



STARTING A NEW CORPORATION

Doing it Right

By Layne T. Rushforth

1. CORPORATION BASICS: A corporation is a legal entity that is established to do business. A corporation is established so that the corporation is an entity that has a legal existence separate from its owners ("shareholders"). If a corporation is properly formed, the shareholders' personal assets are not subject to the corporation's creditors, including judgment creditors¹, except to the extent one or more of the shareholders have agreed to be personally liable, such as by signing a personal guarantee, by signing an agreement or note as a co-obligor, or by providing personally owned assets as security.

1.1 Shareholders. The owners of a corporation are called "shareholders" or "stockholders" because their interests are usually represented by stock certificates representing a number of shares in the corporation. Different types of stock can be issued with different rights relative to voting rights, participation in dividends, and participation in the company's asset upon liquidation.

1.2 Directors and Officers. The shareholders elect one or more directors who direct the affairs of the corporation. The directors elect the corporation's officers, such as President, Vice-President, Secretary-Treasurer. The directors are the policy makers, and the officers are employed by the corporation to put the directors' policies into effect.

(a) In large corporations, the board of directors may select a "chairman of the board", and the board may be subdivided into committees with specific authority. It is also common to have an "executive committee" that has authority to make certain decisions without approval by the full board of directors.

(b) In addition to the traditional corporate officers, there can be other officers, including chief executive officer (CEO), chief operating officer (COO), and chief financial officer (CFO).

1.3 Multiple Roles. Under Nevada law, a corporation only needs one shareholder, one director, and one person acting in roles as several officers. In a large corporation, the chairman of the board may be the CEO, or the chairman of the executive committee may be the CFO.

2. FORMATION: A corporation's formation is governed by state law. If a corporation formed in one state wishes to do business in another, it must qualify to do business in that other state according to the laws of that state.

2.1 Articles of Incorporation. A corporation is formed by filing "Articles of Incorporation" with the Secretary of State. The Articles are usually brief, containing only the most basic information about the corporation that is being formed. The Articles set forth the name of the corporation, the location of the principal office, the name of the agent for service of process, the number of shares of stock, the names of the initial officers and directors, etc. The Articles of Incorporation are simple, but they are only a part of the corporate formalities that must be followed in order to be entitled to the benefits of corporate status.

(a) **Registered Agent.** The corporation must appoint someone to serve as the "registered agent" or "agent for service of process". This is a person or business in Nevada that agrees to be served with papers in the event of a lawsuit. This agent must accept that position in writing, and that written acceptance must be filed with the Articles of Incorporation.

(b) **"Initial List" of Officers and Directors.** On or before the last day of the first month following the filing of the Articles of Incorporation, an officer of the corporation must sign containing the names and mailing addresses for all officers and directors of the corporation.

2.2 Bylaws. The bylaws outline the government of the corporation. The bylaws specify the duties and responsibilities of the corporation's shareholders, directors, and officers. While the Articles of Incorporation are usually very brief, the bylaws are usually much more detailed, including information regarding meetings and the corporation's technical operations. Sometimes the Articles will contain provisions that may be modified by the bylaws, but the general rule is that a provision in the Articles of Incorporation will take precedence over a contrary provision in the bylaws.

2.3 Organizational Meetings. Once the corporation has been legally formed by filing the Articles of Incorporation, the corporation must be organized. The directors named in the Articles must meet to authorize the issuance of stock, elect officers, and adopt the bylaws. The directors may also want to approve a corporate seal, authorize the opening of one or more bank accounts, and make other decisions relating to the startup of the business or its transition into corporate form.

2.4 Federal Tax Identification Number. You should apply for a federal tax identification number ("TIN", also referred to as an "employer identification number" or "EIN"). This is usually done by your accountant, but we can also do this for you. You can apply for a TIN yourself online on the IRS' web site. To do this, point your web browser to <http://www.irs.gov/businesses/small/article/0,,id=102767,00.html>. By doing it online, the number is usually given immediately, without having to wait for a fax or a letter. We recommend getting this number immediately because you will not be able to open a bank account or complete other registrations for the company without a federal tax identification number.

2.5 Business Registration. All businesses formed with the Nevada Secretary of State must file a registration form. This is sometimes referred to as obtaining a state business license. The registration is mandatory, and you cannot form a new business without obtaining the state business license and paying the fee.

2.6 Business Licenses. You must comply with all applicable local ordinances in the operation of the company's business. In addition to the state business license process handled through the Nevada Department of Taxation, you must contact city or county authorities to make sure that you obtain the appropriate business license required for your business operations. A good place to look for information is the Nevada website for businesses: <https://www.nvsos.gov/sos/businesses>. To make sure you have the most up-to-date information, you should contact each city and county in which you intend to do business to

make sure you have all applicable local business licenses. Many have that information posted on the Internet.

2.7 Trade Names, Trade Marks, Copyrights, and Patents. You cannot operate a business using a name of a company or product that is the same or "deceptively similar" to the name already in use by another individual or business. Similarly, you cannot conduct business in violation of applicable copyright and patent law. You are responsible to make sure you are not infringing on the rights of others, and you may need to take steps to discourage others from violating your rights, and to do this, it may be advisable to engage a patent and trademark attorney.

2.8 Employees. You must follow federal, state, and local laws relating to employment, payroll taxes, workers' compensation insurance, occupational safety, and all other laws and regulations relating to employees. If you have Nevada employees, you must register with the Employment Security Division. For many companies, this can be done online at <http://ui.nv.gov/ess.html>.

2.9 Out-of-State Registrations. If any of the company's operations are outside of Nevada, you will need to comply with the laws of each state in which the company is doing business. Each state defines what constitutes "doing business" differently, but usually merely owning an out-of-state asset does not constitute doing business. If you have out-of-state employees or if your representatives are located in another state and deal directly with clients or customers in that state, you are doing business in that state, and you must apply for authority to conduct business in that state through that state's Secretary of State, department of taxation, local business license offices, and other state agencies. This office cannot advise you with respect to the laws of states other than Nevada.

2.10 Stock Issuance. Stock certificates should be issued to each stockholder. Each person receiving stock must pay for the stock, but the payment can be in almost any form, including promissory note and services.²

3. MAINTENANCE: A corporation requires maintenance. If it is not properly maintained, it may be ignored. If you need assistance with any of this, please contact us or another qualified professional.

3.1 Financial Records. A business' most important records are its financial records. Corporate accounting records should be kept current, and all appropriate tax returns should be filed. The corporation's financial records must be maintained separate from those of any director, officer, or shareholder. The corporation must have a separate tax identification number, which should be used for all corporate transactions and tax returns. Corporate assets, including bank accounts, investments, real property, and vehicles should be titled in the name of the corporation. If a shareholder or employee of the company uses corporate assets for personal use, he or she must either pay rent or recognize taxable income (in accordance with acceptable business accounting practices and in accordance with applicable tax laws). Once the corporation is formed and officially recognized, no one should ever pay a corporate obligation with a personal check, and no one should pay a personal obligation with a corporate check.³

3.2 **Meetings.** The shareholders and directors should meet as often as necessary to hold elections and make decisions, not less than once a year. It is common to have the shareholders' and directors' meetings together or on the same day, and for a closely held business where the shareholders and directors are the same people, the meeting of the shareholders and directors can be a joint meeting.

(a) Minutes of the meetings are kept to record the decisions that are made, usually documented in the form of "resolutions" that are adopted pursuant to parliamentary procedure.

(b) Nevada law permits resolutions to be adopted in the absence of a formal meeting, if a "consent resolution" is signed.

(1) As to decisions made by the board of directors, the consent resolution must be signed by all directors.⁴ This is sometimes referred to as a "unanimous consent resolution".

(2) As to decisions made by the shareholders, the consent resolution must be signed by the number of shareholders that would have been required if a meeting had been held and all eligible to vote had attended.⁵

(c) We recommend that at least once a year the shareholders elect the directors and the directors elect the officers. Of course, the officers and directors can be elected for more than a one-year term, and the election of various directors and officers can be staggered so that all are not elected during any one election. These elections may be done at a meeting or by consent resolution (as discussed in paragraph 3.2(b), above).

4. PROTECTING AGAINST LIABILITY: As stated above, a corporation and not its shareholders is normally liable for the corporation's obligations.

4.1 **The "Alter Ego" Rule.** A corporation will be ignored by the courts if it is deemed to be nothing more than the "alter ego" of its shareholders.

(a) The "alter ego" argument is used by company creditors (whether businesses or individuals) who are owed money by the corporation that the corporation itself is unable to pay. Such creditors want the corporation to be ignored so that they can seek payment from the corporation's owners, and they can be successful in having the corporation disregarded as a legal entity if the corporate formalities are not observed, if personal and corporate assets are commingled, if personal obligations are paid for out of company funds, if company assets are used for personal use without payment or without being treated as part of an employee's compensation, and/or if corporate financial records are not properly kept.⁶

(b) The "alter ego" will not be applied to a corporation that keeps accurate records of its meetings of directors and shareholders, that keeps its financial affairs completely separate from those of its shareholders, that has its financial records regularly maintained or at least reviewed by a certified public accountant, and that makes sure that all business is conducted in the corporate name.

4.2 Co-Obligor vs. Guarantor. For new corporations without a solid net worth and an established business track record, it is common for a company creditor (referring to anyone who extends credit to the corporation) to require a shareholder⁷ whose financial resources are substantial to either be a guarantor or co-obligor with the corporation.

(a) A "guarantor" is one who has agreed to meet the corporation's obligations if the corporation is unable to do so. Traditionally, a guarantor could not be held responsible for a guaranteed obligation unless and until the creditor had exhausted its remedies against the primary obligor, the corporation.

(b) A corporation's creditor may consider the enforcement of a guarantee unnecessarily burdensome, and so it is common for the creditor to insist that the shareholder be a "co-obligor" with the corporation. It is not common to see the word "co-obligor" in a written agreement, but it is common to see a provision that makes the corporation and the shareholder "jointly and severally liable". Such a provision allows the creditor to sue either the corporation or the shareholder or both, and the shareholder could be required to pay the entire obligation even if the corporation is able to do so.

(c) Of course, there are arrangements that amount to a cross between a guarantee and a joint obligation, requiring the creditor to make some attempt to collect the obligation from the corporation first, but not requiring the creditor to exhaust all remedies before turning to the shareholder.

(d) So, while a corporation exists to eliminate a shareholder's personal liability for corporate obligations, a shareholder can negate that protection by signing an agreement that makes the shareholder a guarantor or co-obligor.

5. CONCLUSION: If you are going to establish a corporation, do it right. This will involve the observance of proper legal formalities, and it generally requires the advice of qualified financial and legal advisors.

5.1 Business Formalities. A corporation should not conduct business as a corporation until it has been properly formed under state law. This means, at a minimum, that the Articles of Incorporation must be accepted by the Secretary of State, that the shareholders have met to elect the board of directors and adopt bylaws, and the directors have met to select officers and adopt resolutions regarding the operation of the company's business.

5.2 Financial Affairs. The most important advisor for a corporation is its accountant. Making sure that financial records are properly kept and tax returns are timely filed will go a long way to preserve the corporation's good standing and continued legal existence. Of course, if investments are to be made and maintained, investment advisors should also be consulted.

5.3 Legal Matters. Business operations rely on compliance with the law, and the firm's attorney can assist in discovering what laws apply and how to comply with those laws. In addition, it is a rare business that will not be involved in negotiating, signing, and complying with legally binding contracts. Sometimes it can be penny wise and pound foolish for company officers and directors who are not attorneys to act without advice of legal counsel. Similarly, a

shareholder who is asked to sign an agreement as a guarantor or co-obligor should not do so without advice of independent legal counsel.

NOTE: This memo provides general information only and does not contain legal, accounting, or tax advice. For brevity, this memo is oversimplified and should not be relied on for any particular situation. Nothing in this memo can be relied upon for any specific individual's estate plan or to avoid any tax penalties.

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NOTES

1. The corporation does not protect a shareholder from liability arising from his or her own negligence, nor does it prevent claims against an individual who personally guarantees an obligation of the corporation.
2. Anyone receiving stock for services must report the value of the stock as taxable compensation on his or her income tax return.
3. It can be acceptable for a shareholder, officer, or director to loan money to the corporation or for a corporation to loan money to a shareholder, officer, or director, but only if permitted by the articles of incorporation, bylaws, and a resolution adopted without the participation of the affected shareholder officer, or director (unless he or she is the only one, and even then only if proper documentation is done).
4. NRS 78.315(2).
5. NRS 78.320(2).
6. Legally disregarding a corporation is sometimes referred to as “piercing the corporate veil” to make shareholders personally liable for company obligations. If the shareholders ignore the corporation, so can others. For this reason and others, a home owned by the corporation cannot be used as a residence by a shareholder, officer, or director unless the person using the home pays fair market rent or is treated as receiving compensation or a dividend equal to the fair market rent.
7. Because a guarantor or co-obligor is usually the principal shareholder, the term shareholder is used here in that context, but the guarantor or co-obligor can be anyone with resources acceptable to the creditor.