preventing Infringement Claims and Protecting Your Brand.

- Conduct a thorough trademark/trade name search before bringing your product/service to market. A comprehensive nationwide search can be performed for about \$350.
- Conduct a “poor man’s” search. If the business cannot afford an in-depth search, USPTO records may be checked online for free. Use of an internet search engine may identify others doing business using similar names.
- Protect your brand by registering at the federal (if your goods or services will be sold in or affect interstate commerce) or state level. Marks may be “reserved” prior to actual use.

3. No Written Agreement Among Principals Regarding Business Operation/Succession.

Business “marriages” don’t last forever. Eventually one of the principals dies, loses interest and quits, or wants to retire. Not only can such a departure leave a void that is difficult to fill but, absent an agreement to the contrary, any one of these situations may result in a liquidation of the business, sale of the departing principal’s interest to an unwanted outsider, reduction of operating capital to fund a buyout, or admission of an inexperienced heir or relative into the business.

Moreover, when the honeymoon is over, issues of compensation and responsibility, not clearly understood before embarking on the business venture, may lead to conflict among principals. At best, such conflict hinders the business’ success, at worst it can lead to its ruin.

Strategies to Reduce Conflict Between Principals and Provide for Orderly Business Succession. Prospective partners, shareholders, or members of an LLC should:

- Create an operational model that, at a minimum, defines each principal’s contribution to the business’ capital (whether debt or equity), role (as an active participant or investor), employment relationship and compensation, and manner for resolving deadlocks and/or disputes.
- Thoroughly explore the circumstances in which new principals will be admitted, when a buyout will be triggered (death, retirement, bankruptcy), and what party will be the purchaser (the entity or other principals). Also consider how interests will be valued, funded (life insurance?), and terms of payment (in cash or over a period of time).
- Enter into a written agreement memorializing the matters of importance to them.

Contract Mistakes

4. Agreements Not in Writing. Most agreements need not be in writing to be enforceable. Nevertheless, as appealing as it may be to conduct business on a “handshake” and a promise, an oral agreement may be difficult to enforce for the following reasons: (1) the parties may lack clear understanding of deal terms and possible contingencies; (2) the parties often fail to understand each other’s expectations and intent; (3) memories fade; and (4) each party tends to remember matters in the terms most favorable to them. The result can be broken promises, conflict, and difficulty enforcing agreements.

Strategies for Reducing Conflict and Obtaining an Enforceable Agreement.

- Use written agreements wherever possible.
- A follow-up “letter agreement” confirming terms may be enough in a simple transaction.
- Use form agreements with caution, they may contain terms you do not understand.
- Warning: under a general rule of contract interpretation, any ambiguity is construed against the party that drafted the contract (California Civil Code section 1654).

5. Written Agreements Are Not Drafted/Reviewed by Your Counsel. In the world of business contracts, what you don’t know (or understand) can hurt you. Even a short contract can contain terms involving complex legal concepts. Lengthy agreements, involving elaborate transactions, can challenge a seasoned lawyer’s ability to understand. Nevertheless, it’s surprising just how often business owners enter into agreements and are later stunned to discover they did not get what they thought they would or they are required to give more than anticipated.

Such consequences are likely when: (1) the agreement is drafted by the other party’s lawyer (on terms favorable to them but not clearly understood by you); (2) the parties draft their own agreement but fail to spot important legal issues; (3) the parties draft their own agreement (or use someone else’s form) and include ambiguous or superfluous language. In such situations, you may get a rotten deal, misunderstanding and conflict may result, and/or the agreement may be difficult to understand, difficult to perform, and difficult to enforce.

Strategies for Avoiding Disappointment and Getting the Deal You Want.

- Unless you are an expert in the field, have contracts drafted by others reviewed by an attorney you trust. Some attorneys will perform a contract review for a flat fee.
- If your business needs a contract (and it probably does), have it drafted by a business attorney.
- If you choose to draft an agreement, have it reviewed by an attorney prior to use.

Employment Mistakes

6. Failure to Understand the Law of Wrongful Termination. Most employers are aware of the “at will” employment rule codified in California Labor Code section 2922. This rule states: “An employment, having no specified term, may be terminated at the will of either party on notice to the other.” The rule sounds straightforward, but is not. Numerous exceptions apply to employer initiated terminations. Failure to understand these exceptions can expose an employer to liability for wrongful termination. Due, in part, to the widespread availability of employment law information on the internet, it is increasingly likely that an unhappy former employee will assert their rights.

Exceptions to the “At Will” Doctrine. State and federal statutes have created many exceptions to the “at will” doctrine. Examples include terminations based upon discrimination due to the employee’s membership in a protected class (e.g., age, race, sexual orientation, etc.), taking a protected leave of absence, or for whistleblowing activities. Several additional exceptions have been developed by California courts. These include termination in violation of public policy (e.g., the employee refuses to break the law) and breach of an express or implied contract to terminate only for cause.

Breach of an Express or Implied Contract to Terminate Only for Cause. The “at will” presumption may be overcome by evidence of an express (oral or written) or implied agreement to terminate only for cause. Thus, an employer’s promise not to terminate absent good cause can support a wrongful termination claim unless the employee was actually discharged for cause. Moreover, in the absence of an express agreement, such a promise may be “implied in fact” based upon the personnel policies or practices of the employer, the employee’s length of service, or actions by the employer reflecting assurances of continued employment.

Strategies for Preventing Wrongful Termination Claims.

- Become familiar with the statutory exceptions to the “at will” rule and do not terminate (or take other prohibited action) in violation of such statutes.
- Unless specifically desired, avoid written or oral representations to prospective employees (in advertising, interviews, etc.) regarding “long-term,” “permanent,” “steady,” or “secure” employment.
- Use “at will” disclaimers in applications, offer letters, and employee handbooks.
- Require employees to sign a written, integrated (it is the entire agreement between the parties regarding that subject) “at will” agreement.
- Consider obtaining employment practices liability insurance.

7. Misclassifying Workers as Independent Contractors. There are two ways a business can get work done: with employees or independent contractors. Increasingly, independent contractor relationships are preferred both by companies (due to reduced regulation, lack of withholding, no workers’ compensation insurance, etc.) and by workers (who may get tax breaks and want to keep all of their “pay” now). However, because such relationships have been abused, they have come under increased scrutiny by the government agencies responsible for collecting taxes and

administering employee benefits.

For example, since 1989, the IRS has increased independent contractor audits nearly 1000 percent. The results of those audits have cost companies an average of \$1,400 per misclassified worker and earned the U.S. Treasury an average of \$68,000 per audited business (the IRS can look back 3 years and collect taxes that should have been withheld plus penalties and interest). In addition to tax liability, misclassification can lead to many “garden variety” employer liabilities resulting from harassment, discrimination, wrongful discharge, wage and hour claims, etc.

What Is an Independent Contractor? Labor Code section 3353 defines an independent contractor as “any person who renders service for specified recompense for specified result, under the control of his principle as to the results of his work only and not as to the means by which such result is accomplished.” Although each agency uses its own standards to determine if a worker is properly classified, they all focus on the control aspect of the relationship. In the case of the IRS, three main areas are considered: behavioral control, financial control, and the relationship of the parties. They use 20 factors to assess those areas. For more information, see the IRS website, www.irs.gov, or call our office and request a copy of the “20 IRS factors.”

Strategies for Creating a “Defensible” Independent Contractor Relationship.

- Create a “defensible” relationship by complying with the agency tests (e.g., contractor has other clients, special skills, employees, provides tools, does not take instructions on how work shall be performed, advertises services to general public, etc.).
- Gather information to substantiate compliance (copies of: business cards, advertising, business license, workers compensation insurance policy, professional license, etc.)
- Document the relationship in a formal written agreement including a provision wherein the contractor will indemnify the employer for any losses if it is determined the contractor was misclassified.

8. Misclassifying Workers as Exempt From Overtime. Many employers mistakenly believe that salaried workers are exempt from overtime. Others simply rely upon time-tested titles, such as manager or administrator, as justification for not paying overtime. Nevertheless, to be exempt from the overtime provisions of state and federal law an employee must be engaged in work that qualifies them for one of only a handful of narrow exemptions. Most commonly, a worker will be exempt if they meet the requirements to be classified as administrators, executives, professionals, or outside sales persons. To complicate matters, state and federal exemption requirements differ. The requirements of both must be met for an employee to be exempt from overtime.

Consequences of Misclassification. A misclassified employee may bring a state or federal administrative action or file a civil suit to collect unpaid wages. Depending upon the forum and the nature of the claim, an employer’s liability may extend back 2 or 3 years. In a civil action, of which there have been many of the “class action” variety in the last several years, the successful employee will also be entitled to recover costs and attorney’s fees.

Strategies for Preventing Overtime Claims.

- Know the exemptions and ensure the worker's actual job duties meet the requirements. California exemption requirements can be found in the California Code of Regulations (sections 11010-11040, 11060-11150) and are available online at www.dir.ca.gov/dlse/dlse.htm.
- Be prepared to prove it (the burden is on the employer) by using written job descriptions including time spent performing all duties (Tip: have the employee prepare and sign it) and regularly review the job description with the employee documenting its continued accuracy.
- Do not ask, expect, or permit non-exempt employees to work "off the clock" before or after shifts or on weekends.

Trade Secrets

9. No Trade Secret Protection Plan. Businesses often invest substantial time and money developing specialized manufacturing processes, formulas, and customer lists. Such information gives them a competitive advantage and thus, the ability to protect it from unauthorized disclosure and use can be vital to the business' success. Fortunately, under California law, such information may receive protection as trade secrets. When such legal protection is denied, it is usually because the owner of the trade secret failed to take reasonable precautions to keep the information secret.

What Are Trade Secrets? Trade secrets are (1) information, (2) that is not generally known to others, (3) which has independent economic value because it is unknown (i.e., gives the business a competitive advantage), and (4) which the owner has taken reasonable precautions to keep secret.

Customer lists and related information are frequent subjects of trade secret litigation. When they are, value and secrecy are generally the focus of the court's inquiry. The most important questions are: Was the customer list compiled at substantial effort and expense (e.g., through years of marketing)? Are the users of the company's products easy to ascertain (e.g., which stores sell avocados)? Is the customer information sophisticated (key contacts, special requirements, which customers are most valuable)?

Most trade secret litigation involves former employees who use customer lists and information acquired during their employment in another competing business. Generally, the information is used to solicit customers (asking them for business) of their former employer. If the customer list is found to be a trade secret, the former employee and their new employer may be ordered to cease such solicitation and prohibited from doing business with the former employer's customers. However, if the information is only used to announce their new employment affiliation (and not solicit), a former employee may contact customers of their former employer even if their identities are trade secrets of the former employer.

Strategies for Protecting Trade Secrets. A trade secret must be the subject of reasonable efforts by its owner to maintain its secrecy. What may be reasonable for a small business may not be reasonable for a large company. Protective measures might include:

- Limiting access to areas where trade secrets are being used and to areas where trade secret information is stored, including file storage and computer networks, on a “need to know” basis.
- Placing proprietary information notices on trade secret documents and embedding such notices in documents stored electronically and/or use of color coding to remind employees such documents are confidential.
- Shredding or otherwise destroying confidential documents before disposal.
- Placing limits on the number of copies of confidential documents in existence.
- Requiring all persons with access to sign nondisclosure agreements.
- Developing a trade secrets protection plan incorporating the various protective measures to be utilized and including such plan in the employee handbook.

Taxation

10. Failure to Make Timely Deposits of 941 (Withholding and Employment) Taxes. Regardless of the form in which a business is conducted, a person or entity hiring and using employees is treated as an “employer” for federal withholding and employment tax purposes. Every employer is required to withhold income taxes on wages (Internal Revenue Code section 3402), Social Security/Medicare (FICA) taxes (IRC sections 3101-3102), and required to pay an excise tax equal to the withheld FICA taxes. Moreover, depending upon the amount of taxes reported during the previous “lookback period,” employers are required to make either monthly or semi-weekly deposits of these taxes (IRC section 6302). Employers use IRS form 941, “The Employer’s Quarterly Federal Tax Return,” to report taxes deposited during each quarter. All deposits must be made and tax returns filed in a timely fashion. As tempting as it may be to “borrow” from these funds, every business should understand that the rules are strictly enforced.

Penalties. If a business fails to withhold, deposit, or pay income or FICA taxes, both the business and its responsible persons may be subject to a penalty equal to the amount not withheld or remitted, plus the amount not withheld or remitted, plus interest (IRC sections 3402 and 6672). Penalties may also be imposed if the amounts withheld or remitted late (IRC section 6656).

Strategies for Employment Tax Compliance.

- Do not pay employees (or those disguised as independent contractors) “in cash.”
- However tempting, do not touch money earmarked for payroll tax deposits.
- Prevent inadvertent miscalculations of tax amounts and late deposits by using a reputable payroll service.

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