PRACTICAL BUSINESS LAW TIPS
FOR
CORPORATE CFOS AND CONTROLLERS

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This outline should be viewed only as a summary of the law and proposed laws, and not as a substitute for legal or tax consultation in a particular case. Your comments would be appreciated and are invited.

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1. ISSUES I SOMETIMES SEE WITH NEW CLIENTS

1.1. Stock records in a mess[1]

1.1(a) There is no title insurance for stock of a closely-held corporation.

1.1(b) The ultimate evidence of stock ownership is the stock certificate – not the tax return or the Schedule K-1.

1.1(c) Get pledge shares back to the registered owner after the secured obligation is satisfied. Issue a new certificate without a legend about the pledge arrangement.

1.1(d) Collect and cancel the stock certificate when shares are sold. Issuing a new stock certificate is *not* sufficient.

1.1(e) Use stock assignments separate from certificate. Don't write on the back of the stock certificate.

1.1(f) As soon as possible, identify stock certificates that are outstanding but lost. Have the issuee sign an affidavit requesting a replacement certificate. Keep the affidavit with the stock records in place of the lost certificate.

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[1] See my outline *Year-End Stock Sale Issues - For professionals dealing with stock certificates of closely-held businesses* at http://www.staleylaw.com/images/Year-End_Stock_Sales_-_17568.pdf.

1.1(g) Identify gaps in the stock records and get declarations from all of the officers and directors who are now living. The goal is to have evidence to defeat claims of heirs who find stock certificates in their parent's papers.

1.1(h) Be sure the outstanding stock certificates synch with the stock info used for S corporation K-1s.

1.2. **No official list of LLC members and their interests**

1.2(a) If there have been transfers of LLC interests, the manager(s) should prepare a new list of members and interest holders who are not members and the percentage interest of each.

1.2(b) The manager(s) should send this list to all members and interest holders and to the CPA for the LLC.

1.2(c) The same goes for transfers of interests in general partnerships, LLPs and limited partnerships.

1.2(d) Some operating agreements or partnership agreements allow the manager or general partner to amend the agreement to do this. The manager or GP should prepare and circulate the new list, whether or not it amends the agreement.

1.3. **Valuable assets left subject to claims from business operations**[2]

1.3(a) Sometimes a corporation operating a business will also hold valuable real estate or art or aircraft, or a second business.

1.3(b) A claim against the operating business could be satisfied with all of the assets of the corporation, including the

[2] See my outline *Choosing a Business Entity* at http://www.staleylaw.com/images/Choosing_a_Business_Entity_-_20077.pdf.

valuable asset held in the corporation that is not used in the business that generates the liability.

1.3(c) Distributing the valuable asset would probably generate one level of tax in an S corp and two levels of tax in a C corp (or an S corp subject to the built-in gain tax).

1.3(d) If the corporation creates a subsidiary and drops the valuable assets into the subsidiary, the stock of the subsidiary is going to available to creditors of the operating business.

1.3(e) One solution is to create a holding company and to make the operating business the subsidiary.

- If the valuable asset will not generate any liability, put the valuable asset in the parent corp.

- If the valuable asset can generate liabilities (another business, aircraft, commercial real estate), put it in a single-member LLC wholly-owned b the holding company.

  ⇒ Using a single-member LLC is safer tax-wise than a QSub if and when the subsidiary ceases to be wholly-owned by the holding company.

1.4. C corporations that should be S corporations[3]

1.4(a) When a C corps sells its business in an asset sale, the tax rate can reach 63%, including federal and California taxes, the itemized deduction cu-backs, the 3.8% Obama-Care tax on passive investments, and taking into account the federal deduction for California taxes.

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[3] See my outline *C2S: The S Corporation Election for an Existing C Corporation* at http://www.staleylaw.com/images/C2S_-_15369.pdf.

1.4(b) When an S corporation sells its assets, the tax rate is approximately 33% to 39% (depending on how much of the California tax can be deducted against ordinary income).[4] The spread was about as dramatic in 2012.

1.4(c) The built-in gain tax on appreciation in the C corporation's assets up to the day of the S corporation election applies for 10 years after the S corporation election. But if the value of the business continues to appreciate, the double tax is frozen at the date of the S corporation election.

- The ten-year period is reduced to five years for sales in 2012 and 2013.

1.4(d) The basis of the shareholders in their shares will increase in each year in which the S corporation distributes less than all of its profits.[5] This basis increase will reduce the gain on the sale if the shares are sold or redeemed, or if the corporation is liquidated. The basis increase can be passed along when shares are gifted.

- There is no similar basis increase for C corporations

- For shares that are held until death, this basis increase will be wiped out by the basis adjustment to the fair market value at death.

1.4(e) An S corporation can make tax-free distributions to the shareholders, which can be a huge benefit for shareholders who are not employed by the business.

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[4] See page 7 of my outline *Corporate Tax Update* at http://www.staleylaw.com/images/Corporate_tax_update_2012_-_19992.pdf.

[5] See my outline *S Corporations – The Nuts and Bolts* at http://www.staleylaw.com/images/S_corp_Nuts_and_Bolts_-_16392.pdf.

- S corporations are not subject to the penalty taxes on 'accumulated earnings" or on "personal holding companies."

- The "excess passive receipt" penalties on S corporations are manageable and should not prevent a C corporation with a personal holding company problem from making the S corporation election to eliminate the problem.

1.4(f) The bottom line is that a corporation that is eligible to make the S corporation election and has a "build it and sell it" business model should definitely make the S corporation election -- and should do so sooner rather than later.

- If the corporation has unused loss carryforwards, it's a closer call.

- But in some cases it makes sense to walk away from the losses and make the S corporation election.

Note: The tax benefits of S corporation status also could be achieved by converting the C corporation into an LLC taxed as a partnership. *But* – that would be treated as a liquidation of the corporation and would trigger the recognition of all of the corporate-level and shareholder-level gain. That's way too high a price for most C corporations to pay.

1.5. No agreement to protect the valuable S corporation status[6]

1.5(a) C corporation status is the default. The tax benefits from S corporation status can be lost if the corporation ceases to eligible to be an S corporation.

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[6] See my outline *Buy-Sell Agreements for Owners of Closely-Held Businesses: An Overview* at http://www.staleylaw.com/images/BSA_Overview_-_17344.PDF.

1.5(b) Every S corporation with shares held by more than one couple should have a buy-sell agreement to protect the valuable – but fragile – S corporation status.

- This is especially necessary when shares are transferred within a family, with the risk that a shareholder might terminate the S corporation status out of spite. It's happened.

1.5(c) The agreement can also require the S corporation to distribute enough cash quarterly to enable the shareholders to pay their income taxes on their shares of the taxable income of the corporation.

- This provision in the buy-sell agreement can prevent a minority shareholder from being squeezed out by the shareholders who control the board of directors.

1.6. Illegal distributions[7]

1.6(a) A California corporation cannot make a distribution unless:

- The distribution is less than the amount of retained earnings immediately before the distribution, or

- Immediately after the distribution, the value of the corporation's assets exceeds the value of its liabilities, valuing the assets at either book or fair value.

1.6(b) Special rules apply for corporations with preferred stock.

1.6(c) An S corporation distributing S corporation profits will rarely run afoul of this provision.

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[7] See my outline *S Corporation Distributions – How to Make 'Em and How to Fix 'Em* at http://www.staleylaw.com/images/S_corp_Distribs_-_Make_Fix_-_15383.pdf.

1.6(d) A corporation *redeeming its shares* can easily violate this provision. Form a balance sheet perspective, cash and retained earnings are reduced, and liabilities are often increased.

1.6(e) Directors have *personal liability* for violating this provision and creditors can recover the illegal distributions from shareholders.

1.6(f) Similar rules apply for distributions from LLCs.

1.6(g) These rules do not apply when the corporation or LLC dissolves, because other creditor protections apply.

1.6(h) Also, these rules do not apply to a purchase of the shares by a person *other than* the issuing entity. For example, a purchase by another shareholder or by a family member.

- Redemptions also create a "disappearing basis" problem that can be solved in the same way.[8]

1.7. Shares issued to employees without a buy-back agreement[9]

1.7(a) When a shareholder terminates employment, the shareholder is not required to sell his or her shares back to the corporation – unless a buy-back agreement is in place to give the corporation that right.

1.7(b) The buy-back agreement can also protect the valuable S corporation status.

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[8] See my outline *Buy-Sell Agreements: Insurance Funding for C and S Corporations* at http://www.staleylaw.com/images/BSA_Insurance_Funding_OL.pdf.

[9] See my outline *Giving Stock to Employees -- And Other Incentive Programs* at http://www.staleylaw.com/images/Incentive_Comp_Arrangements_-_11057.pdf.

1.7(c) The employee should sign the buy-back agreement *before* the employee acquires stock – or even an option to acquire stock.

1.8. Owner-executives without any succession plan[10]

1.8(a) It's horrible to watch a valuable business collapse after the person who ran it dies or becomes disabled.

1.8(b) Salvaging the value of the business is way beyond the ability of most surviving spouses or inheriting children with no experience in the business.

1.8(c) A first step is a good buy-sell agreement to assure that the survivors are adequately paid for their shares and have a market for them.

1.8(d) But the buy-sell agreement can't assure that there is someone to run the business. It's up to the owner-executive to identify one or more successors and to groom them for succession while the owner-exec is in his or her prime.

- This is often a task that requires a coach who can keep this task "top-of-mind" and who can encourage the owner-exec to press on when good candidates refuse offers or leave the business too soon.

- It is not easy for a CPA or lawyer to get the owner-exec to focus on this. Like estate planning, sometimes it takes a horror story that hits close to home.

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[10] See my two-part outline *Succession Planning - Transferring a Business to the Next Generation* at http://www.staleylaw.com/images/SP_OL_Part_1.pdf and http://www.staleylaw.com/images/SP_OL_Part_2.pdf.

1.9. **Shares and LLC interests not held in the living trust**[11]

1.9(a) Speaking of estate planning, it's a crying shame to see valuable blocks of shares that are not held in a living trust.

1.9(b) If the shareholders have a living trust, the shares should be held in their names are trustees.

1.9(c) If they don't have a living trust but they have a valuable business and other valuable assets, they should sit down with a good estate planner ASAP. The most likely result will be a living trust, followed by an effort to transfer their assets to themselves as trustees.

1.9(d) The bottom line: Finding valuable stock or LLC interests that are no held in trust is like seeing the canary in the coal mine collapse – something is wrong here!

1.10. **Spouses named on shares after a living trust is created**[12]

1.10(a) When there is more than one shareholder, it often would be best if the shareholders have their estate planners create subtrusts within their living trusts. The shareholder and not the spouse would be the trustee of the subtrust, which would hold shares of the closely-held business.

1.10(b) This would prevent the non-employee-spouse-trustee from voting the shares as a trustee and, possibly, canceling the vote of the employee-spouse-trustee.

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[11] See my outline *Don't Let Living Trusts Cause Problems for Owners of Closely-Held Businesses* at http://www.staleylaw.com/images/Living_Trust_OL_-_16335.pdf.

[12] See my outline *Don't Let Living Trusts Cause Problems for Owners of Closely-Held Businesses* at http://www.staleylaw.com/images/Living_Trust_OL_-_16335.pdf.

1.10(c) If the employee-shareholder-trustee died or became disabled, the regular successor trustee provisions would apply.

1.10(d) This can also be addressed in a buy-sell agreement, but it is best addressed *both* in the buy-sell agreement and the living trust agreements.

- It is particularly important when there is no buy-sell agreement.

1.11. Exposure to piercing the corporate veil[13]

1.11(a) If a claim against a corporation exceeds the corporation's insurance coverage and the value of its assets, the claimant is generally unable to collect anything from the shareholders.

1.11(b) An exception applies if the shareholders themselves "disrespected" the corporation as a separate entity or disregarded the corporate formalities to an extent that it would be unjust to allow the corporation to shield the shareholder from liability.

- In that case, the court can require the shareholder to pay the portion of the claim not covered by insurance and the corporation's assets.

- This is "piercing the corporate veil." It's not an esoteric corporate doctrine. Plaintiff's attorney regularly assert it and can conduct discovery to test whether the formalities have been respected.

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[13] See my outline *Choice of Entity Strategies for the Recovery* at http://www.staleylaw.com/images/11002_Staley.pdf.

2. CORPORATE GOVERNANCE 101 [14]

2.1. Shareholders

2.1(a) Shareholders elect and remove directors, approve transactions between directors and corporation, approve changes to bylaws or dissolving

2.1(b) Most of the time, shareholders do no more than re-elect directors annually, often by written consent without meeting (which need not be unanimous for most actions).

2.2. Directors

2.2(a) Directors elect and remove officers, approve distributions, approve major transactions, borrowing, opening bank and brokerage accounts, major leases, executive compensation, adopting, amending or terminating employee benefit plans, etc.

2.2(b) Directors should approve each and every distribution, which should not be made more often than quarterly.

2.2(c) Directors can act by written consent without meeting, but to do so, the consent must be unanimous.

2.2(d) Directors should act at least annually, but often act more frequently.

2.2(e) Personally, I don't think directors should ratify all past actions of the officers, though other attorneys like this practice.

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[14] See my outline *Dissolving Business Entities and Corporate Housekeeping* at http://www.staleylaw.com/images/Dissolving_2011_-_15702.pdf.

2.2(f) It is a good practice, but not a legal requirement, for directors to approve management's budgets and to receive "actual vs. budget" reports at meetings.

2.3. Officers

2.3(a) Officers conduct day to day activities of the corporation, sign documents on behalf of the corporation, hire and fire employees.

2.3(b) Documents signed on behalf of the corporation should be signed by officers and not by directors.

2.3(c) Directors talk with the officers. The officers talk with the world on behalf of the corporation.

2.4. Fiduciary Responsibility, business judgment

2.4(a) Section 309 of the California Corporations Code:

> (a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.
>
> (b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by any of the following:
>
> (1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented.

(2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence.

(3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

(c) A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director. In addition, the liability of a director for monetary damages may be eliminated or limited in a corporation's articles [of incorporation].

2.4(b) Section 204(a)(10) of the California Corporations Code provides, in pertinent part:

[Although the articles of incorporation can limit the liability of a director,]

(A) such a provision may not eliminate or limit the liability of directors

(i) for acts or omissions that involve intentional misconduct or a knowing and culpable violation of law,

(ii) for acts or omissions that a director believes to be contrary to the best interests of the corporation or its shareholders or that involve the absence of good faith on the part of the director,

(iii) for any transaction from which a director derived an improper personal benefit, (iv) for acts or omissions that show a reckless disregard for the director's duty to the corporation or its shareholders in circumstances in which the director was aware, or should have been aware, in the ordinary course of performing a director's duties, of a risk of serious injury to the corporation or its shareholders,

(v) for acts or omissions that constitute an unexcused pattern of inattention that amounts to an abdication of the director's duty to the corporation or its shareholders,

(vi) under [the provision that requires transactions between a director and the corporation to be "just and reasonable as to the corporation"], or

(vii) under [the provision making directors personally liable for illegal distributions, loans or guarantees],

(B) no such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when the provision becomes effective, and

(C) no such provision shall eliminate or limit the liability of an officer for any act or omission as an officer, notwithstanding that the officer is also a director or that his or her actions, if negligent or improper, have been ratified by the directors.

2.4(c) Officers probably have the same duties to the corporation

2.4(d) The articles of incorporation of a California corporation can maximize the corporation's ability to indemnify officers, directors and employees and can minimize the directors' duty of loyalty.

3. LLC GOVERNANCE

3.1. Members have voting and economic interests (rights to distribution) and rights to info

3.2. Members vote to elect/remove manager(s) and on amendments to operating agreement.

3.3. Holders of economic interest (usually transferees) have right to distributions and to accounting info, not to vote.

3.4. Managers manage the day to day operations of the LLC. Managers are like a combination of the board of directors and the officers of a corporation. Managers have no personal responsibility for the debts of the LLC.

3.5. Limits on duties of managers must be in the written operating agreement.

3.5(a) The members must give "informed consent."

3.5(b) Fiduciary can be limited but not eliminated.

- The extent to which they can be eliminated is unclear.

- It's important to make a strong case in the operating agreement for the rationale for any limitations.

3.6. California has a new LLC act that will become effective on 1-1-14.[15]

4. OTHER GOVERNANCE ISSUES

4.1. When officers or directors (or managers of an LLC) change, a

[15] See item 10 in my outline *Corporate Tax Update and Entity Formation Issues* at http://www.staleylaw.com/images/Corporate_tax_update_2012_-_19992.pdf.

new Statement of Information should be filed with the Secretary of State. This is the public listing of the persons responsible for managing the entity.

4.2. Nonprofit directors[16]

4.2(a) If a director of a nonprofit corporation smells a rat, the director must investigate or resign.

4.2(b) Don't "see no evil." Turning a blind eye risks personal liability.

4.2(c) Waiting too long might require a noisy exit (bringing the concern to the attention of the other directors) as opposed to a quiet resignation.

5. CONTRACTS

5.1. For major contracts or those that will remain in effect for a long time, the dispute resolution provisions in the agreement are important.

5.2. Resolve disputes first with consultation between the aggrieved parties, then mediation with a third party, then judicial reference ("rent-a-judge").

5.2(a) Award attorneys fees to the prevailing party -- but only if the winner participated in the consultation and mediation process.

5.3. Use judicial reference and not arbitration or a jury trial (the default). It is public, but many business litigation attorneys tell me this is currently the fastest way to resolve business disputes. Often a quick resolution is the best thing for the business.

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[16] See my outline *Responsibilities of Directors and Officers of a California Nonprofit Public Benefit Corporation* at http://www.staleylaw.com/images/Responsibilities_of_Nonprofit_Directors_-_11048.pdf.

5.4. If possible, provide that disputes will be resolved in the county where your company is based. Failing that, provide that if one party brings an action, it must be resolved near the other party's home base.

6. NON-DISCLOSURE AGREEMENTS

6.1. There is not just one form of NDA.

6.2. One-way - There can be only one party obligated, when only one party is opening the kimono.

6.3. Two-way – If both parties are going to disclose confidential info to the other, each should be obligated to keep the other's confidences.

6.4. An NDA to discuss a sale of the company or new technology will be much different from an NDA for an employee or a consultant.

6.5. There are different degrees of length and strength. Is the company proposing an idea to a trusted long-term vendor or customer (when a light-duty NDA might be best), or proposing to merge with a major competitor (when a heavy-duty NDA and partial disclosures at specified milestones in the process might be best)?

7. INDEMNIFICATION AND LIMITS ON LIABILITY [17]

7.1. In many agreements, the indemnification provisions and limits on liability have the effect of shifting risk and, ultimately, the obligation to insure against that risk.

7.2. If one party is better able to obtain insurance, the agreement can shift to that party the obligation to obtain insurance and to name the other as an additional insured. The insuring party would in-

[17] See my outline *Selling the Business: Practical, Tax and Legal Issues* at http://www.staleylaw.com/images/Sale_of_Business_-_15380.pdf.

demnify the other party. The pricing would reflect that the insuring party shoulders additional financial risk.

7.3. In a sale of a business, there are generally extensive representations and warranties. If any of these turn out to be false, the seller indemnifies the buyer for the resulting loss. This obligation can have minimums, caps and expiration dates.

7.3(a) One of the representations that generally has no cap or expiration is that the seller actually owns the business and that the sale was approved by the shareholders.

- To make the reps, the corporation must know exactly who owns shares.

7.3(b) Another rep might be that the corporation made a valid S corporation election and is currently and S corporation.

- To make a valid S corporation election, all of the shareholders must sign it (and their spouses who might have community property interests in the shares)

- To maintain S corporation status, no shares can be transferred to persons or entities that are not eligible to hold S corporation shares.

7.3(c) All of which brings us back to the importance of keeping good stock records.

[End of outline.]