PROTECTING SHAREHOLDERS FROM LIABILITY

You likely incorporated your company because you wanted to avoid personal exposure to the liabilities and obligations of your business. If you had a major incident involving the company, or if you were sued as a defendant in a significant litigation matter, you would want to have done everything to avoid having your personal assets exposed to those potential liabilities.

In our experience, most small businesses believe that once they have incorporated their company, they have taken the last step to protect their personal assets. In actuality, this is only the first step they need to take to keep their "corporate veil" in tact. The corporate veil is the legal separation between the corporation and the Shareholders that own it. While it is true that a corporation provides limited liability to its Shareholders, this is only true if a corporation continues to act like a corporation and maintains the corporate formalities that must be followed in order to enjoy this protection. Otherwise, litigants, a creditor, and even the IRS can "pierce the corporate veil" and seek to recover from the Shareholders personally.

A key part of maintaining corporate formalities is to ensure that the separation between the corporation and its Shareholders is respected by all parties involved. This protection for Shareholders is only maintained as long the different roles within the corporation are properly kept distinct from one another. Because the Shareholders, Directors and Officers are often the same persons in closely-held corporations, this separation very quickly gets compromised and begins to erode the corporation's liability protection. There is nothing improper about having the same individuals serve in these different capacities, but it is especially important that those individuals keep their roles distinct whenever they take any action, and that accurate records of all business dealings are maintained.

DOCUMENTING CORPORATE FORMALITIES

When the same individuals wear multiple hats – those of Shareholders, Directors and Officers – it is very important to be able to demonstrate that the corporation was making decisions properly. If your corporation is sued, and the opposing party attempts to pierce the corporate veil by claiming that the Directors were not making major decisions for the corporation (as they are required to do), or that the Officers were not acting under the authority of the Directors, how would you defend against such a claim?

The Board of Directors. Contrary to popular belief, the Board of Directors is not just an advisory board that assists the Officers in making decisions. This common misunderstanding of the role of Directors leaves open the possibility that the corporation's corporate veil might be compromised, leading to personal exposure of the Shareholders to the corporation's liabilities. Rather, the Board of Directors is responsible to make *all* significant corporate decisions, including directing the corporation's activities, setting the corporation's goals and policies, approving or ratifying all major decisions, and empowering the Officers to carry out the day-to-day operations of the corporation's business in accordance with the resolutions of the Directors.

The Bylaws of the corporation spell out many types of decisions that require approval by the Board of Directors. If there is a Shareholders' Agreement in place between the Shareholders, this may also modify the terms of the Bylaws and should be consulted as well. We have also provided a Checklist that will assist you in identifying common situations where a vote of the Board of Directors might be necessary.

The Board of Directors should meet regularly. Most corporations set regular meetings of the Board of Directors, as specified in the Bylaws. Notwithstanding, there may be times when special meetings are necessary, especially when decisions of the Board of Directors are required with more frequency than the regular meetings prescribed in the Bylaws.

Written Documentation of Meetings. The only real evidence that the Board of Directors is meeting and managing the corporation is the written records maintained by the corporation. It is therefore essential that written documentation be kept of the actions of the Directors and the Shareholders. Proper documentation is the first line of defense against litigants making claims against the Shareholders of the corporation.

There are two ways in which the Board of Directors can act: (1) the Board can hold an in-person or telephonic meeting, which is designated as a regular meeting or a special meeting; or (2) it can act by unanimous written consent, by which the Directors give their unanimous written approval to one or more resolutions without the formality of a meeting.

Conduct of Meetings. If the Directors take action at a meeting, certain requirements must be met. The meeting must be noticed in accordance with the notice requirements contained within the Bylaws. Meetings held via a telephone conference call must be set up so that all Directors can hear one another. In all cases, a quorum must be present in order to adopt any resolution. If notice cannot be properly given, it must be waived by each Director who does not attend the meeting. A Director who attends the meeting but does not object to the lack of notice is deemed to have waived any objection to inadequate notice. However, for those Directors who are not present at the meeting, their signature on a written waiver of notice is required. The waiver should be filed in the corporate minute book along with the minutes of the meeting.

Minutes of Meetings. Minutes do not need to be in any special legal form, but they do need to clearly describe what was discussed and accurately reflect what decisions were made. Minutes should be prepared by the Secretary of the corporation, signed, and then approved by the Directors (or by the Shareholders for Shareholder meetings) at their next regular meeting. This will minimize any claim that the written minutes do not accurately reflect the action taken. Minutes should always state whether proper notice was given or waived, who was present and who was absent, and that a quorum was present. Any abstentions or dissents on a vote should be noted.

Unanimous Written Consent. Sometimes decisions need to be made without the formality of a meeting. In this case, a Unanimous Written Consent can be used. It is a document that clearly establishes what is being decided and what actions are authorized to be taken by the Officers. As the name implies, it must be unanimously approved by *all* of the Directors as evidenced by their signature. Approval does not need to happen simultaneous. Rather, the resolution contained within the Unanimous Written Consent only becomes effective when it has been signed by all of the Directors. In cases where the Directors cannot sign the same physical form, each can sign on duplicate originals, and all signatures will constitute one consent. The Unanimous Written Consent should be placed in the corporation's minute book.

Keeping Roles Clear. A corporation will often claim that meetings of its Officers or its staff should be considered a Board meeting because the Officers and Directors are actually the same persons. Legally, this will not suffice. This confusion of roles is exactly the failure to maintain corporation formalities that leads to a piercing of the corporate veil. Because the Bylaws and the Corporations Code state that certain decisions must be either made or ratified by Shareholders, it is equally important to document in writing any actions that must be taken by the Shareholders. The Checklists below will help you determine when a decision by the Board of Directors or the Shareholders (either with the Directors or separately) might be required.

Other Record Requirements. California law also requires that each corporation maintain a record of its shareholders, along with accurate accounting records of the company's operations. Records of the corporation must be made available to any Shareholder in certain circumstances as set forth in the Bylaws or as required by the Corporations Code. Corporations are also required to send an annual report to Shareholders not later than 120 days after the close of the fiscal year. This requirement can be waived in the Bylaws by corporations with fewer than 100 shareholders. The Bylaws should be consulted for additional details in regard to annual reporting requirements and requests for record inspections.

Issuance of Stock. Failing to actually issue stock to the Shareholders of the corporation is evidence of a lack of corporate formalities. Issuing stock does not require the formality of stock certificates unless the Bylaws or a Shareholders Agreement require stock certificates. However, a Shareholder ledger and journal must be accurately maintained by the Secretary of the corporation and kept in the minute book so that an up-to-date record of the ownership of all outstanding shares of stock is maintained by the corporation.

AVOIDING COMMINGLING OF ASSETS

Keeping your company's corporate veil intact requires maintaining the separation between the corporation and its Shareholders. In addition to proper record keeping, which was discussed above, it is crucial that the corporation avoid commingling funds with its Shareholders. Most business owners understand that the corporation's cash assets must be kept separate from the Shareholders in a bank account held by the corporation, but this separation often gets blurred in other ways.

Commingling Funds – Inflows. To determine whether commingling has taken place, courts look at whether a Shareholder treats the assets of the corporation as if those assets were his/her own. This could involve a Shareholder intentionally siphoning off company assets for personal benefit. Alternatively, it could involve a Shareholder taking money out of the company, or putting money into the company, without adequate documentation that would evidence the separateness of the corporation and the Shareholder.

For example, if the company was running low on capital to meet payroll, a Shareholder cannot simply deposit personal funds to make up the difference. Such commingling evidences a lack of belief on the part of the Shareholder that his or her assets are separate from those of the corporation. If the Shareholder confuses the two (Shareholder and corporation), attorneys seeking to pierce the corporate veil will argue that they are one and the same, and that the Shareholders should therefore be held personally liable. The Shareholder should have *loaned* money to the company (as evidenced by a written promissory note and an entry into the company's accounting records consistent with a loan from a third party) or he/she should have *capitalized* the funds (by purchasing more stock of the company in exchange for the funds being deposited permanently).

Commingling Funds – Outflows. Similarly, Shareholders should be very careful when they take funds out of a company. Funds that are paid to Shareholders should be documented as wages (if the Shareholder is an employee), dividends, or some other payment authorized by the Board of the Directors. Absent documentation, it again appears that the Shareholder has no regard for the corporate separateness between the Shareholder and the corporation. Having an employment contract in place between any Shareholder who is also an Officer, employee or contractor of the company is further evidence that this separateness is understood and maintained.

A helpful rule is to imagine that the Shareholder is a complete stranger. A complete stranger would not transfer money into the corporation's account to help the company meet payroll unless it was clearly stated in writing what that money was for. Is it a loan? Then the transaction should be documented in that fashion. Is it a purchase of stock? Then the third party would require evidence of the purchase. The same is true with any payments that are made by the corporation to the Shareholder.

Commingling Business and Personal Expenses. Finally, commingling can happen when personal and business expenses are not kept separate. If an employee purchases office equipment for the company, he or she would expect a reimbursement. That is because they are clear about the fact that they are not the same person as the corporation. However, Shareholders in small businesses often ignore this formality, and purchase items used by the corporation without seeking reimbursement from the corporation. Even more often, Shareholders utilize business assets to pay for personal expenses, and this practice again evidences a lack of corporate separateness that can allow a potential creditor to pierce the corporate veil.

UNDERCAPITALIZATION OR FRAUD

In addition to documenting corporate formalities and avoiding commingling of funds, courts also look at whether a corporation was undercapitalized. The exact definition of "undercapitalized" is not always clear, and the definition changes depending on the nature and size of the business. However, the corporation should never intentionally operate in a manner where it lacks the assets necessary to pay its creditors. Rather, the Shareholders should make a reasonable initial investment in the company, and funds should be maintained at all times sufficient to operate the business without the need for frequent capital injections. A corporation which is routinely drained to almost zero assets can be deemed a "sham" company that is not deserving of corporate protection. The company does not need to anticipate every foreseeable capital need of the business, but it should maintain sufficient funds to take on a "fair" share of the risks of business failure.

The corporation should avoid payments that would render it insolvent, or any amount that would seem unreasonable to an outside observer. Document the justifications for large payments made to Shareholders. Consult with counsel before making significant payments or transfers of any assets while litigation is pending, or when litigation has been threatened, as this might be considered a fraudulent transfer.

Courts also examine whether Shareholder(s) used the company to perpetrate a fraud or make fraudulent representations about the business. This could involve making misrepresentations about the corporation's financial status, promising that the corporation will perform its obligations while knowing that this is impossible, or making representations that would lead a creditor to believe that someone, other than the corporation, stands behind a debt. As a general rule, the corporate veil does not shield Shareholders from actions or liabilities for fraud and other forms of intentional misconduct.

A WORD ABOUT CONTRACTS AND SIGNATURES

One of the best ways to evidence that a corporation is separate from its Shareholders, Directors and Officers is to clearly indicate that the person signing for the corporation is doing so on behalf of the corporation and in their corporate capacity. This is especially true if the person signing the contract happens to be a Shareholder of the corporation while at the same time acting as an Officer or Director. As a general rule, a Shareholder should never sign a contract on behalf of the corporation. If the Shareholder is also an Officer or Director, they should sign in the most appropriate capacity (most often as an Officer), and indicate their capacity in the signature block. For example, the President of the company might sign their name, followed by their title and the name of the corporation, as follows: John Smith, President, All American Corporation, Inc. This will make it clear to anyone reading the contract that the President was not signing the contract personally, and was only intending to bind the corporation.

Similarly, all contracts should be in the name of the corporation, including client contracts, office and equipment leases, vendor agreements, utility bills, insurance policies, credit cards, tax payments, etc. Purchases should also be made in the name of the corporation whenever possible.

MAINTAIN THE CORPORATION'S STATUS

Each year, the corporation must file a Statement of Information with the Secretary of State, and file tax returns with the Internal Revenue Service and the Franchise Tax Board. The failure to file the Statement of Information, file tax returns or make tax payments to the Franchise Tax Board can lead to the suspension of the corporation. In addition to penalties and interest, a suspended status can be evidence of the lack of adherence to corporate formalities. Moreover, a suspended corporation cannot initiate litigation or defend itself in a lawsuit until it has been returned to active status.