Governance and Records in Closely-Held Companies

Incorporation by Itself Doesn't Guarantee Protection From Personal Liability

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Corporate governance isn't important until it is. The greatest hazard of poor governance is compromising protection against personal liability. In addition a review of corporate governance records is high on the due diligence lists of lenders, investors or buyers, and a half-empty minutes book may be perceived as symptomatic of other deficiencies.

This article applies only to smaller, closely-held private companies. Governance for larger and especially public companies becomes substantially more complex.[1]

Why form a corporation or LLC in the first place?

The primary reason for using a corporation or LLC (Limited Liability Company) to operate a business is to protect the owners and management from personal liability for claims against the business. One of the prerequisites to preserving this shield is to observe, practice and document the basic formalities of corporate governance.[2]

What is Corporate Governance?

Corporate governance is a generic term that refers broadly to the rules, structures, processes, customs or laws by which businesses are operated, regulated, and controlled and the ways in which rights and responsibilities are shared between shareholders, directors and management.

Why is Corporate Governance important for a small, closely-held company?

A corporation is supposed to be an independent entity clearly distinguishable from the person(s) who own and manage it. Even the smallest entity must behave and look like a bona fide corporation if it expects to be treated as one. A corporation that doesn't observe fundamental corporate governance standards and practices jeopardizes the shelter that it should otherwise provide its owner(s) from personal liability.

One of the first things someone asserting a serious claim against a closely-held private company looks to do is "pierce the corporate veil", i.e. get to the owner's personal assets, alleging that the company and the owner(s) are indistinguishable "alter egos". Companies owned and managed by one person are particularly tempting targets and need to be especially careful to differentiate between themselves and the business.

[1] Corporate governance also includes establishing long-range strategic goals and policies, but that becomes moot for companies whose owners, directors and management are the same individuals. In addition, public companies are subject to a plethora of rules and regulations, e.g. the Sarbanes Oxley Act

[2] ***Close Corporations***, allowed in some states, and ***LLCs*** have lower prescribed corporate governance standards than corporations, but it is prudent nonetheless to adhere to the best corporate practices to reduce the risk of alter ego claims.

Corporate Governance and Records in Smaller, Closely-Held Companies

Where's the "rule book" on Corporate Governance?

A company's by-laws (or an LLC's Operating Agreement) contain some of the rules, as do state and federal laws, but they are not all codified in one place.

In addition there are some basic, long-standing legal principles applicable to all corporations that need to be observed in order to earn limited liability protection:

- Don't co-mingle business and personal assets and activities, e.g. bank accounts, real estate, insurance, shareholder loans, investments, and especially toys. In other words, don't use the corporation as a personal checkbook.
- Document all material actions and relationships between the company and its owner(s) as if they were arms-length transactions between unrelated parties, which is precisely what they are supposed to be.

For some companies such distinctions and documentation may run counter to tax planning strategies, in which case the relative benefits and costs need to be weighed.

In short, specifically what does the small, closely-held company need to do?

The Company should appoint directors and officers annually, and document approval or ratification of significant company actions as they occur, as if between unrelated parties.

Who's responsible for Corporate Governance?

Responsibility for corporate governance is shared by shareholders, directors and management, which, in small companies may all be the same person(s).

Shareholder actions are typically limited to annual election of directors and appointment of auditors, if any. One-time actions requiring shareholder approval include amending articles of incorporation (e.g. change of name, additional authorized shares), stock option plans, by-law amendments affecting the size or composition of the board and approval of a merger, acquisition or sale of assets above a threshold.

The Board of Directors is responsible for the annual election of officers and approval or ratification of transactions outside the ordinary course of business (e.g. major leases, contracts, borrowings); executive compensation, issuance or redemption of shares or options. Special rules apply when a director has a personal interest in a transaction.

Management: the CEO's and CFO's responsibilities with respect to corporate governance are to keep the board informed, to bring issues to the board for action, and generally to carry out policies and mandates of the board. In addition, the Secretary of the corporation is responsible for noticing meetings, maintaining corporate records and accounting for share issuances and transfers.

Do personal guarantees compromise protection from personal liability?

While many lenders and landlords require personal guarantees from company owners, if they are properly documented, they should not per se contravene corporate protection from claims against individuals any more than the fact that they also provided capital.

How can insurance be used to limit individual liability?

Insurance can mitigate the company's as well as the owners' exposure, but exclusions in corporate general liability policies for claims against owners or management personally as well as certain exposures, such as product liability, errors and omissions or employer liability, need to be understood.

What exposures are not protected by a corporation?

Liabilities against which the best corporate governance (nor insurance or corporate or even personal bankruptcy) cannot protect owners, directors and management, include non-payment of payroll taxes and claims of "securities fraud", as well as criminal charges, all of which automatically go to the individual(s) involved.

What documentation needs to be maintained?

Documentation should be in the form of formal corporate minutes, signed and kept in a Minutes Book along with related documents. Also, actually issuing shares, which is often overlooked, can be just one more proof of "corporate behavior".

Absent meetings per se, *Written Consents* are by law considered the equivalent of actual meetings. Written consents of shareholders may be by a majority for certain actions, but director consents must always be unanimous.

Accumulating reams of redundant documents repeating the re-appointment of the same board and officers year after year may seem to place form over substance, but it does provide generally accepted evidence of adherence to corporate governance practices.

Resist, however, memorializing irrelevant digressions; stick to the hard facts. Those documents may end up as "Exhibit A".

Does documentation need to be contemporaneous?

Good corporate governance prescribes contemporaneous documentation, but given a choice between missing documentation and filling in the gaps after the fact, the latter is preferable as long as it correctly reflects the facts and circumstances as they were known to be true at the time (and provided that the records aren't the possible objects of an inquiry, investigation or litigation).

Can a sole owner be the sole director as well as CEO, CFO and Secretary?

Although it may look better from a corporate governance perspective to have more than one director on a board, it is perfectly acceptable for a single-shareholder company to have a board with only one director provided the appointment formalities are observed. The same goes for one individual occupying all mandatory offices, usually CEO, CFO and Secretary, provided it is permitted by applicable state law.

What changes when a single-shareholder company adds more shareholders?

When a company adds shareholders or prospective shareholders (e.g. through options), a new source of liability is created in the form of a third party to whom fiduciary duties are owed. It may not be the new investor, partner or manager, with whom a disagreement is inconceivable – it may be their heirs, executor, ex-spouse, or creditors.

In addition, in most states a company with two shareholders must have at least two directors and one with three or more shareholders, a minimum of three directors.

Also, the purchase, issuance or promise of any equity interest should be memorialized in professionally-prepared stock purchase and "buy-sell" shareholder agreements.

Is it necessary to have an attorney maintain the corporate governance records?

An attorney should be involved in the incorporation and initially setting up the books. However, given that a small, closely-held company is unlikely to have more than a few corporate actions a year, routine maintenance of corporate records may not require the services of an attorney except for periodic review and advice on specific situations.

The foregoing has been prepared for general information and educational purposes only, does not constitute legal advice or legal opinions and should not be relied upon without first seeking the advice of an attorney.

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