

Closing Letter to Client After Formation of a Closely Held Corporation

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INTRODUCTION

Forming a corporation for a client usually involves a flurry of activity, including one or more meetings with the client and his or her advisors and senior employees to discuss various formation issues; signing articles of incorporation, by-laws, directors' resolutions, and other corporate documents; necessary filings; completion of many "housekeeping matters" to reflect the formation of the corporation; and attention to the event or transaction that precipitated the need for formation of the corporation in the first place. All of this may try the patience of a small business client who rarely uses an attorney. As a result, the corporation may have been formed and transactional issues dealt with, but certain corporate matters may remain unaddressed. The client's budget for legal fees may not permit another lengthy meeting, yet the client needs further advice regarding the operation of its business as a newly formed corporation.

A closing letter to the client is appropriate in this context. The letter gives the attorney an opportunity

to address some of the issues faced by a new corporation in a writing that the client can consult and absorb at leisure. The letter should cover certain essential topics, but must be readable. The author therefore should avoid an overly complicated analysis of corporate, tax, payroll, employment, and licensing issues. A closing letter should present the issues clearly, offer some indication of their relative simplicity or complexity, and indicate that if the client has further questions, he or she should contact the attorney and the attorney will address the client's concerns in a prompt and efficient manner.

This article sets forth a sample closing letter. The letter below assumes that the newly formed corporation is a closely held California corporation, but has not elected the statutory "close corporation" status. It also assumes that the articles of incorporation have already been filed with the California Secretary of State. The practitioner should customize this letter as necessary to cover operational or financial issues that may be unique to an individual client's business.

Appendix

FORM. Closing Letter

Dear __[Name of client]__:

The purpose of this letter is to outline certain matters concerning the formation and operation of a corporation in the State of California. The following discussion does not represent a comprehensive summary or analysis of all legal issues that may affect your corporation. Rather, it is intended

to provide you with some general guidance. Please contact me if you have any questions concerning the substance of this letter or any other legal matter that may arise in connection with the operation of your corporation.

Concluding Formation of the Corporation

The formal existence of your corporation began with the filing of the articles of incorporation with the California Secretary of State. The filed articles will bear a stamped date, which is deemed to be the date of formation. But formation involves several other steps as well. The incorporator must designate an initial director or directors; the incorporator or the directors must adopt the by-laws; the directors must elect a chief executive officer, a treasurer, and a secretary (all of whom may be the same individual); the directors must authorize the issuance of stock; and the corporation must receive payment for the stock in cash, assets, or past services. All of these steps are usually addressed in an initial organizational meeting.

The first organizational meeting usually also addresses several other matters, which, although not essential elements of corporate formation, are nevertheless important and should be faced early in the operational life of the entity. If the corporation is qualified and wishes to be a Subchapter S corporation under state and federal income tax laws, the decision to elect Subchapter S status and to file the appropriate documents with the Internal Revenue Service and the Franchise Tax Board should be memorialized in the minutes of the first organizational meeting of directors. Subchapter S status will permit corporate income to be taxed to the shareholders of the corporation rather than to the corporation itself. The tax year of the corporation is usually also established at the first organizational meeting. In general, an S corporation must use a calendar year for its tax accounting, while a corporation not making the Subchapter S election may use another date for its fiscal year end, perhaps to better reflect its business cycle or to allow for other corporate planning as desired. Finally, the directors commonly designate a bank at which to maintain the corporation's checking account, and authorize certain officers to be signatories on corporate checks.

Transfer of Assets; Assumption of Debts

If an existing business is being incorporated, the corporation typically issues stock in exchange for an assignment of the assets of the business. For most assets, the transfer of ownership can be accomplished with a simple assignment document. If ownership is evidenced by a certificate of title, such as a motor vehicle "pink slip," or if transfer requires special recordings, as is the case with patents and registered copyrights and trademarks, the procedures for transfer required by the applicable governmental agency must be followed. Additionally, if debt is being assumed as part of the incorporation, an assumption agreement must be executed, which should address the corporation's payment duties, whether any arrearages will be assumed, and whether a release of the assigning debtor's obligations will be sought from the creditor.

Statement of Information

Following the filing of the articles of incorporation, each California corporation is required to file within 90 days of incorporating a Statement of Information with the Secretary of State. The blank form of Statement of Information is usually attached by the Secretary of State's office to the returned articles of incorporation. The form requires disclosure of (1) the

names and addresses of the corporation's officers and directors; (2) the address of the corporation's principal executive office; (3) the corporation's agent for service of process; and (4) the principal business of the corporation. A nominal filing fee (currently, \$20) must accompany the return of the completed form. If the form is filed late, a penalty of \$250 is assessed. The form must be filed every other year thereafter. If the corporation does not receive a blank form from the Secretary of State in the mail, the form must be obtained independently and filed by the deadline to avoid the penalty.

Annual Reports to Shareholders

Unless the corporation has fewer than 100 shareholders and this requirement is waived in the by-laws, the corporation is required to send an annual report to its shareholders, no later than 120 days after the close of its fiscal year. The annual report must include copies of the corporation's financial statements.

Shareholder "Buy-Sell" Agreements

If there is more than one shareholder of a closely held corporation, even if the shareholders are closely related (perhaps *especially* if they are closely related), it is important to consider adopting a shareholder agreement that addresses what should happen in the event that a shareholder wants to transfer his or her shares to a third party, or in the event of a shareholder's death, permanent disability, or other triggering event. Typically, a shareholder agreement for a closely held corporation will require a shareholder desiring to transfer his or her shares to offer them first to the other shareholders, so that ownership and control of the corporation will remain within the existing shareholder group. This type of provision is usually referred to as a "right of first refusal" or an "option," and will include a mechanism for valuation of the shares proposed to be sold, either with reference to the price offered by the third party purchaser or with reference to an appraisal. The same type of provision can operate in the event of death or permanent disability of a shareholder. Such agreements are generally referred to as "buy-sell" agreements. Shareholder agreements may cover other topics, such as voting.

Operational Issues: Doing Business as a Corporation

Observance of Legal Formalities

With some exceptions, the corporate form affords shareholders immunization from the liabilities of the corporation's business. To enjoy the protection of the corporate liability shield, however, the corporation must observe certain legal formalities.

Some of the formalities have been addressed above: The corporation must adopt by-laws, elect directors and officers, issue stock, receive proper payment for the stock, and transfer assets used in the business into the name of the corporation. Other factors are also important. The corporation must keep written minutes of all meetings of its shareholders and directors, and maintain a list of the names and addresses of all shareholders (along with the number and class of shares held by each) at its principal executive office. The corporation should conduct its business in such a manner as to reflect its corporate existence. If required by local law, a business license in the corporation's name should be obtained from the city or county where the corporation is doing business. Business cards and stationery should reflect the corporation's name. (Many corporations include a reference to

"Inc.," "Co.," or "Corp." in their names, but if the corporate name does not itself indicate corporate status, the words, "a California corporation," should be added to the cards and letterhead.) The corporation should execute its contracts and conduct its correspondence using signature blocks that evidence the corporate status of the business and the representative capacity of the person signing the document. For example, a corporate signature block should appear as follows:

Weeping Willow, Inc.,
a California corporation

By: _____
Stephanie Smith, President

Transactions With Officers or Directors

Business dealings between the corporation and any of its officers or directors (or any businesses in which those officers or directors have an ownership interest) must be conducted at arms' length and must be just and reasonable to the corporation. The terms and conditions of any such transactions must be fully disclosed to the board of directors, and approved by a vote of the disinterested directors or shareholders.

Financial Affairs

Certain formalities relating to the financial affairs of the corporation must be observed in order to maintain the integrity of the corporate liability shield and otherwise to conform with California law. The corporation is required to keep separate and accurate books and records of account. The corporation should have its own checking account in which only corporate transactions are conducted. It is desirable to establish the company's checking account at an institution other than the one at which the shareholders' personal accounts are kept, to help avoid the risk that a shareholder might be tempted to use the corporate account for non-business, personal reasons. If a shareholder, director, or officer is to receive a salary, the salary payment should be evidenced by a check, and the corporation should comply with all federal and state withholding requirements. These disciplines will reinforce the existence of the corporation as an entity separate from its shareholders, and also facilitate the task of preparing the corporation's tax returns.

Adequate Capitalization

The shareholders of the corporation must ensure that the capitalization of the corporation, whether in the form of money paid or hard assets transferred in exchange for stock, is sufficient for the conduct of the corporation's business, at least during the initial period of the corporation's existence. If the corporation is not able to pay its bills in the ordinary course of its business, it will be insolvent. Creditors of the corporation could then attempt to "pierce the corporate veil" and recover the amounts owed to them directly from the corporation's shareholders.

Insurance

To support its financial condition, the corporation should obtain adequate insurance for its business, including general liability insurance, fire and casualty insurance, automobile insurance, business interruption insurance, and workers' compensation insurance. When incorporating an exist-

ing business, the corporation must contact its insurance agent to assure that the policies are re-issued in the name of the corporation.

Operational Issues: The Role of Directors and Shareholders

Number of Directors; Role of Directors

The board of directors is responsible for the management of the corporation, and all corporate powers are exercisable only by or under the director of the board. The number of directors is set in the by-laws (unless the shareholders choose to set the number in the articles of incorporation). If the corporation has only one shareholder, there need be only one or two directors. If the corporation has only two shareholders, only two directors are required. Otherwise, there must be at least three directors. The directors are responsible for the hiring of senior management and for monitoring their performance. The directors are also responsible for setting corporate policy and goals. Directors owe a fiduciary duty to the corporation in discharging their duties. This includes a duty to act in the best interests of the corporation and a duty to refrain from self-dealing.

Shareholder and Director Meetings

Boards of directors are not required to meet on any regular schedule, although many corporations hold at least one board meeting a year and some corporations hold board meetings quarterly or even monthly. In contrast, shareholder meetings are required to be held on an annual basis. Notices of the meetings must be given in accordance with the by-laws. Notice may be waived, and director and shareholder business may be conducted by written consent in lieu of a meeting, as long the procedures for action by written consent follow the requirements set forth in the by-laws and the California Corporations Code. For director action, the consent must be unanimous.

Minutes should be kept of all director and shareholder meetings. Minutes should reflect the date and time of the meeting, the individual presiding, the method of notice (or waiver of such notice), the names of the persons in attendance, the subjects discussed, the motions made and seconded, and the voting results. The minutes should be kept in the corporation's minute book. When certified by the Secretary, minutes constitute prima facie evidence of the meeting and of the matters set forth in the minutes.

Matters Requiring Shareholder Approval

The following constitutes a partial list of matters required to be approved by resolutions of the board of directors or the shareholders. Common transactions requiring shareholder approval include:

- Election and removal of directors;
- Amendment of the articles of incorporation;
- Adoption, amendment, or repeal of by-laws;
- Transactions between the corporation and a shareholder, director, or officer;
- Approval of loans or guaranties of loans to shareholders, directors, or officers;
- Adoption of a corporate stock purchase plan, stock option plan, or employee benefit plan that includes officers or directors;
- Sale or transfer of substantially all of the assets of the corporation;
- Some corporate reorganizations;
- Most corporate dissolutions; and
- Transactions affecting shareholder rights or obligations in general.

Matters Requiring Director Approval

Common matters requiring approval by the board of directors include:

- Election of officers;
- Adopting, amending, or repealing bylaws;
- Electing directors to fill vacancies on the board;
- Adopting business policies and plans;
- Approving issuance and sale of securities;
- Declaring dividends and other shareholder distributions, and share redemptions;
- Amending the articles of incorporation in certain cases;
- Approving the sale, lease, conveyance, exchange, transfer, or other disposition of corporate property or assets;
- Approving the adoption of pension, profit-sharing, and other employee benefit plans;
- Approving corporate borrowing and loans;
- Designating corporate depository banks and authorized signatures; and
- Removing directors in some instances.

Shareholders and directors should consult counsel in specific instances to determine whether approval of a proposed corporate action is required, and if so, whether approval by more than a majority vote is necessary.

Operational Issues: Federal and State Tax Compliance

Retention of Accountant

Few operational matters can seem as overwhelming to a new business as tax compliance, including payroll tax compliance. If the principals of a newly formed corporation are not familiar with tax and accounting matters, they should retain an accountant and consider the advisability of using an outside accounting or payroll service to assist the corporation in meeting federal, state, and local tax law requirements.

Obtaining an Employer Identification Number (EIN)

A newly formed corporation must obtain an employer identification number (EIN) from the Internal Revenue Service (IRS) for purposes of tax reporting and to open bank accounts. An EIN is obtained by filing IRS Form SS-4, Application for Employer Identification Number, with the IRS Service Center that services the location of the principal place of business of the corporation. Because the IRS may take as long as four weeks to process Form SS-4, it may be preferable to obtain the EIN number immediately through the IRS's "TELE-TIN" service. This service allows the corporation to obtain an EIN number by calling the local IRS Service Center and providing the required information. Thereafter, the completed and signed Form SS-4 is faxed to the IRS (with a hard copy of the original to follow by mail).

State and Local Registrations

A California corporation with employees must also register with the California Employment Development Department (EDD), on EDD Form DE-1. Just as the EIN number is used in all communications and filings with the IRS, so is an EDD identification number used for all communications with the EDD. Form DE-1 must be filed within 15 calendar days after the first date that the employer pays wages to employees in an amount that in the aggregate exceeds \$100.

The California Franchise Tax Board (FTB) does not require that new businesses provide the FTB with separate notice of formation. The EIN or, in some instances, the number assigned to the corporation by the California Secretary of State, is typically used in communications with the FTB.

Sales and use taxes are administered by the California State Board of Equalization (SBE). Seller's permits may be obtained from the local SBE office and registration may be available by telephone.

Along with the IRS and state agencies, local government authorities may also impose taxes or license fees on the business. These authorities should be contacted to determine what business licenses are required and what real property, personal property, gross receipts or payroll-based taxes, or other taxes and fees may be expected.

Record-Keeping

Once all relevant governmental authorities have been contacted and the required initial filings have been made, the newly formed corporation must set up and maintain appropriate business records for purposes of complying with future filing and tax requirements. The IRS may challenge a taxpayer for a period of 3 years for ordinary adjustments on income tax returns, but longer periods apply for challenges based on other grounds. A challenge based on fraud faces no time limitation; therefore, a business may have to retain its records indefinitely.

Information Returns

Corporations are required to file information returns with the IRS to report wages paid to employees and certain other payments made to third parties. Generally, the reporting company must also give the recipient a copy of the return on or before January 31 of the following year. The company must collect all information necessary to complete the returns, including the recipient's tax identification number and address, the amounts paid, and any amounts withheld from the payment (such as income and employment taxes).

Following is a sample of some of the information returns that may be required. The corporation should consult its tax advisor to determine precisely what its reporting obligations will be.

- **IRS Form W-2, Wage and Tax Statement.** Employers use this form to report wages and other compensation (including bonuses and severance) paid to, and tax payments withheld on behalf of, employees.
- **IRS Form 5498, IRA Contribution Information.** Employers use this form to report contributions on behalf of an employee to an IRA or a simplified employee pension plan.
- **IRS Form 1099-DIV, Dividends and Distributions.** Corporations must file this form to report dividends and other distributions made to shareholders.
- **IRS Form 1099-INT, Interest Income.** Corporations must file this form to report certain interest payments.
- **IRS Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc.** Corporations must use this form to report distributions from retirement or profit-sharing plans.
- **IRS Form 1099-S, Proceeds From Real Estate Transactions.** This form is used to report payments made in connection with sales or exchanges of real estate.

- **IRS Form 1099-MISC, Miscellaneous Income.** This form is used to report payments of royalties, rents, and service compensation (including medical and health care payments, commissions, and payments to persons who are not employees).

Federal and State Income Tax Returns

C Corporations must report income and pay all taxes due annually to the Internal Revenue Service on IRS Form 1120 and to the Franchise Tax Board on FTB Form 100. For calendar-year taxpayers, these forms must be filed by March 15 of the following year; for taxpayers on a fiscal year other than the calendar year, these forms must be filed by the 15th day of the third month following the close of the fiscal year. Six-month extensions may be obtained for both the federal and state deadlines. Estimated tax payments must be made quarterly to the IRS and the state.

S corporations face the same annual federal and state filing deadlines, using IRS Form 1120S and FTB Form 100S. In addition, S corporations must distribute Schedule K-1s to all shareholders. S corporations are generally not subject to quarterly estimated payment requirements, inasmuch as S corporations are pass-through entities for federal tax purposes. At the state level, however, an S corporation is required to pay tax on its net income, at the rate of 1.5 percent, and a minimum franchise tax.

Corporations also have significant payment and contribution responsibilities with regard to wages paid to employees. These responsibilities are discussed more fully below.

Operational Issues: Employee Matters and Payroll Procedures

Hiring Employees

The process of hiring employees is fraught with legal issues, most of which are beyond the scope of this letter. Matters such as development of job qualifications, recruiting, interviewing, background checks, testing, and medical examinations should be discussed with labor counsel or a trained human resources professional.

One increasingly common issue when presented with a job applicant from a competitor is the status of information possessed by the applicant concerning his or her former employer's operations. Does this information rise to the level of a legally protected trade secret? It should be determined whether the applicant signed a confidentiality agreement in favor of his or her former employer, and other steps should be taken as necessary to avoid potential liability for infringement.

Pursuant to the federal Immigration Reform and Control Act of 1986 (IRCA), the identity and immigration status of a new employee must be confirmed within 3 days after hiring. A Form I-9 must be maintained for each employee, and an employee's refusal to present proof of identity and employment authorization is grounds for refusing to hire the applicant. The IRCA imposes monetary and criminal penalties on the employer for non-compliance.

Withholding Requirements

Under both federal and state law, employers are required to withhold amounts due for taxes from employees' wages, and pay over withheld amounts (together with matching amounts due from the employer) to the taxing agency. At the federal level, an employer must withhold income taxes and Social Security taxes (the latter often referred to as "FICA," in reference to their authorizing statute, the Federal Insurance Contributions

Act) from the wages of its employees. Additionally, the employer must pay an excise tax for each employee, in an amount equal to the withheld FICA (often referred to as the employer's matching contribution). The employer also must pay state unemployment taxes under the Federal Unemployment Tax Act (FUTA), unless the wages paid are less than a small threshold amount.

California law similarly requires that income taxes be withheld by the employer. An employer must also withhold the state disability insurance tax (SDI). Finally, the employer must pay an unemployment insurance tax, which, like FUTA, is subject to a minimum threshold on wages paid.

All of these so-called employment taxes must be paid over to the applicable taxing agencies on a monthly basis, or, if the aggregate amount of taxes are great enough, on a semi-weekly basis. Severe penalties apply if these deposits are not made timely or are not made at all. The penalties apply not only to the corporation itself, but also to its responsible officers personally. The corporation could find its bank accounts frozen and its business shut down for noncompliance with these withholding, payment, and deposit requirements.

Workers' Compensation Insurance

Almost every employer is required to obtain workers' compensation insurance for its employees. Work-related accidents are the liability of the employer, regardless of the employee's negligence. Workers' compensation insurance can be obtained through the State Compensation Insurance Fund or from a state-licensed private carrier. A business may also obtain a certificate permitting it to self-insure. These permits are issued by the Director of Industrial Relations.

Federal and State Securities Laws

Offerings and sales of stock, options, warrants, promissory notes, and even profit-sharing plans in the corporation are subject to federal and state securities law requirements. These requirements are complex, and each proposed transaction must be evaluated to determine whether federal or state registration or other filings are required, or whether exemptions are available. Even an inadvertent violation of the securities laws during the offering stage can cause an otherwise proper sale of securities to be unlawful. Unwinding an improper transaction can be time-consuming and expensive. If the corporation or any shareholder anticipates offering any interest in the corporation for sale, legal advice concerning securities law compliance should be sought well in advance of the proposed transaction.

Trademark and Other Intellectual Property Issues

In the last decade and particularly with the advent of the Internet, businesses have come to realize that their intellectual property rights are among their most valuable assets. These rights include the corporate name, the name under which the corporation does business (which is not always the same as the corporate name), and the trade names of products of the business. Newly formed corporations should consider taking steps to perfect rights in these assets by filing trademark or service mark applications on a state and federal level. Copyright and patent laws may also apply to protect intellectual property rights of the business. It is important to recognize, however, that without more, the mere obtaining of a corporate name from the California Secretary of State does not of itself authorize the use of the corporate name in California in violation of the rights of any other per-

son who may have acquired rights to use the name by reason of common law or federal or state statutes.

Conclusion

We are pleased to have been able to assist you in the formation of your corporation. Please contact us if you have any questions concerning the conduct of your business or if we can be of any further assistance to you in the future.

Very truly yours,

Date: _____

____ [Signature of attorney]____

__ [Typed name of attorney] __