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Client Memorandum

A memorandum
for clients
and friends
of the firm

October 2003

Avoiding Common Pitfalls of The Small Business

*“Corporation, n. An ingenious device for obtaining individual profit without individual responsibility.”
Ambrose Bierce, The Devil’s
Dictionary.*

As Ambrose Bierce’s trenchant definition of the corporation illustrates, one of the principal reasons businesses incorporate is to shield the personal assets of the owners from the debts of the corporation and to limit the shareholders’ liability from claims against the corporation. This limited liability is a function of the corporation’s status under state business corporation statutes as a distinct legal entity, separate and independent of its owners. A corollary of the corporation’s status as a separate and distinct legal entity is the requirement that its shareholders observe the legal requirements appropriate to its status. Where the shareholders themselves disregard the corporation’s independent status, they place themselves at risk of having a court ignore the corporate entity and impose personal liability on the individual shareholders.

One of the challenges for the small business owner who cannot afford an in-house legal staff is

to ensure that its business is in fact operated as a distinct legal entity and that it properly adheres to all the corporate formalities to maintain the protection of the corporate form. Unfortunately for many small businesses, the consequences of ignoring these formalities only become apparent when it is too late. Presented below are some of the common pitfalls of the small business owner and what you need to do to avoid them.

1. Fill Out The Corporate Kit. Although most incorporation services provide a corporate kit when forming the corporation and filing the certificate of incorporation with the New York Secretary of State as part of their service, it is not uncommon to find the corporate kit for many small businesses sitting unopened and forgotten, collecting dust on a bookshelf, even after the business has been in operation for many years. A corporation that is run this informally is a corporation in name only, and will most likely have failed to issue shares, elect directors, or keep proper books and records. Unfortunately, this failure becomes apparent only when a problem arises, such as in a dispute among the principals regarding ownership, or a challenge to the legality of a corporate act, and at that point the resolution may carry a heavy cost. The corporate kit contains the requisite notices for the organizational meeting for the corporation, and the first meeting of the shareholders and directors. It is important to begin filling out the corporate book as soon as the corporation is formed and to

document important corporate decisions with proper minutes.

2. Issue Shares to the Shareholders of the Corporation. Although this point appears obvious, it is not at all uncommon that small privately held businesses neglect to issue shares to the owners of the corporation, with the result that needless disputes develop as to who the owners of the corporation are when disputes between the principals arise. I have litigated many cases where shareholders have fraudulently issued themselves all or the majority of the company's shares to the exclusion of the other shareholders. Accordingly, it is important to issue share certificates to the shareholders, to record the names of the shareholders in the company's share register, and to document the corporation's receipt of payment for the shares. If the shares are par value shares, make certain that the corporation receives at least the par value in cash.

3. Open A Separate Bank Account for the Corporation. As a distinct legal entity, it is crucial to open a separate bank account in the name of the corporation and to keep meticulous records of all transactions. All corporate funds received by the corporation should be deposited in the corporate account; similarly all withdrawals from the corporate account should be fully documented and accounted for. Under no circumstances should the funds of the corporation be commingled with personal funds of the owners or any other corporate entities. This is one of the main factors the courts look to in determining whether to disregard the corporate form.

4. Hold Regular Board of Directors' and Shareholders' Meetings. It is important to hold at least annual shareholders' and board of directors' meetings, and to document such meetings with proper notices, minutes, and, where appropriate, with resolutions of significant actions adopted at meetings of the Board. New York's Business Corporation Law requires at least an annual shareholders' meeting to elect directors, but permits shareholders to act without a formal

meeting on written consent.

5. Document All Loans Between the Shareholders and the Company. If the shareholders make loans to the corporation, or if the corporation makes loans to the shareholders, make sure that these loans are properly documented on the books and records of the corporation, that such loans are approved by the directors and reflected in the board minutes, and that the loan is evidenced by a promissory note that provides for regular payments with interest. In the absence of a promissory note, a shareholder loan may be deemed a contribution to equity, which, in the event of a dissolution, may not be repaid until all other creditors are paid in full. Conversely, loans to shareholders that are not properly documented will create the appearance that the shareholder is disregarding the corporate entity and treating corporate accounts as his personal accounts. Such informal, undocumented "loans" ignore the existence of the corporation as a distinct legal entity, and may cause a court to ignore the corporate entity as well.

6. Pay All Wage Claims, Withholding and Sales Taxes. It is crucial that the corporation pays all withholding and social security taxes and sales taxes. By statute, a corporation's shareholders and officers can be held liable for these taxes. Accordingly, it is important that the corporation hire a competent and trustworthy controller or CFO. Unfortunately, for smaller companies, the temptation is often great to ignore these payments to deal with what the company believes is a "temporary" cash flow problem. This is a huge blunder that transforms a corporate debt into a personal obligation of the principals. Similarly, all wage claims and union benefits must be timely paid by the corporation, or the ten largest shareholders may be held personally responsible.

7. Maintain a Current Corporate Address with the Secretary of State. It is critical that the corporation maintain a current address with the Secretary of State for service of process. It is not uncommon to find corporations that still have

their address when initially incorporated on file with the Secretary of State, even though the corporation may have moved several times and abandoned the initial address long ago. Do not assume that this address will be corrected because the corporation updates its address on its tax returns and other government filings. (You may check the address on file for your corporation with the Secretary of State by visiting the Department of State's website, available as a link on this firm's website at www.monteleonelaw.com). Unless a current address is on file with the Secretary of State, a lawsuit may be commenced against your corporation by service on the old address, and a judgment may be entered against the corporation on default, without your learning of the lawsuit until a creditor restrains your company's bank account.

8. Always Sign the Corporation's Legal Documents In Your Corporate Capacity. All legal agreements entered into by the corporation should be signed by the corporation by a proper corporate officer, with his corporate title clearly indicated next to his name. Contracts entered by the corporation should be clear that it is an obligation of the corporation, and should never be signed without the officer's corporate title prominently shown, so that it cannot be deemed a personal obligation or guarantee, unless that is what is intended.

9. Pay the Annual Franchise Tax. A corporation is required to pay an annual franchise tax, even if it does not earn any income. If the corporation fails to pay the franchise tax, the corporation may be dissolved by the Secretary of State.

10. Establish Separate Corporations for Separate Businesses. If you have separate businesses or real estate holdings, you should establish separate corporations to conduct these businesses or to hold these assets. In this manner, if one business or investment suffers a reversal, the other businesses will not be responsible for the loss. Of course, you will have to maintain and operate these separate corporations as distinct entities in the manner set forth above.

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