

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

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GIBSON FERRIN & RIGGS, PLC
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Running a successful business is hard work in any economic environment. Competition is fierce. Technological developments come at you at an increasingly faster pace. Your products and services require constant development and improvement. Staffing issues, bookkeeping, marketing, scheduling, planning, and managing. Whew! You have more to do than reasonably can be accomplished in a busy work week.

To succeed, you must focus and prioritize. The challenge is that your priorities often are sitting quietly on the sideline, waiting patiently for you to give them the attention they need, while relatively unimportant distractions clamor for your undivided attention. Unless you make time for the important but not urgent aspects of your business, they will remain quietly on the sideline until it is too late, leading to disastrous consequences for your business.

Avoid the ten fatal mistakes that business owners often make when they fail to focus on the things that can help them achieve long-term growth and prosperity. Each of these mistakes can be deadly for a business; each of the mistakes is preventable with proper planning and preparation.

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

1. Failure to Set Up a Proper Business Entity.
2. Failure to Maintain Corporate Formalities.
3. Failure to Segregate Business Enterprises into Distinct Entities.
4. Failure to Use a Qualified Statutory Agent.
5. Failure to Establish a Buy-Sell Agreement.
6. Failure to Fund the Buy-Sell Agreement.
7. Failure to Create and Regularly Update an Estate Plan.
8. Failure to Follow State and Federal Employment Laws.
9. Failure to Set Up Reasonable Restrictive Covenants.
10. Failure to Protect the Intangible Assets of the Business.

The following examples illustrate how easily the Ten Fatal Mistakes can arise in any business.

Mistake No. 1: Failure to Set Up a Proper Business Entity.

Starting a new business is a rush of adrenalin. Everything is new and exciting. Unless you set a proper foundation, however, your business is likely to collapse.

Susan was thrilled to start her own business. For more than twenty years, she had worked for other people, followed their instructions, and enriched their bank accounts. Susan's husband, Bob, brought the technical knowledge to the business; Susan would handle the financial affairs of the business.

Six months after they had opened their doors for business, a customer approached Bob with an incredible opportunity. The job would take them out of their comfort zone, but it offered the promise of an incredible pay day. Bob jumped into the job head first, working late nights and weekends to meet the

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

customer's tight deadlines. The customer was very demanding, but Bob ultimately was able to satisfy his concerns.

Six months after the job was completed, Susan received a demand letter from a lawyer who represented the customer. The lawyer claimed that Bob had been negligent in his work, and threatened to file suit against Bob and Susan unless they paid \$100,000 for damages the customer claimed he had suffered.

Bob and Susan immediately sought advice from a lawyer, concerned about whether their business could survive a law suit. Their concern turned to distress, however, when their lawyer told them that their personal assets were at risk because they had not operated the business as a corporation or limited liability company.

How to Avoid Mistake No. 1: When properly set up and maintained, both a corporation and a limited liability company protect you from liability arising from owning and operating a business. The law recognizes a corporation or limited liability company as a separate "person" with separate finances, assets, and liabilities. Any company obligations remain at the company level, and your personal assets are protected.

Setting up a formal business entity provides you with numerous other advantages. Formal business entities create wealth because the owners have

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

something concrete (stock or membership interests) that they can sell. A formal business enterprise also enables the owners to bring in other owners by selling part of the business.

If you have not set up your business as a corporation or a limited liability company, you are waiting for problems that inevitably will come.

Mistake No. 2: Failure to Maintain Corporate Formalities.

The second deadly mistake is a variation of the first. Business owners who make the effort to set up a formal business entity often fail to treat the company separate from their personal affairs. If you do not separate your business and personal interests, a court may find that you are personally liable for the obligations of the company.

Roy was excited to begin his new business. Anxious to protect his personal assets, he submitted the appropriate paperwork for his company.

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

The business grew at a steady pace. When money was scarce at home, it was nice to have the business pay his mortgage or his son's college tuition. Roy and his wife, Jean, enjoyed taking the neighbors out to dinner courtesy of the business credit card. The business bought season tickets to the Suns and Cardinals for Roy, and season tickets to the theater for Jean. After a few years, the business bought a cabin in the mountains where Roy and Jean could relax on the weekends.

As the business continued to grow, Roy began to spin off related companies. From time-to-time, one of the related companies was short on funds, so Roy's Racers, Inc., the strongest of the companies, would cover a payroll or pay a vendor. It was easy for Jean to transfer funds back and forth between the entities using online banking.

Business took a turn for the worse. Roy cut expenses, but it wasn't enough to keep current on company bills. Creditors began filing lawsuits against the companies. The attorneys for his creditors kept poking and prodding at company finances, ultimately asserting that were "alter egos" for Roy and Jean. Roy was stunned when he learned that because he had not maintained proper corporate formalities, the court could disregard the corporate entities – "pierce the corporate veil" is how the attorney described it – and enter judgment against Roy and Jean personally.

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

How to Avoid Mistake No. 2: If you have gone to the effort to formalize your business through a corporation or limited liability company, be sure to treat the business like a real business. Keep business and personal finances separate. Open separate bank accounts for each entity. Hold regular meetings of the shareholders, officers, and directors. Update corporate minutes each year. Corporations should file annual reports with the Arizona Corporation Commission. Update the contact information on file with the Arizona Corporation Commission as needed.

Treat your business like a real business. Maintain the formalities that will allow you to protect yourself from personal liability.

Mistake No. 3: Failure to Segregate Business Enterprises into Distinct Entities.

When you operate too many business ventures out of the same company, you place all of your ventures at risk. Segregate your business enterprises into distinct entities.

Growing up, Pete and Fred were as inseparable as two brothers can be. Not surprisingly, when Pete and Fred entered the business world, they did so as partners. Fred learned of an opportunity to import inexpensive furniture from the Orient, which the brothers sold to their college classmates. Upon graduating, the brothers opened a small shop to sell their wares.

The brothers made a good team, and their business prospered, leading to additional opportunities. They expanded their operations, creating a very profitable financing division that supported the sales division.

Their foreign contacts put them in touch with clothing manufacturers, and they began to import clothing. The clothing was wildly popular, particularly with young people. Soon the brothers had a second chain of stores, this time focusing on clothing. As their profits grew, the brothers purchased retail space

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

for each of their store fronts. They also obtained increasingly larger lines of credit to finance their businesses.

Styles changed, and the clothing line floundered. Initially, the brothers attributed the drop in sales to generally slow retail sales, but after time they concluded that the market had changed fundamentally. They cut prices hoping to recoup their costs, but the clothing still did not sell. Ultimately, they had to close the clothing stores.

Fortunately, the furniture business remained profitable, and the finance division was a steady source of income. The profitable divisions could cover the obligations of the clothing stores.

Their banker had different ideas. Fred and Pete had nearly \$500,000 on their line of credit when the bank refused to renew the loan and demanded immediate payment of their obligation.

How to Avoid Mistake No. 3: Pete and Fred treated their business dealings as a single venture, when it actually consisted of many discrete businesses. Each furniture store and clothing store is a separate business, each building a separate venture. Separating each store and building into a separate corporation or limited liability company allows business owners to treat each portion of their business enterprise as what it really is – a separate and independent business undertaking.

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

Separating business ventures increases accountability. Each business venture either makes or loses money on its own merit. A wildly profitable store is not dragged down by an unproductive location. Separateness allows you to make business decisions based on the merits of each unit.

Separated business entities create wealth.

Mistake No. 4: Failure to Use a Qualified Statutory Agent.

Acting as statutory agent for your company can have devastating consequences if you do not properly respond to legal notices that are served on the company from time to time.

Anne had no delusions of grandeur when she started her cooking school. Anne organized her business as a limited liability company. She set up a separate bank account for the business, rented a location for the school, and began holding classes.

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

Three years later, Anne was thrilled that she could make a secure living doing what she enjoyed most. Anne could not believe how successful her little school had become.

The school's success made it all the more perplexing when she was unable to make a purchase using the school's debit card. Anne had made a sizable deposit the day before, so she knew that the account had more than enough money to pay for the purchase.

When she called the bank, Anne was stunned to learn that the account had been garnished. Anne panicked: the next day was payday. In addition, Anne had just mailed checks to her vendors, and they would be cashing the checks in the next few days.

After several hours of investigation, Anne learned why the account had been garnished. Miranda, the school's receptionist, had failed to pay her credit card bill. The creditor sued, and obtained a default judgment against Miranda. The creditor then attempted to collect the judgment by serving a garnishment on Miranda's employer, the school.

Unfortunately, the process server left the garnishment papers with Miranda. Embarrassed by the situation and unwilling to face her problem, Miranda shredded the garnishment papers. Because the school did not

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

respond to the garnishment papers, the creditor eventually obtained a judgment against the school.

Anne promptly hired an attorney, who was able to have the garnishment released and the judgment set aside because of Miranda's subterfuge. Though the attorney worked quickly, she was unable to get the garnishment set aside in time for Anne to make payroll. In addition, Anne spent hours on the telephone with her vendors explaining why her payments to them had been returned by the bank. When the invoice from her attorney arrived, Anne tried not to think about the cruise she had to cancel to pay her attorneys' fees.

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

How to Avoid Mistake No. 4: Arizona law requires that every corporation or limited liability company identify a statutory agent to receive certain legal notices, including certain legal notices in litigation and notices from the Arizona Corporation Commission. If your company fails to respond properly to a document served on your statutory agent, it may be subject to devastating legal consequences.

Anne thought she was being frugal when she identified herself as the statutory agent for the school, but she was actually laying the ground work for legal difficulties. You should not serve as the statutory agent for your business. Rather, identify a statutory agent who is available to receive service of process and who knows what to do when it is served with legal notice.

Mistake No. 5: Failure to Establish a Buy-Sell Agreement

All good things must come to an end. Successful businesses plan for this eventuality, and decide how to terminate their business relationships before one of the owners wants out.

Steve and Harold had operated their internet-based store for more than five years. Each of the men owned half of the stock in the company, with Steve handling the financial matters, while Harold focused on sales and marketing. They made a good team, and their business prospered.

Though they had similar goals when they started the business, Steve and Harold found that they no longer saw eye to eye. Harold wanted to expand the merchandise available at the store; Steve felt it was critical to focus on their existing product lines. When they could not reach a joint decision, Harold

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

purchased new product lines over Steve's objections. Steve retaliated by ignoring the invoices from the vendor and shutting off Harold's cell phone.

Each of them wanted to separate their business relationship, but they did not know how. Harold said that he would sell his 50 percent of the business to Steve for \$1 million cash. Steve hired an appraiser, who determined the value of the company to be \$1.5 million, but Harold challenged the appraiser's opinion. Their disagreement became more and more contentious. Ultimately, they refused to talk to each other.

In desperation, Steve filed suit to dissolve the corporation. Sales stalled and the value of the company plummeted as the two owners wrestled with their legal dispute. Some eight months later, after they each spent more than \$100,000 in attorneys' fees and litigation costs, Harold agreed to sell his interest in the company to Steve for \$150,000. Each was bitter about the demise of the business; each felt that he had been cheated in their separation.

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

How to Avoid Mistake No. 5: If you have business partners, you need a buy-sell agreement. Ideally, you should prepare the agreement when you set up the company. If you have not already formed a buy-sell agreement, do so immediately to ensure that you have a plan in place to address the transition of the business.

A buy-sell agreement typically addresses terms on which one owner can sell his interest to the other owners, setting forth the methods of calculating the purchase price and of establishing the terms of sale. Not only does it provide a mechanism for resolving impasses between owners, but it also provides an orderly way to handle the death, disability, illness, bankruptcy, divorce, or retirement of one of the owners. Among other things, a buy-sell agreement considers the following matters:

1. When can an owner sell his interest in the business?
2. Who is allowed to buy an interest in the business?
3. Under what circumstances may an owner be required to sell her interest in the business?
4. How will the parties determine the value of the interest in the business?

A properly drafted buy-sell agreement allows the ownership and management of the business to continue without having the departing owner's

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

successor forced on the remaining owners. It also fairly compensates the departing owner for his interest in the company, while still meeting the liquidity needs of the company. Once the agreement is in place, you should review and update it regularly to ensure that it continues to meet your needs.

Mistake No. 6: Failure to Properly Fund the Buy-Sell Agreement.

A buy-sell agreement should have a source of funding available to allow the surviving owner to purchase a deceased owner's share of the business. That funding generally comes through life insurance policies. If the agreement is not adequately funded, it provides limited protection to the owners.

Ralph, George, and Michelle each owned one-third of their consulting business. They knew that they needed a buy-sell agreement to ensure the orderly transition of the business, so they had their attorney draft a mutually acceptable buy-sell agreement when they formed the company. They had big

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

plans for the company, so each purchased \$500,000 dollars of life insurance to fund the agreement.

Over the next few years, the company grew consistently. Each of the three owners developed a reputation for excellence in their respective niches. They hired additional consultants to add knowledge and depth to the company's expertise. The company eventually had 22 consultants and 17 support staff members. Revenues and profitability grew each year.

After 18 years, the company had grown well beyond what they had envisioned. Ralph knew that they needed to update their buy-sell agreement, but everyone was busy. They were all at least 15 years away from retirement, so Ralph did not worry too much about the needed changes.

When George was killed in a biking accident, Ralph and Michelle were devastated. He was not only their business partner, but a close and valued friend. It was difficult to think of the firm going on without George.

A business appraisal set the value of the company at nearly \$9 million, substantially more than the three owners had dreamed possible when they formed the firm 18 years earlier. The investment portion of George's life insurance policy had grown, but it was still nearly \$2 million short of the amount that Ralph and Michelle needed to buy out George's widow, Estelle.

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

Ralph and Michelle feared that they would have to liquidate the company to meet their obligations to Estelle.

How to Avoid Mistake No. 6: An inadequately funded buy-sell agreement is almost as devastating as no buy-sell agreement. While the amount of life insurance may have been adequate at the time the three partners formed the company, that amount was grossly inadequate at the time of George's premature death.

The solution is to review your buy-sell agreement regularly with your legal counsel – at least every two to three years – to ensure that it still meets your ongoing needs. Part of that review includes determining whether the buy-sell agreement is still adequately funded. If the agreement is not adequately funded, an untimely death may force the survivors to sell the business at a loss to pay estate taxes or to pay off the estate of the deceased owner.

Mistake No. 7: Failure to Create and Regularly Update an Estate Plan.

As your business becomes more valuable, you will want to ensure that you have properly taken care of your loved ones.

Eric and his wife, Joyce, met with an estate planning attorney to set up an estate plan tailored to their needs. Eric named Joyce as his sole heir, and she returned the favor.

Eric and Joyce had always argued, but wasn't that true of all couples? Still, Eric was taken back when Joyce stormed out of the home two years later after one of their spats and did not return. A few days later, a man came to Eric's home and served him with divorce papers.

The divorce was long and bitter. Fortunately, they did not have any children, so they were not fighting over custody and visitation, but the property settlement was difficult. Eventually, Eric traded his interest in their home and in some stocks so that he could keep his business.

Eric worked hard, and his business flourished. He had no plans for marrying again, but changed his mind when he met Hilda. They immediately fell in love, and, a few months later, were married. And guess what? They didn't argue. Eric had never been happier.

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

With Hilda's support, the business grew as never before. Over the next eight years, three children joined their family.

Shortly after their 10th anniversary, Eric was killed in an accident. Family and friends rallied to support Hilda and the children. Even Joyce attended the funeral and expressed her condolences.

A few weeks after the funeral, Joyce's attorney sent Hilda a letter asserting that since Eric had never updated his estate plan, Joyce was his sole heir.

How to Avoid Mistake No. 7: As the old saying goes, nothing is certain but death and taxes. And if you don't have an appropriate estate plan, your heirs will pay unnecessary taxes when you die. Further, your heirs may be forced to sell your business if you have not coordinated your estate plan with your buy-sell agreement.

If you own a business, you must have an estate plan that is tailored to meet your specific needs. Regularly review and update that estate plan to make sure it is still applicable. If you experience any major life changes – marriage, divorce, birth of a child, or death of a spouse or child – update your

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

estate plan immediately. If you don't your estate may not end up where you want it to go.

Mistake No. 8: Failure to Follow Prudent Employment Practices.

Your employment practices are key to the success of your business. If you don't take care of your employment practices, you can easily find yourself on the wrong end of a law suit.

John owned and operated a bar and restaurant serving the spiciest Mexican food in town. Though the restaurant was the proverbial hole in the wall, it was incredibly popular. Beginning shortly after 5 p.m. each work day, customers rushed to join the Happy Hour, often staying through the evening. On the weekends, it was virtually impossible to find a parking spot within two blocks of the restaurant. Customers often had to wait more than an hour to be seated, but they kept coming. The food was great, prices were affordable, and the atmosphere was raucous.

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

To keep up with demand, John had at least eight cooks in the kitchen at any one time. Counting the hostesses, busboys, wait staff, bartenders, and dish washers, the restaurant employed more than 25 people, many of whom had worked for the restaurant for years. The work place was fast paced and boisterous, with people constantly on the move. The staff got along great, or so it seemed.

John was stunned when he received a packet from the Equal Employment Opportunity Commission containing a Charge of Discrimination filed by Amanda, his most dependable hostess, who had resigned one week earlier. Amanda claimed that Charles, the head waiter, had made unwanted sexual advances toward her. When Amanda rebuffed him, Charles began taunting her, encouraging others to join him. Amanda claimed that the harassment was so severe and extreme that she had no alternative but to resign. She claimed that Charles' conduct constituted illegal sexual harassment under Title VII of the Civil Rights Act of 1964, and that she had been passed over for a promotion when she objected to Charles' illegal conduct.

How to Avoid Mistake No. 8: State and federal law create an alphabet soup (ADA, FMLA, ADEA, OWBPA, and others) of employment obligations that raise serious concerns to all business owners. These laws and their

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

corresponding regulations present challenges for even the most sophisticated employer.

Prudent employment practices begin before you hire your first employee, using sound interviewing and hiring policies. Those policies and procedures include well-drafted employee handbooks with comprehensive policies and procedures, followed by thorough and continuous training to ensure that those policies are followed. Implement appropriate disciplinary procedures and, when necessary, dispense discipline even-handedly and fairly. Review your practices and procedures regularly to ensure that they meet the ever-changing legal requirements.

Mistake No. 9: Failure to Set Up Reasonable Restrictive Covenants.

Sid's business was booming. Over the past three years, he had developed a strong base of clients and prospects. Through effective branding and marketing campaigns, he had garnered a growing niche for his company's products.

The demand was so great that Sid could no longer act as the company's sole salesman. He needed to devote more time to training new employees and to fine tuning the development of the company's new products. Sid was pleased when Jennifer, an experienced and affable sales rep, responded to his Help Wanted Ad, and thrilled when she accepted a sales position with the company.

Sid introduced Jennifer to his existing clients. She quickly won them over with her quick wit and her attention to detail. Sales grew at a steady pace.

Jennifer began working the list of prospects, and began winning new business. Company profits soared to record highs. At Jennifer's suggestion, Sid hired two additional sales reps – Wendell and Terri – to help Jennifer work

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

the expanding client base. Sid divided the client list into three territories and assigned a rep to each territory. As the most experienced (and most effective) sales rep, Jennifer received the largest territory.

Sid continued to monitor the ongoing sales events, but the demands of a growing company made it increasingly more difficult for him to regularly visit clients. Ultimately, he promoted Jennifer to Director of Sales, and turned over all responsibilities for sales to her.

Sid was stunned when Jennifer turned in her notice of resignation. Two weeks later, the local newspaper announced that she had joined his primary competitor as the Vice President of Sales. The next day, Wendell and Terri resigned their positions and joined Jennifer. Business plummeted as customers followed the three defectors. Sid scrambled to try to keep the business, but the damage was done. Sid questioned whether he could keep the business open.

How to Avoid Mistake No. 9: Protect your business by using carefully drafted restrictive covenants. Non-solicitation agreements prevent former employees from contacting your customers and staff after leaving your company. Confidentiality agreements protect your trade secrets and other

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

confidential information. Courts will enforce limited non-compete agreements if they are no broader than is necessary to protect your legitimate business interests.

Properly drafted and enacted restrictive covenants help you minimize the possibility of unfair competition when key employees leave your business.

Mistake No. 10: Failure to Protect the Intangible Assets of the Business.

Patents, trademarks, copyrights, and trade secrets are critical to the success of virtually every modern business. How you take care of those intangible assets will determine whether your business succeeds.

Margaret developed a formula for an environmentally friendly cleaning agent. Though the product was made from commonly available chemicals, Margaret had discovered that if she heated the chemicals to a precise temperature, they combined in a way that was unknown to others in her industry. Margaret's formula was safer than anything her competitors made, so safe that the salesmen would take a drink of the formula during their sales pitch to show how harmless it was. All of her competitors recommended wearing gloves when using their cleaning agents.

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

Martin joined the company in an entry-level position, but showed a great aptitude for the business. Margaret gave Martin positions requiring increasingly more responsibility. He eventually became the head of production.

Margaret was disappointed when Martin left after eight years of service, but wished him well. Shortly afterwards, her sales representatives told her that Martin had formed a competing business that offered a product he claimed was “just as safe” as Margaret’s product. He even drank some of the product in his sales meetings, just like Margaret’s salesmen did.

Martin sold his product for 20 percent less than Margaret sold hers. Customers told the salesmen that while they liked Margaret’s product, Martin’s was just as safe and effective – and it cost less.

Margaret’s investigation revealed that Martin’s formula was made at the precise temperature that she used in her process. To make matters worse, other competitors somehow learned how Martin made his formula, and three different companies began selling a product that was “just as safe” as Margaret’s product. Margaret’s sales plunged.

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

How to Avoid Mistake No. 10: Did you know that 75 percent of the value of publicly traded companies comes from intangible assets? The percentage is even greater for many small businesses, which often have few assets other than their intellectual property and goodwill. More than 90 percent of all new technology is protected as a trade secret, making trade secrets the crown jewels of corporations. If it is unknown to others in the industry, almost any type of information may meet the legal definition for a trade secret. Your trade secrets may be your company's most important and valuable assets.

Once a trade secret becomes publicly known, it no longer is a trade secret. If you want to protect your most valuable assets, you must act today. Develop a plan to assess, inventory, and protect your trade secrets. Regularly audit your practices and procedures to make sure that they adequately protect your trade secrets. Teach all employees the importance of your trade secrets, and enact policies that guard your assets. Require employees to sign appropriate trade secret agreements as a condition of their employment.

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Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

Knowing the Ten Fatal Mistakes is not enough. Successful businesses take affirmative steps to avoid and overcome the Mistakes. Will you choose to heed the warnings?

If any of the ten illustrations remind you of your own business, take action today to make sure you won't succumb to the Ten Fatal Mistakes. Contact your lawyer today. Develop and implement a plan for addressing the Ten Fatal Mistakes. Follow that plan through conclusion.

Running a successful business is hard work in any economic environment. Avoid the Ten Fatal Mistakes, and help your business succeed.

Ten Fatal Mistakes that Business Owners Make (And How to Avoid Them)

About the Author

Any lawyer can answer a client's questions about how the law impacts her business. It takes vision to be able to help that client navigate her business through legal minefields the client has not yet discovered.

For more than 20 years, Scott F. Gibson has provided Arizona businesses with practical, timely, and creative solutions to their most complicated legal challenges. He knows how to help your business succeed.

Scott is the managing partner of Gibson, Ferrin & Riggs, PLC, located in Mesa, Arizona. He is an adjunct professor of law at the Sandra Day O'Connor College of Law at Arizona State University, and served for 16 years as a judge pro tem in the Maricopa County Superior Court. He has received the highest ratings possible from Avvo ("Superb") and from Martindale Hubbell ("AV"). Find out how he can help your Arizona business grow and succeed.

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