



Mary Hanson



## About the Business Advisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

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She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

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## HOW TO FORM A CORPORATION THAT IS COMPLETE AND COMPLIANT

by Mary Hanson

**T**he primary reason for forming a corporation is to protect shareholders from personal liability arising from the operation of a business. However, in order to obtain and maintain this protection from personal liability, a corporation must be set up in accordance with legal requirements and must also take steps to maintain its status as a valid separate entity. Proper formation requires more than the filing of Articles of Incorporation.

Here is a checklist for the steps and issues involved in properly setting up a corporation:

- (1) File Articles of Incorporation with the Secretary of State. This begins the corporation's existence, but more needs to be done to establish a corporation capable of withstanding a challenge.
- (2) Unless the directors are named in the Articles of Incorporation, the Incorporator who signed the Articles of Incorporation needs to execute an "Election of Directors," naming the initial directors to make up the Board of Directors. The Incorporator may also adopt Bylaws.
- (3) After the Articles of Incorporation have been filed the Board of Directors needs to take action to organize the corporation, including adopting (or approving) Bylaws, naming the President, Treasurer, and Secretary to serve as officers of the corporation, issuing stock in exchange for the initial capital

contributed to the corporation, approving the opening of a bank account, and authorizing other actions appropriate for the new corporation.

At the organizational meeting other forms may be executed for filing, such as the form for election of S corporation status if this status is desired, the Notice of Transaction to be filed with the Department of Corporations to comply with state securities laws, and the Statement of Information to be filed with the Secretary of State.

The Secretary of the corporation signs minutes of this initial meeting, documenting the actions taken by the Board of Directors at the organizational meeting. If the Board wishes to take actions without a meeting, a "Written Consent to Action Without Meeting" must be signed by ALL the Directors. Holding a meeting is preferable when there are several individuals involved in the formation of the corporation.

(4) Typically the content of corporate bylaws for a California corporation is about 90% a restatement of the provisions of the California Corporations Code, setting out the requirements for calling meetings, holding valid meetings, notice of meetings, voting, corporate records, amendments, and structural topics.

(5) Make certain that stock is issued in exchange for assets or cash. Under California law, stock must be paid for

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*“Compliance with state tax requirements is essential to keeping a corporation in good standing.”*

with funds, assets, or for something of value (including services already provided). A promise to pay money or promise to provide services is not proper payment for stock under California law.

If stock is issued in exchange for assets contributed to the corporation (as is often the case in the incorporation of an ongoing business), make certain that a list of contributed assets is completed and checked with the business’s accountant.

Although assets can be contributed in exchange for stock, it is easier to have shareholders contribute funds and then use the funds to either purchase the assets or reimburse the parties who used funds to purchase assets for the corporation.

It is important that the corporation is adequately capitalized with funds and/or assets, that the amount of capital is properly shown on the corporation’s financial statements, and that the assets intended to belong to the corporation show up on the books of the corporation. Good minutes of the organizational meeting of the Board of Directors document how funds or assets were transferred to the corporation in exchange for stock.

(6) Have stock certificates prepared to document the ownership of the shareholders. The issuance of stock should be reflected in several places: The minutes of the meeting at which the Board of Directors authorized the issuance of the shares in exchange for payment; the stock certificates made out to the shareholders; and the stock ledger, showing each stock certificate and shareholder with the number of shares owned by each.

Make sure the total number of shares issued does not exceed the authorized number of shares stated in the Articles of Incorporation. Shares issued in excess of this number are invalid. Issuance of less than the authorized number facilitates future issuance of shares without the need to amend the Articles of Incorporation to authorize additional shares.

(7) Comply with state and federal securities laws with regard to the issuance of shares. A single owner can take the stance that the stock is not a security because he or she is only investing his or her own funds in a business operated by him or her. At the other end of the spectrum, a corporation that is selling shares of stock to investors or that intends to attract investment funds must be scrupulous in complying with securities laws. A business planning to raise funds from investors should get advice early on in the formation of the corporation to assure that no errors are made or unwise steps taken that might jeopardize future issuances of stock to investors.

For the typical small business which is owned by family members or individuals who established the business together, there are easy exemptions from registration of the stock. A form must be filed with the California Department of Corporations reporting the use of the exemption.

Records must be maintained to show that the exemptions used for the issuance of stock were appropriate for each particular issuance and the particular shareholders.

(8) Obtain a Federal ID Number (the “EIN” or “Employer ID Number”) for the corporation from the IRS. This ID number is needed early in the

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organizational process. It is required by banks in order to open a corporate bank account as well as by the IRS for tax reporting and filing.

(9) If S corporation status is desired, IRS Form 2553 should be filed with the IRS within 75 days of the filing of the Articles of Incorporation. The filing of this form makes the corporation an S corporation, provided that the S corporation status is accepted by the IRS. The form requires the signatures of all the corporation's shareholders (and their spouses, if the shareholders reside in a community property state).

(10) Within 90 days after the Articles of Incorporation are filed, a Statement of Information must be filed with the Secretary of State. On this form the address of the new corporation, the type of business, the names of officers and directors, and the agent for service of process for the corporation are reported. This form must be filed annually. Keep a copy of every Statement of Information filed for your corporation. When you file the form on-line, you need to print out a copy of the form before you submit it. The information cannot be printed or retrieved after the form is submitted.

If any of the information – the address, the directors, the officers, or the agent for service of process – changes or is incorrect, a Statement of Information form must be sent in to the Secretary of State to amend or update the information. The form should correctly list the directors and officers elected at your most recent annual meeting.

Calendar the due date for filing your annual Statement of Information. You are responsible for filing this

annual form by the due date and there is a \$250 penalty for failure to file the form. The due date is the last day of the month of your incorporation.

(11) Establish a plan to hold regular meetings. The legal requirement is for an annual meeting of the shareholders. Plan to hold the annual meeting of shareholders once a year, as required, at which the shareholders elect Directors. Plan to hold a meeting of the Board of Directors following the annual shareholders' meeting. In order to properly function as a corporation, the Board must make corporate decisions. Most corporate Bylaws provide for an annual meeting following the annual meeting of the shareholders.

If other actions are taken by the Board of Directors during the year, record the actions in minutes of the special (not annual) meeting, or have the Directors sign a Written Consent to Action Without Meeting.

Keep copies of all adopted corporate resolutions, whether in minutes of meetings or in Written Consents in your corporate record book.

If you have a number of shareholders or directors who do not get together on a regular basis, plan to send formal meeting notices in order to comply with the requirements of the California Corporations Law. Make sure all your meetings are valid meetings, by taking steps to follow the rules. A corporation with only one shareholder has no problem, but if there are more shareholders, each shareholder needs to receive notice of a meeting (or sign a waiver of notice) for each meeting. The use of "templates" is recommended because of the many "rules" that apply to corporate meetings, but such



*“Make sure  
all your  
meetings  
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the rules.”*

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## Publisher's Note

In a long-lived corporation with a lot of shareholders, keeping an accurate stock ledger is especially important. Since transfers of shares from existing shareholders are NOT an issuance of stock and do not normally require any approval, authorization, or other action by the Board of Directors, there might be no meeting minutes mentioning a transfer, and the stock ledger may be the corporation's primary source of information on transfers by shareholders and current share ownership.

The person maintaining the stock ledger and stock certificates has to be tough in requiring shareholders to provide accurate information. Where stock is transferred to a trust, the exact name of the trust and the names of the trustees as shown on the trust should be correctly stated in the ledger.

This person also needs to be aware of restrictions on transfer and avoid transfers in violation of restrictions, whether arising from shareholder agreements, corporate bylaws, Articles of Incorporation, or restrictions imposed on the shares when they were issued.

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templates need to accurately reflect the requirements of California law and the particular corporation.

(12) Work with an accountant familiar with the corporate tax filing requirements to assure proper reporting, filing, and payment of taxes to state and federal tax agencies. Compliance with state tax requirements is essential to keeping a corporation in good standing.

(13) Maintain an accurate stock ledger, especially once there are any changes in ownership. The stock ledger should be an accurate and convenient record of all stock issued and all transfers of stock, including every stock certificate by number, the name of the holder of the certificate, the number of shares evidenced by

that certificate, the date the holder became the owner of those shares, and the date and to whom those shares were transferred. Beginning with the original issuance of shares, it should be possible to determine who holds every share of outstanding stock in a corporation.

Proper formation, capitalization, compliance with required corporate filings, tax reporting and payment of taxes are necessary to establish and maintain the "corporate veil" that protects shareholders from liability arising from the business of the corporation. In addition, proper corporate records avoid disputes and misunderstandings regarding ownership, control, and the validity of corporate actions.

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