

“Checkup” on Your Corporation’s Legal Health

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Has your California corporation had a checkup lately? Because a corporation exists as a “person” under the law, certain “formalities” must be followed to keep it “legally” healthy. To prove they were, written records must be maintained. Neglecting to do so may result in “alter ego” (personal) liability to shareholders, if creditors bring an action to “pierce the corporate veil.” Moreover, if periodic statements are not filed with the Secretary of State, the corporation may be fined and suspended, even if franchise taxes are being paid. If suspended, a corporation may no longer conduct business, may not maintain or defend a lawsuit, and may lose its name to anyone attempting to register the same name during the period of suspension. Performing a checkup each year, and taking corrective action if necessary, may immunize the corporation against such maladies.

How does a corporation get a checkup? The best way is to have its records examined by an attorney experienced in corporate matters. However, a review of the records described below will give a general idea of the corporation’s “legal” health. If this is the first checkup since the corporation was organized, or many years have passed since corporate records have been reviewed, start at the beginning of the corporation’s “life.” This will identify any gaps in the formation process as well as subsequent record-keeping activity.

First, gather the corporation’s formation and governance documents as well as records related to the minutes of meetings, stock transfers, and corporate filings (excluding tax returns). To make periodic review simple, it is best to keep these records in a three ring binder divided by index tabs. This is the traditional way of keeping corporate records and many attorneys provide such a record book to their clients at the time of incorporation. However, labeled file folders also work well. Because all shareholders have the right to inspect these records, good organization will also make it easier to comply with any inspection requests.

The corporation’s record book should be divided and, at minimum, have separate sections for the articles of incorporation, bylaws, minutes of director meetings (and written actions taken without a meeting), minutes of shareholder meetings (and written actions), copies of the periodic “Statement By Domestic Stock Corporation” filed with the Secretary of State, record of shareholders, and copies of securities filings. Other sections might include a “buy-sell” agreement, fictitious name statement (D.B.A.), state and federal employer identification numbers, sellers permit, or election by small business corporation. If the corporation’s directors or shareholders have frequent meetings or take frequent actions, a separate “minute book” may make organizing these records easier.

Articles of Incorporation

A corporation is “born” when articles of incorporation are filed by the Secretary of State. After filing, the Secretary of State returns a certified copy of the articles to the incorporator or attorney for the incorporator. This copy, together with certified copies of article amendments, if any, should have a home in your record book.

Like a birth certificate, the certified copy of the articles is an important legal document. It indicates the date the corporation came into being (which determines timing for a number of subsequent filings) and sets forth the name of the corporation, a statement of its purpose, the initial agent for service of process, and the class or classes and maximum number of shares authorized. The articles may also provide for matters such as the number and names of initial directors of the corporation, preemptive rights of shareholders, or

a statement that the corporation is a statutory “close corporation.” Although few are, if your corporation’s articles state it is a “close corporation,” much of this checkup will not apply.

Bylaws

The bylaws of a corporation set forth the rules that govern the conduct of its affairs. Matters typically found in bylaws relate to the holding of meetings, the election, number of directors, and their powers, and the officers and their authority. Bylaws will generally provide for other related management matters and must be in accord with the articles and California law.

A common area of discord between bylaws and California law involves the number of corporate directors. Under the law, the minimum number of directors is three, with several exceptions. If the corporation has one shareholder, it may have one or two directors; if the corporation has two shareholders, it may have two directors. Thus, if the the number of shareholders has increased since formation, the original number of directors set forth in the bylaws may no longer be in compliance. If that is the case, the bylaws should be amended.

Because of its importance as a governing document, a copy of the bylaws, as amended, should be kept in a separate section of the record book and referred to often by the officers and directors of the corporation.

Actions by Incorporator(s)

Articles of incorporation may be filed by the initial directors of the corporation, if their names and addresses appear in the articles, or by one or more incorporators. For flexibility, an incorporator is typically used. When that is the case, the incorporator generally adopts bylaws and appoints the directors, which need not be shareholders. This action should appear in written form and may be filed in a separate section of the record book or precede the minutes of the first meeting (or written action) of the directors.

Minutes of Meetings

Following formation, the corporation’s business activities should be documented in minutes of regular meetings of shareholders (at least one annually to elect directors and take action required to be approved by shareholders) and directors (at least one annually to elect officers and take action requiring director approval) and committees of the board (e.g., an executive committee), if any, as often as necessary to document the activities delegated to them. Records indicating proper notice was given to (or waiver of notice from) all entitled to attend should be kept with the minutes of each meeting. Look to the bylaws for guidance on the frequency, dates, notice, and quorum requirements for meetings and votes necessary to approve various actions (also known as resolutions).

The minutes of meetings should appear as an unbroken history of important actions taken on behalf of the corporation. That history usually begins with action taken by directors, at a meeting or in writing, to complete the organization of the corporation. That action should include:

1. Electing officers (All corporations must have three officers: a chairman or president, a secretary, and a chief financial officer. One individual may hold more than one office and officers need not be directors or shareholders.);
2. Adopting bylaws (which may have previously been adopted by the incorporator) and otherwise

- ratifying acts of the incorporator;
3. Appointing a permanent agent for service of process;
 4. Approving the form of share certificate (including any restrictive legend thereon), authorizing the issuance of shares in the quantity to be received by each shareholder, and specifying the consideration paid for such shares;
 5. Establishing the location of the principal executive office;
 6. Electing "S" corporation status;
 7. Statement of intent to qualify stock for treatment under Internal Revenue Code section 1244;
 8. Adopting employment agreements;
 9. Establishing a banking relationship; and
 10. Any other action needed to leave the corporation ready to do business.

As noted above, thereafter, the shareholders and directors should meet at least as often as required in the bylaws. Written minutes should be filed in the record book as evidence such meetings were held. Careful attention should be taken to document all important decisions and especially insider transactions or agreements, such as loans to or from the corporation with officers, directors, or shareholders. If there is disagreement over action to be taken, votes on such matters should also be carefully documented.

Statement By Domestic Stock Corporation

An initial "Statement By Domestic Stock Corporation" must be filed within 90 days after the articles were filed and periodically thereafter. This statement was required to be filed annually for years 2000 and before and is required biennially thereafter. An amended statement should be filed when information changes (especially the corporation's address). The Secretary of State generally includes a blank form for completion and return by the corporation with a certified copy of the filed articles. That office also sends a form to the corporation's last address prior to the due date of the annual or biennial statement. Failure to file the statement, even if it was not received from the Secretary of State, may result in a penalty of \$250 and suspension of the corporation. The Secretary of State's office estimates they suspend approximately 2,400 corporations each month for failing to file these statements.

Among other things, each statement should set forth the location of the principal executive office, the names and addresses of all directors and required officers, number of board vacancies, and the agent for service of process. This information should be in agreement with the minutes of shareholder and director meetings.

Record of Shareholders

Every holder of shares in a corporation is entitled to a share certificate. Concurrent with the preparation and delivery of share certificates and receipt of the consideration paid therefor, the corporate secretary should prepare a record of shareholders. This should be kept in the record book and indicate the name and address of each shareholder as well as the number and class (if more than one issued) of shares held. If shares were subsequently transferred, or additional shares issued, the record of shareholders should reflect all such transfers and issues. Moreover, the total number of shares issued must not exceed that amount authorized in the articles.

Not only is the maintenance of such record required by California law, all shareholders have the right to inspect the record for any purpose reasonably related to their interests as a shareholder.

Securities Filings

The shares of a corporation are considered to be securities. As such, their issuance and transfer is regulated by state and federal securities laws. Although an exemption from qualification will apply to most small corporations, a “notice of transaction” form, specifying the exemption, must be filed with the California Department of Corporations for each issue of shares. Thus, a section of the corporate book should contain copies of all such notices, together with proof of filing.

Other Records

In addition to the above, records of other matters undertaken at, or shortly after, incorporation should be maintained for convenience purposes in the corporation’s record book. These include:

1. Records related to the application and receipt of federal and state employer identification numbers (Banks generally require the former to open an account; the latter is required prior to paying wages.);
2. “Election by Small Business Corporation” form (The “S” corporation election must be made on or before the 16th day of the third month following incorporation if intended to take effect that tax year. Otherwise, it may be filed any time during a year when such election is to take effect the following year, or on or before the 16th day of the third month of the current year if intended to take effect during that year. Beware of making such an election if the corporation has been operating as a regular “C” corporation for some time.);
3. Fictitious name statements (D.B.A.’s, as they are otherwise known, should indicate the corporation, as its name appears in the articles, and not a shareholder or employee, is doing business under the fictitious name.);
4. Copies of local business licenses;
5. Copies of any agreement between shareholders relating to restrictions on the transfer of shares (buy-sell agreement); and
6. Copy of sellers permit from the State Board of Equalization.

Beyond matters discussed above, the proper operation of a corporation as a business requires good financial management, maintenance of business records, and compliance with many laws including, but not limited to, obtaining licenses for the business activity engaged in (e.g., a contractors license in the correct classification for construction-related activity), payment of taxes and filing returns, and compliance with state and federal labor laws. Failure to comply with applicable law and to otherwise observe prudent business practices may result in serious financial harm to the corporation. Failure to observe corporate “formalities” and maintain the records to prove it may bring such financial harm to rest upon the corporation’s shareholders. Performing a corporate checkup each year should provide the directors and officers with a measure of “sleep insurance” and may save shareholders from personal liability in an attempt to “pierce the corporate veil.”

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