

Business Start-Up

Chapter 1

How To Begin: Checklist for Forming an Ohio Corporation

- 1) Call the secretary of state at (614)466-3910 or toll free at (877)767-3453 to determine if the proposed corporate name is acceptable. It is possible to e-mail the Business Services Division from the Ohio Secretary of State's Web site at www.sos.state.oh.us/sos; click "business filings," and you can conduct your own search on the secretary of state's Web site. The proposed name must be "distinguishable upon the records" of the secretary of state. A name is not considered to be distinguishable from another name if the only difference is:
 - a) Reversing of words (*e.g.*, Fast Copy, Copy Fast);
 - b) Use of Arabic numbers or Roman numerals (*e.g.*, Jim's Sales I, Jim's Sales II);
 - c) Use of possessives (*e.g.*, Thompson Auto Body, Thompson's Auto Body);
 - d) Phonetic spelling (*e.g.*, Quick, Kwik);
- 2) Determine availability of the proposed corporate name in any other states in which the business will operate.
- 3) File the articles of incorporation with the Ohio Secretary of State, Business Services Division, P.O. Box 670 Columbus, Ohio 43216. Expedited filing is permitted by paying an additional \$100 fee and sending the articles and the fees to: Secretary of State, P.O. Box 1390, Columbus, Ohio 43216.
 - a) You must use Secretary of State Form 532.
 - 1) The name of the corporation must end with "Company," "Co.," "Corporation," "Corp.," "Incorporated," or "Inc."
 - 2) The articles must indicate the corporation's principal office—city, village or township and county.
 - 3) The articles must state the number of authorized shares that can be issued and their express terms. NOTE: The number of shares authorized determines the filing fee.
 - 4) If the corporation plans to have an initial stated capital, it must be included.
 - 5) You may appoint the initial board of directors in the articles.
 - 6) The articles must be signed by all incorporators.
 - b) The Original Appointment of Agent is included in the Secretary of State Form 532.
 - 1) The statutory agent must acknowledge and accept the appointment.
 - 2) The statutory agent's address must contain a street address and zip code. Post office boxes are not acceptable.
 - c) The filing fee must be in the form of a check made payable to the secretary of state. The minimum fee for filing the articles is \$125. This minimum fee permits the issuance of 1,500 shares. See *Ohio Revised Code* Section 111.16(A)(2) for the appropriate filing fee if more than 1,500 shares are to be issued.
 - d) The secretary of state's office will not return the articles after filing. Send a photocopy of the articles and retain the original articles.
- 4) Incorporators, or the directors if named in the articles, should start a minute book by acknowledging the filing of the articles and including the original of the filed articles.
 - a) Incorporators, or the directors if named in the articles, should authorize the issuance of shares.
 - b) The investors should sign a *subscription agreement*, the agreement in which the investor agrees to buy the shares for a given price.

- c) The incorporators, or the directors if named in the articles, may set the value of non-cash assets in payment of the subscriptions.
 - d) The incorporators, or the directors if named in the articles, accept the subscriptions.
 - e) The incorporators must give notice of the first shareholders' meeting.
- 5) Consider becoming a "Subchapter S" corporation for federal and state tax purposes. See Sections 1362 *et seq.* of the *Internal Revenue Code*.
 - a) Use IRS Form 2553. File with the Internal Revenue Service Center, Cincinnati, Ohio 45999 within the 16th day of the third month of the beginning of the tax year.
 - b) Shareholders and the corporation must file a notice of the subchapter selection with the Ohio Department of Taxation.
 - 6) If the business will operate under a name other than its corporate name, a Report of Use of a fictitious name must be filed on Form 534 with the Ohio Secretary of State, P.O. Box 670, Columbus, Ohio 43216. There is a \$50 fee to file this form.
 - 7) A trade name may be registered with the secretary of state by completing Form 534, and sending it, along with a \$50 filing fee, to the address provided above in item 6.
 - 8) Make sure your business complies with the Ohio securities laws. The most common exemption from the Ohio registration requirements for small businesses is a small business equity investment to ten or fewer investors (*Ohio Revised Code* Section 1707.03[O]). To comply with this exemption, the subscription agreement must include statements that: 1) the purchaser is aware that no market may exist for resale of the securities; 2) the purchaser is aware of any restrictions on transfer of the securities; and 3) the purchaser declares that the purchase of equity is for investment purposes and not for redistribution. If there are non-Ohio investors, check with their resident state security regulator.
 - 9) Make sure your business complies with federal securities laws. Registration is required unless an exemption is available. Following are the two most common exemptions for small businesses:
 - a) Intrastate exemption (see Securities and Exchange Commission Rule 147);
 - b) Private placement exemption (see Regulation D of the Securities and Exchange Commission).
 - 10) Obtain the taxpayer identification number from the Internal Revenue Service. Submit Form SS-4. See the procedure set forth on the IRS Web site: www.irs.ustreas.gov. Note that any person filing a Form SS-4 other than a corporate officer must file an IRS Form 2848 with the Form SS-4.
 - a) By filing the Form SS-4, the corporation is automatically pre-enrolled in the Electronic Tax Payment System.
 - b) By filing the form SS-4, the corporation will receive the IRS Circular E Employee's Tax Guide – Forms for Payroll.
 - 11) Take the following action at the first shareholders' meeting or by written consent of all shareholders.
 - a) Elect directors.
 - b) If the directors named in the articles have not done so, the shareholders should adopt the regulations for the internal government of the corporation.
 - c) Consider adopting a close corporation agreement (see *Ohio Revised Code* Section 1701.591).

- d) Set value for any non-cash payments by investors to the corporation.
 - e) Consider adopting a shareholder's buy and sell agreement.
 - f) Set the fiscal year for the corporation.
- 12) Take the following action at the first meeting of the board of directors or by written consent by all directors.
- a) Elect officers.
 - b) Set compensation of key employees.
 - c) Consider adopting benefit plans.
 - d) Consider adopting group term life insurance plan (see *Internal Revenue Code* Section 79).
 - e) Consider adopting accident and health insurance plan (see *Internal Revenue Code* Section 105[b]).
 - f) Consider adopting medical reimbursement plan (see *Internal Revenue Code* Section 105[b]).
 - g) Consider adopting a death benefit plan (see *Internal Revenue Code* Section 101[b]).
 - h) Consider adopting a Section 1244 plan. This allows the stockholders to take an ordinary tax loss rather than a capital loss if the business fails and the stockholders lose their investment (see *Internal Revenue Code* Section 1244).
 - i) Adopt a resolution for leasing business space.
 - j) Adopt a resolution for the purchase of any real estate.
 - k) Set up a bank account by adopting a bank-provided resolution.
- 13) Consider requiring key employees to execute employment agreements with covenants not to compete.
- 14) Issue stock certificates or transaction statements for paid shares.
- 15) Consider adopting policies about the following issues to protect the company, the directors and the executives:
- a) Sexual harassment;
 - b) Non-discrimination;
 - c) Trade secret protection;
 - d) Company ethics (*e.g.*, corporate gifts, anti-kickbacks);
 - e) E-mail, computer and Internet use;
 - f) Compliance with environmental laws;
 - g) Compliance with the anti-trust laws;
 - h) Compliance with the worker safety rules;
 - i) Development of procedures to prevent hiring of illegal aliens; and
 - j) Political contributions.
- 16) Obtain the following posters to be placed conspicuously in the workplace:
- a) Ohio Civil Rights (contact the Ohio Civil Rights Commission, Education and Community Relations, 111 East Broad Street, 3rd Floor, Columbus, Ohio 43205-1371);
 - b) Fair Labor Standards Act – Minimum Wage poster;
 - c) Employee Polygraph Protection Act – poster advising employees of federal rights when confronted by a request from an employer to undergo a lie detector test;
 - d) Rights of employees under the Family and Medical Leave Act poster;
 - e) Posted notice of company's anti-discrimination policy and anti-harassment policy (sex, race, national origin, etc.);

- f) Federal Occupational Safety and Health Act (OSHA) poster (states the rights of employees under OSHA);
 - g) Federal Equal Employment Opportunity Commission poster;
 - h) Ohio Wage and Hour requirements poster (See Web site: www.com.ohio.gov/laws/docs/laws_minimumwageposter2009.pdf).
- 17) Become an Ohio income tax withholding agent. File Form IT-1, Application for Registration as an Ohio Withholding Agent, with the Ohio Department of Taxation. See the Ohio Business Gateway for Electronic Filing (<http://business.ohio.gov/efiling>) or the Ohio Department of Taxation (www.tax.ohio.gov).
 - 18) File Form JFS 66300, Report to Determine Liability (Unemployment Compensation), with the Ohio Department of Job and Family Services, Contributions Section, P.O. Box 182404, Columbus, Ohio 43218-2404 or go to Ohio Business Gateway (<http://business.ohio.gov>) or the Ohio Office of Unemployment Compensation (www.jfs.ohio.gov/ouc).
 - 19) File Form U-3 Application Coverage with the Ohio Bureau of Workers' Compensation. It is possible to apply online. See www.ohiobwc.com.
 - 20) File the commercial activity tax registration Form CAT-1 with the Ohio Department of Taxation (www.tax.ohio.gov).
 - 21) Obtain a vendor's license from the county auditor. This is needed for compliance with Ohio sales tax on goods. Use Form ST-1. The filing fee is \$25. (Go to www.tax.ohio.gov.)
 - 22) If selling services, your corporation must register as a service vendor for the sales tax on services. Use Form ST-1S and file with the Ohio Department of Taxation, Registration Unit, P.O. Box 182215, Columbus, Ohio 43218-2215. There is a \$25 filing fee.
 - 23) Form JFS 07048 must be filed with the Ohio New Hire Reporting Program by mail at P.O. Box 15309, Columbus, Ohio, 43215-0309, by FAX at (888)872-1611 or online at www.oh-newhire.com.
 - 24) Obtain from local authorities the information and forms for local income tax compliance.
 - 25) Information can be obtained from the following state agencies:
 - a) 1st Stop Business Connection: (800)248-4040 or (614)466-4232 or www.development.ohio.gov/edd/1ststop);
 - b) Ohio Secretary of State (614)466-3910;
 - c) Ohio Department of Taxation: (888)405-4089;
 - d) Ohio Department of Securities: (614)644-7381, or (877)767-3453.

—by Jason C. Blackford, an attorney with the Cleveland firm, Weston Hurd LLP.

Know the Advantages, Disadvantages of C-Corporations, S-Corporations and Limited Liability Companies

Q: *What is a C-corporation and what are the principal advantages and disadvantages of using one?*

A: A C-corporation is typically a business organized as a corporation under state law, and is subject to federal income tax under sub-chapter C of the *Internal Revenue Code*. A C-corporation is subject to federal corporate income tax on its taxable income, and its shareholders are subject to federal income tax on any dividends at a maximum 15 percent federal income tax rate (as of December 2008) if certain requirements are met. Otherwise, dividends are subject to federal income tax at the shareholder's ordinary income tax rate. These two layers of tax are sometimes referred to as double taxation.

If the federal corporate income tax imposed on business profits is less than the individual income tax on those same profits, then a C-corporation may provide a modest federal income tax advantage. Currently, the first \$75,000 of taxable income of a C-corporation is subject to a maximum federal income tax rate of 25 percent. If earnings of the business will be retained in the corporation and reinvested in the business, then using a C-corporation takes advantage of these lower federal tax rates. This advantage will be lost if the earnings are distributed by the C-corporation to shareholders as dividends to be taxed again at the shareholder level.

The principal non-tax advantage of any corporation is that the corporate form of doing business is familiar. Many statutes and administrative rules anticipate corporate structures, and there is a developed body of case law that helps set parameters for appropriate conduct for shareholders and directors.

State corporate law lets a corporation have different classes of stock with varied distribution and voting rights, such as preferred stock or classes of stock with special rights and preferences. A C-corporation can generally use this flexibility without affecting its tax treatment.

Another disadvantage, aside from the double taxation that applies to C-corporations, is the "trapping" of losses in the corporation. C-corporation net operating losses are generally carried forward or back to offset income of the C-corporation; they cannot be used by shareholders to offset personal income.

Finally, in many states, and in Ohio through 2009, the C-corporation is subject to a separate state franchise tax that does not apply to S-corporations or limited liability companies (LLCs). For tax year 2010 and later, Ohio's franchise tax will remain in place only for financial institutions and certain holding corporations.

Q: *What are the principal advantages and disadvantages of using an S-corporation?*

A: An S-corporation is generally treated as a *flow-through* entity for federal income tax purposes; that is, income and losses of the S-corporation are reported on the shareholders' personal income tax returns. Thus, the chief advantage of an S-corporation is the ability to generally eliminate the federal entity-level income tax while using the corporate form of organization under state law that is generally familiar to business people and fits well

with most statutes and regulations. Also, subject to applicable limitations, shareholders can use their pro rata share of an S-corporation's losses to offset other personal income.

A major disadvantage of an S-corporation is its rigid requirements to qualify for and retain its S-corporation status. If any requirement is not satisfied, then the corporation will lose its status as an S-corporation and be subject to federal income tax as a C-corporation. For example, one requirement mandates that the S-corporation have only one class of stock, which generally means that all outstanding shares of stock must confer identical rights to distribution and liquidation proceeds. Also, the number of shareholders is generally limited to 100, and there are restrictions on who can be a shareholder. Only individuals who are not non-resident aliens for federal income tax purposes, estates, and certain trusts and tax-exempt entities can be S-corporation shareholders. Corporations and other entities, such as partnerships, cannot own S-corporation stock.

Q: *What are the principal advantages and disadvantages of using a limited liability company?*

A: The limited liability company, like a corporation, generally provides its owners with limited liability. Except in special circumstances, only the company, not its owners, is liable for the debts and obligations of the business.

The limited liability company, like the S-corporation, has *flow-through* taxation unless an election is made to treat the LLC as a C-corporation for federal income tax purposes. This means that the income and losses of the business are reported on the owners' personal income tax returns, and the LLC does not have any federal income tax liability. Unlike the S-corporation, the LLC can create different classes of interests, such as interests having a preference on liquidation and/or dividends, or with varied distribution rights. Also, LLC interests, unlike S-corporation stock, can be owned by any individual or entity without affecting the LLC's flow-through tax treatment.

The limited liability company is more flexible than a corporation and allows the members to be creative in developing a management structure. The LLC can be managed by a manager, its members, a board, or a combination of these elements. As a result, the LLC structure, as described in its operating agreement, can resemble the structure of a corporation, a partnership or something in between.

A disadvantage of the LLC is that it is a relatively new form of entity. Ohio's LLC statute is just 15 years old, whereas Ohio's corporation law predates the codification of the *Ohio Revised Code* in 1955. There is less case law interpreting the LLC form of organization, and not all state statutes and regulations explain how an LLC should fit into their schemes.

Another disadvantage of the LLC is that self-employment taxes generally apply to a member's distributive share of trade or business income of the LLC, subject to certain exceptions.

Caution: This discussion assumes that the LLC is treated as a partnership for applicable income tax purposes or, if there is only one owner, it is being disregarded (ignored) for applicable income tax purposes.

Q: How do business owners choose from among these options?

A: Most owners desire the protection of limited liability, and all of these options afford their owners limited liability from obligations and liabilities of the company. In choosing among the three entities, the facts and circumstances of each business must be considered. For many businesses that wish to avoid the double taxation of a C-corporation, but want flexibility in management and distributions, the LLC is an increasingly popular choice. Owners may also want to consider how to pass a business on to the next generation or the potential effect of a sale or other disposition of all or part of the business.

—by Cleveland-area attorneys Jack Kurant and Michele R. Yeh. Updated by Jeanne M. Rickert and Wade Wagatsuma, attorneys in Jones Day’s Cleveland office. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the law firm with which they are associated.

C-Corporations, S-Corporations and Limited Liability Companies Are Taxed Differently

Q: How are C-corporations, S-corporations, and Limited Liability Companies (LLCs) different for income tax purposes?

A: The taxable income of C-corporations is subject to a corporate level federal income tax, and a shareholder-level tax is imposed on cash or other property that is distributed to shareholders as a dividend. Thus, the earnings of a C-corporation are potentially subject to two layers of federal income tax (*i.e.*, double taxation).

Both S-corporations and LLCs (taxed as partnerships for federal income tax purposes) generally are pass-through entities for federal income tax purposes. Income and deductions attributable to business operations of the entity are passed through to the owners in accordance with applicable law. The results of the entity's operations are reported on the owners' individual income tax returns, and also reported on the entity's federal information tax return. The entity generally does not pay federal income taxes. However, even if the entity does not make any cash distributions to the owners, the owners still must pay federal income tax on the earnings of the business.

Caution: Certain publicly traded limited liability companies and LLCs that specifically elect to be taxed as corporations will be taxed as C-corporations. For purposes of the following discussion, LLCs will be assumed to be taxed as partnerships for federal income tax purposes.

Q: Does the choice of entity affect how owner-employees are treated for payroll tax purposes?

A: Yes. With either a C-corporation or S-corporation, only the amounts paid to the shareholder-employee as compensation are subject to payroll taxes. The compensation must be "reasonable," or the IRS may treat the excess compensation as a non-deductible dividend or distribution.

The different tax rules for C-corporations and S-corporations create different incentives in determining the amount of compensation paid to owner-employees. In a C-corporation, the tendency is to set salary/compensation at the higher end of the reasonable compensation range so that the corporation can deduct such payments to the shareholder and reduce the amount paid out dividends, which are subject to double taxation. (Dividends are not deductible by the C-corporation.) Conversely, salary paid to an S-corporation shareholder-employee would more likely be set at the lower end of the reasonable compensation range and provide for a larger dividend distribution, which would mitigate payroll taxes on such distribution.

By comparison, an LLC owner-member does not receive a salary. All amounts reflected on the tax return of the owner-member who performs services for the business are generally subject to self-employment taxes.

Q: Can losses incurred by the entity be used to offset the owners' personal income?

A: In a C-corporation, the answer is no. Losses of the C-corporation can only be used by the corporation and, generally, are carried forward or back to offset corporate income.

Losses generally do pass through to shareholders of S-corporations and members of LLCs to offset their other personal income.

The amount of losses the S-corporation shareholder/LLC member can use, however, depends upon applicable tax rules and regulations, which depend, among other things, on the owner's tax "basis" in his or her stock or LLC interest, and in the case of S-corporations, certain debt instruments. Whether the losses can offset other income of the owner, such as wages or interest, depends again on applicable rules, notably whether the S-corporation shareholder/LLC member is regularly active in the operation of the business.

In an LLC, a member's tax basis in the member's LLC interest will be increased in accordance with applicable law if the LLC borrows money, which will then generally provide the member with increased capacity to take additional losses on his or her tax returns.

A shareholder's basis in any indebtedness of the S-corporation to the shareholder increases the shareholder's capacity to report loss deductions. After the shareholder's stock basis has been reduced to zero, the basis in such indebtedness may be reduced (though not below zero) by deductions passed through to the shareholder-creditor.

—by Cleveland-area attorneys Jack Kurant and Michele R. Yeh. Updated by Jeanne M. Rickert and Wade Wagatsuma, attorneys in Jones Day's Cleveland office. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the law firm with which they are associated.

The LLC: A Useful Business Entity

Since the 1994 enactment of legislation in Ohio that gave us the limited liability company (LLC), this new form of business entity has become immensely popular. And for good reason. The LLC is a flexible and valuable tool for business owners. In this brief article, I will talk about what an LLC is and how you might make use of it.

The LLC is an entirely separate type of business entity. Although it is not a corporation or a partnership, it can share attributes of each. Like a corporation, the LLC will generally shield its owners (called “members”) from the company’s creditors. The LLC is similar to a partnership in that it can choose to be taxed as a partnership or, in the case of a single-member LLC, as a sole proprietorship. In either case, the LLC will not be a tax-paying entity. Instead, its net income and other tax items will flow through to the members and will be reported on their income tax returns. In this way, the LLC is similar to the Subchapter S-corporation (S-corp).

Although the LLC is similar to the S-corp, the LLC is more flexible. With the LLC, there are no restrictions on the number or type of owners, and the LLC can have more than one class of ownership (similar to common and preferred stock). For employment tax reasons, however, the S-corp is sometimes a preferable choice to an LLC.

If you currently own a business, you might consider forming an LLC, perhaps with your business partners or family members, to hold newly acquired real estate, equipment, or other assets that can then be leased by the LLC to the main business entity. This approach protects the main corporation from liabilities associated with the assets. To the extent that family members are involved, this approach might also have income and estate tax-planning benefits.

—by Michael J. Stegman, an attorney with the Cincinnati firm of Kohlen & Patton LLP.

Essential Elements for Operating Agreements of Limited Liability Companies

The limited liability company (LLC) is quickly becoming the business organization of choice for many small business owners. The growing popularity of LLCs is the result of their simplicity and flexibility. Limited liability companies are separate legal entities, like corporations, but are treated as pass-through entities for tax purposes, provided they have not elected with the IRS to be treated as taxable entities. The members are protected from personal liability for the company's debts. Profits and losses are passed directly through to the members, which avoids double taxation because the LLC does not pay income taxes itself.

An essential element to the efficient operation and governance of an LLC is the operating agreement. An Ohio LLC can be organized without a written operating agreement. However, if there is no written operating agreement, the provisions of Chapter 1705 of the *Ohio Revised Code* govern the relationship of the members and the operation of the LLC, and many of the statutory default rules leave open important issues.

An operating agreement should provide sufficient detail to serve as a road map for the members with respect to LLC governance and operation. This is all the more important since LLCs are a relatively new form of entity in Ohio and the parties involved and the public at large likely will have very little experience in dealing with LLCs than with other forms of business entities. The initial drafting of the operating agreement is very important because a well-drafted agreement will reduce the potential for disputes between the LLC members and managers in the future.

Every LLC operating agreement should address these essential elements:

Contributions of the members. Many statutory rights of the members are based on the value of their capital contributions, so it is vitally important that this information is recorded in the operating agreement. If contributions will be in a form other than cash (such as services), it is important that the members explain the form and value of such non-cash capital contributions.

Transferability of membership interests and admission of new members. The operating agreement should describe the restrictions on the transferability of membership interests and explain the rules governing transfers and the admission of new members.

Withdrawal rights. If the members want a right to withdraw from the LLC, the terms and conditions governing withdrawal must be addressed in the operating agreement.

Death, bankruptcy or divorce of a member. It is important that the members specify what will happen to their membership interests in the event of a death, bankruptcy or divorce of a member. Otherwise, there may be a number of undesirable possible outcomes. For example, an heir of a deceased member, a divorced member's ex-wife, or a creditor of a member may become a member of the LLC.

Allocation of profits, losses and distributions. It is often desirable to allocate profits, losses and distributions in a manner other than based on the value of the capital contributions of each member. By addressing these issues in the operating agreement, the members can ensure fair allocations to the members.

Management. It is important to indicate whether the LLC will be managed by its members or by elected managers. If managers are elected, the operating agreement should specify which actions managers may take on behalf of the LLC (such as day-to-day business activities) and which actions require the approval of the members (such as material financing or business acquisition transactions). The operating agreement also should specify whether the members' voting rights are per capita, pro-rata based on capital contributions, or determined in some other manner.

Indemnification. The operating agreement should outline the terms and conditions regarding indemnification by the LLC of the members and managers.

Confidentiality. The operating agreement should address restrictions on a member's rights to use or disclose the LLC's confidential information.

Covenants not to compete. The operating agreement should address any restrictions on a member's right to compete with the LLC's business or pursue opportunities that should first be made available to the LLC. Ohio case law involving LLCs, although still limited, has established that the common law fiduciary duties of the members can be modified or eliminated by the terms of the operating agreement.

—by D. David Carroll and Adam J. Biehl of the Columbus law firm, Bailey Cavalieri, LLC.

Letters of Intent: To Do or Not To Do

Business people involved in mergers, acquisitions and divestitures love them; their lawyers dislike and fear them. What are they? They are letters of intent.

The legal issue with a letter of intent has to do with whether the letter is a legally binding document or just an expression of the parties' intent to try to make a deal. When drafted by the inexperienced, a letter of intent that was only meant to be an expression of ideas about a possible future agreement can produce costly litigation. Further, a court may decide that the seemingly nonbinding letter of intent is a wholly or partially legally binding contract.

Business people are often drawn to letters of intent because they feel that putting something on paper makes a deal more likely to happen. A party may erroneously believe that the letter of intent morally commits the other side, while counting on the "nonbinding" nature of the letter to avoid making its own firm commitment.

Over the years, a lot of litigation has involved the binding effect of letters of intent. Even some letters of intent that specifically say they are not binding are held by a court to be binding in whole or in part for a variety of reasons. Lawyers tend to dislike letters of intent because they understand the litigation risks and the uncertainty even when the letter says, "This is not a legally binding document."

Nevertheless, a properly written letter of intent dealing with the merger acquisition or divestiture of a business sometimes serves a useful purpose. Such a letter is usually partially binding and partially non-binding. The usual binding provisions concern the preservation of confidentiality, exclusivity of negotiations, expense allocation and due diligence procedures. During a buyer's due diligence, the parties negotiate the definitive purchase/sale agreement containing details of the transaction, such as the exact purchase price, price adjustments, and payment terms, representations and warranties, closing contingencies and a host of other matters that need to be covered as facts become known through due diligence.

The bottom line is this: If you decide to use a letter of intent for any transaction, use it carefully and with help from experienced counsel.

—by Charles R. Schaefer, an attorney with the Cleveland firm of Walter & Haverfield LLP.

Internal Governance – Codes of Regulations and Bylaws

A corporation's code of regulations regulates and governs the internal affairs of a corporation and the relationship among the corporation and its shareholders, directors and officers. The code is essentially a contract among those constituents and it addresses the governance and management of the corporation. A code of regulations is an extremely important tool for avoiding conflict. Governance and management issues that seem insignificant may become stumbling blocks if regulations are not in place to address them.

Some of the more important aspects of a code of regulations include:

- the time and place of shareholders' meetings, the manner in which they may be called, notice, quorum and voting requirements for meetings and procedures for taking action without a meeting;
- the number, classification, terms, and manner of fixing compensation for directors;
- the time and place of directors' meetings, the manner in which they may be called, notice, quorum and voting requirements for meetings and procedures for taking action without a meeting;
- the appointment and authority of board committees;
- the titles, duties, authority, term of office and manner of fixing compensation for corporate officers;
- the rights of officers and directors to be indemnified by the corporation; and
- procedures that spell out how the code of regulations is amended by the shareholders.

In light of our country's experience with terrorism and war, it has never been more important for businesses to address emergency regulations. In Ohio, a corporation's emergency regulations are effective during times when the governor has declared a state of emergency, for example, after attacks upon the United States and natural disasters in general. In such situations, emergency regulations allow the corporation to continue operations, even if it would not have authority to do so under normal conditions. In the corporate setting, emergency regulations may allow any director to call a meeting. Further, the normal quorum requirements can be abandoned, when necessary, in favor of emergency quorums that may consist of any director or directors who appear at the meeting. Such emergency meetings and board actions can allow the business to move forward in even the most trying times.

Bylaws

Unlike a corporation's code of regulations, corporate bylaws are internal rules enacted by the board of directors. Bylaws are less common than codes of regulations and are likely only necessary, if at all, for corporations with large and active boards of directors. While bylaws must be consistent with a corporation's articles of incorporation and code of regulations, they have another purpose: to address the authority and internal governance of the corporation's board of directors. In Ohio, bylaws are often confused with codes of regulations because the instrument Ohio refers to as the *code of regulations* is referred to as the *bylaws* in a number of other states.

In many instances, a corporation's board members are entirely unfamiliar with the state law governing corporations. Therefore, it is common for a corporation's bylaws to include summaries of the relevant statutes affecting the rights, authority and duties of the directors. For example, bylaws often will recite the specific provision of state law regarding the general authority of the directors. Bylaws also may address how to obtain a quorum of directors, how to take action without having a meeting, and how to remove directors and fill vacancies on the board.

–by D. David Carroll and Jameel S. Turner of the Columbus law firm, Bailey Cavalieri, LLC, and Todd J. Samples of Alliance Data Systems in Columbus.

Franchise Laws Protect Investors

Q: *I am interested in buying a franchise. Are there laws that protect me in this situation?*

A: The Federal Trade Commission (FTC) has a rule which requires a franchisor to provide detailed written disclosures to prospective franchisees. The franchisor must deliver these disclosures at least 14 calendar days before you sign any binding agreement with, and pay any money to, the franchisor.

Q: *What type of information must the franchisor provide?*

A: There are more than 20 categories of information covered by the FTC rule. This includes history of the franchisor, fees the franchisee will owe, the investment required to start the business, training, the franchisee's obligations, the franchisor's obligations, termination, transfer, dispute resolution and other matters.

Q: *Does the FTC check the accuracy of the franchisor's disclosures?*

A: No. The FTC makes no review of the written disclosures. You will need to study the disclosures carefully. You also should consult with an advisor, such as your lawyer.

Q: *What can I do to gather more information?*

A: The written disclosures must list current franchisees and persons who ceased to be franchisees within the past year. You definitely should contact both current and former franchisees to obtain information and the benefit of their experiences.

Q: *Does the FTC regulate the terms of the franchise relationship?*

A: No. The FTC does require the franchisor to provide the franchise agreement along with the detailed disclosures, but the FTC does not review the agreements. Because the franchise agreement will govern your franchise, you should study it carefully with an advisor.

Q: *Can I rely on oral promises made by the franchisor?*

A: No. Nearly every franchise agreement states that it is the entire agreement and there are no other promises or agreements.

Q: *How, then, can I make certain I have the benefit of oral promises?*

A: You will need to negotiate the franchise agreement with the franchisor. You should insist that the franchisor include in the franchise agreement all promises that are important to you.

Q: *Are there other documents I should review?*

A: Nearly all franchisors have an operating manual. The franchise agreement usually requires the franchisee to do what is in the operating manual. Before buying a franchise, you should obtain and review the operating manual.

Q: *Does Ohio have a law to protect me in buying a franchise?*

A: Certain states have laws requiring franchisors to make disclosures. Certain states regulate aspects of the franchise relationship such as termination. Ohio does not have a specific franchise law, so the FTC rule governs in Ohio.

Ohio *does* have a business opportunity law. This law requires persons who offer others the opportunity to start a business of selling goods or services to make certain

disclosures. The law prohibits misleading statements. The law allows persons who are misled to recover damages. This law applies to many, but not all, franchises.

Also, if a franchisor makes misrepresentations in selling the franchise, the franchisee may be able to sue to recover damages resulting from the misrepresentation.

—by G. Jack Donson Jr., a partner in the Cincinnati firm of Taft, Stettinius & Hollister, LLP, and Christopher A. Kuhnhein, an associate at that firm.

Buyer Beware: The Steps to Purchasing a Business

If you are looking to buy or acquire a business, you will need patience, honed detective skills, legal and accounting advisors, and attention to every detail. The process of buying a business is a negotiation between the seller and the buyer, with both looking out for their own interests, as well as the future of the business—but for different reasons.

As the potential buyer, it's important to consider the seller's motivation to sell: Is it retirement? Or does seller foresee changes in the market place and have an aversion to putting more capital at risk? Knowing the reasons for the sale will help a buyer prepare an offer, including whether to purchase the assets of the business or the stock.

As the buyer and seller negotiate through the sale, there are key documents to consider prior to the definitive agreement, including:

Confidentiality agreement: In order to receive basic information about seller, the buyer signs a document agreeing to use the information revealed only for the purpose of considering buying the business. Particularly, if the potential buyer is a competitor of the seller, the agreement may also preclude buyer from hiring seller's employees for a period of time, if the sale does not occur.

Letter of intent (LOI): This is generally a non-binding offer for the business. Buyers prefer a short LOI, seeking to delay negotiations of difficult issues such as risk allocation and seller's indemnification obligations, until the definitive agreement. Sellers prefer a more detailed LOI, as their greatest leverage is before its execution. Many times, sellers can be talking to multiple potential buyers prior to execution of a letter of intent. The signed LOI generally contains a provision giving the potential buyer exclusivity on negotiations for a 60- to 90-day period. Since disclosure of a potential sale, followed by no sale can cause morale problems for seller's employees and leave the seller with a reputation as damaged goods, the seller wants as many details resolved in the letter of intent as possible. Additionally, if there are roadblocks to the sale, the seller will want to know them as soon as possible to reduce legal fees and time commitment to the failed transaction.

Due diligence:

Following execution of the confidentiality agreement, buyer conducts preliminary due diligence—an analysis of seller's business and financial results. The analysis at this stage determines whether buyer remains interested and establishes the potential price. Following execution of letter of intent, the buyer completes due diligence, which may include talking to key customers, suppliers and personnel. Due diligence is designed to provide the buyer a full understanding of the risks and liabilities of the business. Many times, buyer revises its bid based on information generated during due diligence.

As a buyer, you need to ask yourself what key assets you want to acquire in the purchase of the business: a patent or important license, the seller's employees, key customer contracts or supply agreements, or equipment. If the documents are drafted to accomplish the purchase of the key elements of the business and to allocate the risks for past and future events in a manner you, as the buyer, understand and accept, the purchase is being done correctly. Finalize the deal.

—by Michael A. Ellis, an attorney with the Cleveland office of Porter Wright Morris & Arthur LLP.

The Business Acquisition Checklist

One important way a small business can grow is by merging with or acquiring another company. An owner considering a merger or acquisition should take as many of the following steps as possible to evaluate the target company before deciding whether or not to proceed.

- ✓ Review financial statements for the previous five years or longer if possible. Note items that should be recast or restated.
- ✓ Prepare a comparative and ratio analysis of the financial information to identify significant trends, potential problems and opportunities.
- ✓ Review copies of federal, state and local tax returns for the previous five years.
- ✓ Determine if all payroll, sales, excise and other miscellaneous taxes have been paid.
- ✓ Review the business minute book.
- ✓ Ask for any asset and business appraisals.
- ✓ Review the depreciation schedule in detail, giving attention to the original cost, age and condition of the assets.
- ✓ Prepare a detailed list of products and services the company offers.
- ✓ Prepare a list of major customers by name, volume and product.
- ✓ Determine if the seller has any patents, trademarks or licenses that need to be acquired.
- ✓ Review all leases.
- ✓ Prepare an organizational chart.
- ✓ Give consideration to the economy of the community where the business is located.
- ✓ Prepare a list of major suppliers.
- ✓ Determine which assets are mortgaged or pledged and review the loan documents.
- ✓ Determine if the key individuals are willing to sign a non-competition agreement.
- ✓ Review local zoning restrictions.
- ✓ Determine if the company is subject to any governmental regulations or restrictions.
- ✓ Inquire about any existing lawsuits and any contingent liabilities such as environmental liabilities.
- ✓ Review all employee fringe benefit plans.
- ✓ Determine if there are any employment contracts with key personnel.
- ✓ Obtain copies of all union contracts.
- ✓ Look for win-win opportunities throughout the negotiation process.
- ✓ Determine if there are any tax audits and review the results of the audits.
- ✓ Seek advice from competent professionals.
- ✓ Consider the synergistic effect of the prospective sale on both the buying and selling businesses. Consider recasting the financial information to take this effect into account.
- ✓ Prepare or review forecast, budgets and business plan.
- ✓ Compute an acceptable range of value for the company and an appropriate offering price.
- ✓ Determine how the offering price should be allocated among the various assets to get the best tax benefits.

–by Bruce D. Bernard, Esq., tax strategist with Bernard Law, LLC in Worthington.

Marriage Plans Affect Business

Q: I am a business owner and plan to marry. Is there anything I can do to protect my business interests before I marry?

A: Yes. Consult an attorney about drafting a prenuptial agreement for you and your future spouse to sign in advance of the wedding. In such an agreement, you can state in advance of the marriage who will be entitled to your business interests in the event that your marriage should end or in the event of your death. For example, you might want to stipulate that your future spouse would not be entitled to any business interest that you now own, or any appreciation of a business interest you now own, and/or any business interest you might acquire later.

If such an agreement is in place and you later divorce or die, a court would follow the terms of the prenuptial agreement in distributing the value of your business interests. (By contrast, courts are sometimes not obligated to follow the terms of the prenuptial agreement regarding spousal support awards and can reassess spousal support at the time of the divorce.)

Q: If we decide not to make a prenuptial agreement and later divorce, what would happen to my current ownership interest in my business?

A: The value of the interest that you accumulated in your business before the marriage would be considered your own separate property and generally would be awarded to you and not your spouse. However, if the business interest that you owned before the marriage appreciates after the marriage, or if you acquire a new business interest after the marriage, then these interests may be considered “marital property” and your spouse generally may be entitled to receive one-half of the value.

Q: If we decide not to make a prenuptial agreement and I die before my spouse, what would happen to my ownership interest in the business?

A: Without a prenuptial agreement, your spouse may be entitled to receive some portion of the value of your interest in the business. For example, if you wrote a will leaving the entire interest to your children by a previous marriage, your spouse has the right to *elect against the will* and automatically take a portion of the share that was left to your children. If you die without a will, state statutes provide that your spouse would still be entitled to a share of your interest. (If you have no children and die without a will and without a prenuptial agreement, your spouse generally would be entitled to inherit all of your interest.)

Q: I just became engaged and I'm planning to marry in about six months. I hate to wreck my romance and would rather wait until all the wedding details are out of the way before working out a prenuptial agreement. Is there any hurry?

A: The biggest mistake that most people make regarding prenuptial agreements is waiting too long to consult an experienced domestic relations attorney, then trying to negotiate an agreement too close to the wedding. The circumstances surrounding the signing of a prenuptial agreement must follow a fair procedure or the agreement may be unenforceable. In determining whether to uphold a prenuptial agreement, courts look at how much time both spouses had to consider the agreement, whether both spouses

understood the agreement, whether both spouses had counsel, and whether there was full financial disclosure.

–by Laura S. Zeldin, a Columbus attorney; updated by Pamela J. MacAdams, a partner in the Cleveland firm, Morganstern, MacAdams & DeVito Co., LPA.

Divorce Affects Business

Q: I am married and I currently own a business. If my marriage should end, how might my ownership interest in my business be affected?

A: If your marriage ends and you acquired your business interest during the marriage, the value of your interest would be considered *marital property* under Ohio law. Marital property is divided according to an *equitable distribution* analysis. Generally, your spouse may be entitled to receive 50 percent of the value of your business interest unless it is determined that an absolutely equal division would be inequitable (unfair).

Q: If I divorce, what will happen to my ownership interest in my business if all or part of my interest in the business was acquired before the marriage?

A: The value of the interest in your business accumulated before marriage would be considered your own *separate property* and generally would be awarded to you and not your spouse. If, however, the business interest that you owned before marriage has appreciated (grown in value) during the marriage, then the value of appreciation may be considered marital property and be subject to a 50/50 division unless the court finds that such a division would be inequitable. In some courts, this depends upon proof of any marital contribution of monies or labor to the business during the marriage.

Q: Is it possible that my spouse will receive part of my pension, retirement and other business benefits if I divorce?

A: Yes. The value of pension and retirement plans accumulated during the marriage is also considered marital property and is subject to equitable distribution. Generally, your spouse may be entitled to one half the value of the pension accumulated during the marriage unless it is determined that an absolutely equal division would be inequitable.

Q: Does the equitable distribution property analysis with the 50/50 starting point still apply even though the business interest is in my name and my spouse did not work in or have any connection with the business?

A: Yes. The equitable distribution formula applies even if your spouse has no connection to your business, assuming the business was started or acquired during the marriage. In Ohio, marriage is viewed as an economic partnership and both spouses are considered to have contributed equally to marital property that is produced or acquired by either one of them during the marriage. Marital property can be titled in the name of either spouse or both. The fact that the business interest is in your name is not the deciding factor in determining whether the property is marital or separate.

Q: Does equitable distribution mean that the court presumes my spouse is entitled to own half of my business interest after the marriage ends and will also be entitled to be involved in my business?

A: No. After the marriage ends, your spouse is entitled to half of the *value* of your interest in the business—not necessarily half of the business interest itself. However, if both spouses were actively involved in the business, Ohio law does not *require* one of them to stop being involved simply because the marriage has ended. Commonly, however, the court will seek to separate spouses in business as well as marriage by dividing assets such that only one spouse stays with the business.

Q: After deciding to separate, my spouse and I reached an agreement to distribute the value of the business interest (as well as our other marital property) that is different from the equitable distribution formula. Will the court accept and adopt our agreement?

A: The court will probably adopt your agreement if you and your spouse have fully disclosed all of your assets, and you and your spouse state that you have had the chance to find out about all financial matters, including the value of your assets.

However, after the court accepts an agreement made by both parties and grants your divorce, the agreement will not be set aside later just because one of the parties comes to feel it is a bad deal. Therefore, it is extremely important that both spouses at least consult an attorney to review their agreement and determine whether a spouse is receiving more or less than a court might award. Sometimes the court will reject an inequitable distribution if it is not convinced that each spouse had the benefit of legal counsel.

Q: What about the debts my business has? Will these be divided between my spouse and me?

A: Debts must also be distributed when a marriage ends and can be classified as *separate* and *marital*. Usually, debts related to a marital property business interest will have been factored into the net value of the business interest that is being distributed. Also, any ongoing responsibility for the debts of the business will generally remain with the spouse who continues to participate in the business. If, however, the business is a sole proprietorship and the spouses have filed joint tax returns in the past, the non-owner spouse who will no longer keep an interest in the business should make sure that the divorce paperwork contains language to protect himself or herself from any future tax liabilities related to past joint tax returns. If the business debt is jointly incurred, the spouse not keeping the business will also want strong language protecting him or her from collection of such debt by providing for recourse against the non-paying spouse if a creditor collects against the non-owner spouse after divorce.

Q: My spouse was not interested in finances and business during the marriage, so do I have to show my spouse my business and financial records now that the marriage is ending?

A: Yes. Full financial disclosure is required. If your spouse asks for your financial records and information, and you do not provide the information voluntarily, then your spouse has the right to obtain the financial records through a formal *discovery* process, which may involve *interrogatories* (formal written questions and answers) or *depositions* (*under oath* verbal questions asked outside the courtroom), or official requests asking you to produce the documents. Your records may even be subpoenaed (the court would issue an order commanding you to bring the records).

—by Laura S. Zeldin, a Columbus attorney; updated by Pamela J. MacAdams, a partner in the Cleveland firm, Morganstern, MacAdams & DeVito Co., LPA.

Incorporation Limits Liability

Q: *I own a small business, which has two employees. Am I legally responsible if one of my employees is negligent?*

A: Yes. The legal doctrine of *respondeat superior* imposes vicarious liability on an employer for the negligent conduct of its employees committed within the scope of the employee's duties—even when the employer is not directly involved in the acts of misconduct. For example, an employer may be required to pay monetary damages for injuries caused to a third party in a motor vehicle accident when the employee is making a delivery to a customer. The employer, however, will not be liable for injuries caused by an employee who stops at a bar on the way home from work, has several drinks, and then causes a motor vehicle accident while driving home. Under those circumstances, the employee would not be acting within the scope of his or her employment, and the employer would not be vicariously liable for the employee's misconduct.

Q: *What can I do to protect my personal assets against vicarious for my employee's negligence?*

A: A small business owner should always maintain a general commercial liability insurance policy for the business. In addition, the owner should also obtain automobile, malpractice or *errors and omissions* insurance policies when appropriate. Apart from insurance coverage, a small business owner should consider forming a legal entity for the business. Formation of a legal entity, such as a corporation, will expose only the corporate assets, as opposed to the personal assets of the owner, to liability in the event that an employee negligently injures another person.

Q: *What steps must I take if I want to form a legal entity for my business?*

A: There are several different types of entities to consider for a small business. The most common and the easiest to form is called a limited liability company (LLC). An LLC is created by filing a document called *articles of organization* with the Ohio Secretary of State. Management of an LLC occurs through its members. Many LLCs have a document called an operating agreement, which defines how the LLC is to be managed and how the financial aspects of the LLC are to be organized.

Another option is a corporation. A corporation is created by filing a document called *articles of incorporation* with the Ohio Secretary of State. Articles of incorporation must include the name of the corporation and a statutory agent must be appointed. A statutory agent is a person who resides in the same county as the corporation, and who is available to receive official notices and papers served upon the corporation.

A third alternative is to form what is known as a limited liability partnership.

Limited liability companies, corporations and limited liability partnerships are controlled by different provisions in the *Ohio Revised Code*, have different structures in terms of ownership interests, and also result in different tax consequences to the owners. For example, a C-corporation bears a double tax burden in that the corporation pays taxes for earnings during the fiscal year and the shareholders also pay taxes on dividends received from the corporation. Limited liability companies, on the other hand, have *flow-through* tax advantages in that the LLC does not pay taxes independently on earnings. Earnings (or losses) flow through the entity to the individual members, who then pay taxes on the income they receive.

Q: Are there any circumstances where a creditor could access my personal assets even though I have established a corporation or LLC for my business?

A: Yes. In rare circumstances, a creditor may be able to *pierce the corporate veil* and collect on a business owner's personal assets even though a corporation or LLC has been formed. Business owners should be very careful to separate their business assets from their personal assets at all times, including accounting records and books, bank accounts, lines of credit and tangible assets. An owner must also be careful to abide by corporate formality in order to avoid the appearance that the business entity and the business owner are, in reality, one and the same.

Q: Are there ever circumstances where I can be held liable for the criminal or reckless misconduct of my employee?

A: Rarely. A criminal act is generally considered to be outside of the scope of employment; however, if an owner knowingly participates in, or has knowledge of, but ignores the criminal or reckless behavior of an employee, the employer may still be liable for that employee's misconduct. For example, if an employer knows that his employee is trespassing upon the land of a third party to obtain a natural resource for the benefit of the business, the business owner will be vicariously liable for the intentional misconduct of the employee. An employer may also be held vicariously liable for the reckless conduct of an employee who is engaged in an ultra-hazardous activity, such as shooting a firearm, demolition, cleaning toxic substances and similar activities.

Q: Under what conditions can I make an employee an owner in my business?

A: An employee may become a co-owner of a business entity with the consent of the other prior owners. In the case of a corporation, the employee might receive shares of stock in the corporation as a merit bonus or through the purchase of shares as part of a capital contribution. In the case of an LLC, the employee would obtain a membership interest either through assignment or purchase. The process for bringing in new owners is defined in the articles of incorporation for the entity or in the operating agreement.

Q: What is the best entity to form for my business?

A: You should consult with an attorney and/or an accountant to weigh the benefits and detriments of each type of business entity and to determine what would be the most appropriate entity to use for your business.

—by Jack Neuenschwander, retired partner of the Piqua firm of McCulloch, Felger, Fite & Gutmann Co., LPA. Updated by Christopher R. Pettit, an attorney in the Columbus firm of Lane Alton & Horst LLC.

Shareholders Can Be Personally Liable for Corporate Obligations

Q: Businesses incorporate to protect their owners from liability for corporate obligations. Are there any statutory provisions imposing personal liability on shareholders?

A: Yes. Ohio statutes impose personal liability on shareholders in the following situations:

- 1) When a person subscribes for shares in a corporation, there is a personal obligation to pay the corporation for those shares.
- 2) Any shareholder who knowingly receives any dividend, distribution, or payment made contrary to law or the corporate articles is personally liable to the corporation for the amount received in excess of the amount that would have been paid or distributed without violation of law or the articles.
- 3) A shareholder may be personally liable for the purchase price of corporate shares and punitive damages if the shareholder sells such corporate shares in violation of the Ohio Securities Act.
- 4) Any shareholder selling shares in an insolvent corporation without disclosing the financial situation of the corporation is personally responsible for the purchase price to the purchaser.
- 5) Any shareholder exercising corporate rights, privileges and authority after the corporate Articles of Incorporation have been canceled or after the corporation has been dissolved are subject to the obligations resulting from the shareholder's actions.
- 6) A shareholder having control of more than one-third of the shares of a corporation may be held personally responsible if the corporation fails to report and remit Ohio sales and use taxes.

Q: Are there federal statutes that impose personal liability on a shareholder for the shareholder's conduct?

A: Yes. In addition to the federal liabilities on shareholders who are also officers and directors of corporations, there are several statutes that impose liability on shareholders simply for being shareholders.

- 1) To prevent 10-percent shareholders of a publicly held corporations from using inside information, these shareholders must return to the corporation any profits resulting from the shareholders' purchase and subsequent sale of the corporation's equity securities within a six-month period.
- 2) The Comprehensive Environmental Response Compensation and Liability Act (CERCLA) imposes a liability on *owners and operators* for the costs associated with the clean-up of any spills, discharges or releases of hazardous substances. The Environmental Protection Agency considers shareholders to be owners, but normally has confined its imposition of liability to those shareholders who are active in the business. The courts have generally limited shareholder liability to those situations in which the corporation entity can be disregarded under state law.
- 3) A shareholder in "control" of a publicly held corporation is liable personally for the acts and omissions of that corporation in violation of the federal securities laws.

Q: What is meant by the phrase, “piercing of the corporate veil?”

A: In addition to the statutory liabilities, courts have imposed liability for corporate obligations on a shareholder when the corporate form is used to perpetrate a fraud or an illegal act. Normally, this *piercing of the corporate veil* is applied against a shareholder who dominates the corporation so that the corporation is considered to be an extension or “alter ego” of the shareholder and that the corporation has no separate mind or will of its own. Courts have not established a precise test for determining when corporate domination by a shareholder occurs to the extent that the existence of the corporation is disregarded. Each case is decided on its own facts. The shareholder’s domination and control of the corporation must be used to commit fraud or an illegal act. The injury or loss must directly and foreseeably result from both the shareholder’s control and the fraud, illegal act or unjust conduct.

Q: What can be done by shareholders to prevent a court from piercing the corporate veil?

A: Observe the formalities of the corporate organization. Hold meetings of the directors and the shareholders. Authorize actions such as loans, purchases of property and leases of real estate by written action or at a meeting following these steps:

- 1) Keep separate financial records for the corporation.
- 2) Keep the corporate record book up to date and record all corporate actions by the shareholders and directors.
- 3) Do not commingle the assets of the corporation with the assets of the shareholder or any affiliated entity.
- 4) Provide the corporation with adequate capital to start its operation.
- 5) Never mislead a creditor as to the financial condition of the corporation.
- 6) Use the formal corporate name on all purchase orders, invoices and communications with customers and third parties.
- 7) The corporate bank account should be set up in the name of the corporation and with the name of the corporation on all checks.

It is possible that a shareholder, by his or her conduct, may assume a personal liability. To avoid this, all corporate contracts, agreements, notes, documents and checks should be signed in the individual’s corporate capacity, as in the following example: “Smith Corporation by John Smith, its president.”

Q: Is there any duty of a shareholder to the other shareholders?

A: Yes. The courts have imposed upon a dominant or majority shareholder a fiduciary obligation when dealing with the other shareholders. The dominant or majority shareholder must take actions for the benefit of the corporation and all of the shareholders. The dominant or majority shareholder must act in good faith when dealing with other shareholders. For example, in a corporation where there are two shareholders—both of whom work for the corporation—one owning 60 percent of the shares and the other owning 40 percent of the shares, a fiduciary duty could be breached if the majority shareholder fires the minority shareholder without good reason and for the purpose of increasing the majority shareholder’s salary.

—by Jason C. Blackford, an attorney with the Cleveland firm, Weston Hurd LLP.

Understanding Personal Liability for Corporate Obligations

A major benefit of incorporation is to protect shareholders' personal assets from corporate liabilities. The general rule is that shareholders are *not* liable for the debts or obligations of a corporation; however, if a corporation cannot pay its debts, there are circumstances where courts sometimes disregard the general rule and attempt to impose personal liability for the corporate debt on the shareholders by *piercing the corporate veil*. When this so-called piercing the corporate veil is successful, a claimant against the corporation may be able to collect from a shareholder's personal assets.

In Ohio, a claimant against a corporation must satisfy three elements to successfully pierce the corporate veil and collect from shareholders' personal assets. The claimant must be able to demonstrate that:

- 1) the corporation is completely controlled and dominated by its shareholders;
- 2) the corporation was used to commit fraud or an illegal act; and
- 3) the fraud or illegal act resulted in an injury or unjust loss.

Adherence to the following principles and compliance with state laws reduces the risk that a court will pierce the corporate veil.

1) Keep the corporation completely separate from its shareholders.

- **Observe corporate formalities and respect the legal separateness of the corporation.** Issue stock in compliance with the law. Hold regular shareholder and director meetings when required and ask shareholders or directors, as appropriate, to approve actions outside the ordinary course of business. Officers and directors should exercise independent judgment that is in the best interest of the corporation. Shareholder votes must be based on the number of shares held. In some instances, a close corporation agreement may serve to reduce the need for certain of the required formalities mentioned above.
- **Maintain adequate corporate and financial records.** Adequate records are especially important when shareholders and directors approve significant corporate activities (*e.g.*, borrowing, compensation and purchase decisions).
- **Use corporate funds and property only for corporate purposes.** Never use corporate funds for personal use. Pay dividends only when appropriate.
- **Conduct business in the corporate name.** Use corporate letterhead and the full corporate name in estimates, quotes, bids, invoices, purchase orders, contracts, etc. Have corporate officers sign their names and official capacity on all contracts and other corporate documents.
- **Keep corporate assets separate from shareholders' assets.**
- **When starting a corporation, conduct due diligence to ensure there is enough capital to fund the type and size of the business and to cover accompanying risks.** Avoid regular shareholder loans or contributions.

2) Make sure shareholders do not commit fraud or illegal conduct.

- **Shareholders should not siphon funds** to try to protect the corporation from judgments or other debts.
- **Shareholders must not mislead third parties** by suggesting they will fulfill corporate obligations or that the corporation has assets that are really owned by shareholders.

- **Do not permit the corporation to incur additional debts or liabilities if it is insolvent or in financial distress.**

In summary, in order to pierce the corporate veil and collect from shareholders' personal assets, a claimant must demonstrate that the corporation's shareholders reaped corporate benefits and profits at the claimant's expense. The mere fact that the corporation ceases operation without being able to pay all of its debts is not enough to cause shareholders to be personally liable for the corporation's obligations. But in today's economic climate, even the most basic corporate transactions are scrutinized to the highest degree when a corporation becomes insolvent.

Compliance with the above principles will undoubtedly help shield shareholders from being liable for corporate obligations. Nevertheless, corporate officers and shareholders must remain vigilant and alert in their objective to operate their corporation within the boundaries of law—separately, independently, and free from fraud or illegality.

—by attorney D. David Carroll of Bailey Cavaliere LLC in Columbus and Hollie K. Foust, formerly of the same firm. Updated by D. David Carroll and Jameel S. Turner, both of Bailey Cavaliere LLC.