

Your Business as a House

Jeffrey S. Waldron
Fall 2013 Firm Newsletter
09.03.2013

The wise man builds his house on the rock, but the foolish man builds his house on sand. The rain will come down, the streams will rise, and the winds will blow and beat against that house; yet it will not fall, because it had its foundation on the rock.

In a lot of ways, a business is like a house. For each, shortcuts, inadequate planning, and poor maintenance can cause significant problems. The legal elements and procedures involved in establishing a business can be complex and confusing. The analogy to a house provides a simple framework to help clarify the roles of various documents in forming the business and maintaining its legal structure.

For example, for a corporation:

- The articles of Incorporation establish the corporate existence. Like the foundation and framework of a house, the Articles contain the basic, defining characteristics of the business.
- The Bylaws function like the internal systems of a house, such as the electrical and plumbing systems. The Bylaws set forth the rules and practices under which the corporation self-regulates.
- The Control Agreement's role in a corporation is analogous to house rules for the occupants, defining the shareholders' rights to control the business and their economic relationship to it.
- The Buy-Sell Agreement establishes the doors of a house, the Buy-Sell Agreement controls exits from the business.
- The corporation's liability shield functions like a roof over the business, keeping its occupants safe from the elements. With careful planning and regular maintenance, this "roof" protects shareholders from personal liability for the debts and liabilities of the business.

1. Foundation = Articles

The Articles of Incorporation typically include the following:

- The company's name and registered office and agent for service of legal process.
- The classes of stock and the number of shares that the corporation has the authority to issue.
- The names of the corporation's initial board of directors.
- The limitations on director liability to the corporation or its shareholders.
- Whether and to what extent the board or the shareholders may take action in writing in lieu of a meeting.

- Special defining characteristics, such as preemptive rights or cumulative voting.

Just like laying the foundation of a house, forming an entity may seem conceptually simple, but there are traps for the unwary that can result in significant problems. For example, an organizer who forms an entity but fails to properly transfer authority to the company's new board of directors renders the corporation unable to take any legal action. This problem can be difficult and expensive to fix, particularly after the corporation has attracted investors, obtained bank financing, or been sold to a third party. In addition, the problem might cause the corporation's liability shield to fail.

Maintenance Items

- Keep the corporation's registered office and agent up to date to ensure that the corporation receives prompt notice of legal, tax, and other matters.
- Adjust the classes and authorized shares of stock, as needed, to help prevent disruptive and expensive challenges to stock ownership.

2. Internal Systems = Bylaws

The Bylaws primarily:

- Establish the authority and duties of the corporation's officers and directors.
- Govern the process for shareholder and board meetings, including notice, attendance, and frequency requirements.
- Establish the required books and records of the corporation.
- Set forth the corporation's indemnification obligations to officers and directors.
- Establish procedures for electing or removing officers and directors.

A properly utilized, thorough, and cohesive governance system avoids "faulty wires" and, potentially, costly fires. For example, consider a circumstance where an action requiring shareholder approval does not have unanimous support. The Bylaws set forth the procedures for calling a meeting on the action, giving notice to shareholders, and conducting the meeting. Adhering to those procedures helps ensure that any action or inaction is not subject to challenge by a dissenter due to procedural failures. Moreover, following the proper procedures when making decisions helps insulate directors from claims that, by action or inaction, they breached their duty of care to the corporation.

Maintenance Items

- Review the procedures set forth in the Bylaws regularly to ensure that the corporation is functioning properly.
- Take action by calling meetings or executing written actions when necessary in accordance with the procedures set forth in the Bylaws.

- Amend the Bylaws as needed for changes in business operations.

3. House Rules = Control Agreement

A Control Agreement can be utilized for various purposes, including:

- Establishing special voting or governance items, such as veto or board representation rights.
- Establishing economic agreements among the owners, such as when and how distributions are made.
- Setting forth confidentiality and non-compete obligations.
- Providing for additional contributions by shareholders, including the conditions under which such contributions can be required.
- Setting forth terms and conditions for admitting additional shareholders.
- Establishing other specific agreements between the shareholders.

Anyone who has ever had roommates quickly learns the importance of living together under clearly established expectations and guidelines. The Control Agreement is used to customize shareholder governance and economic relationships. Unlike the Bylaws, the Control Agreement must be agreed to by all shareholders, including anyone who has signed a subscription or contribution agreement. Amendments to a Control Agreement typically require unanimous approval.

A Control Agreement is binding on all shareholders, including all persons who subsequently become shareholders, but only if they have knowledge of the existence of the Control Agreement. The best practice is to have a new shareholder expressly agree to be bound by its terms. A Control Agreement is not enforceable against a new shareholder who has not signed it and is not aware that it exists. For that reason, a Control Agreement must be filed with the corporate records, and the corporation's stock certificates must include a notation indicating that a Control Agreement exists.

Due to the flexibility available with an LLC, a Control Agreement is especially important. A corporate structure is more rigid, thus a Control Agreement may not be necessary unless the owners have specific guidelines they want to establish.

Maintenance Items

- Communicate the Control Agreement's control provisions to all shareholders.
- Review the Control Agreement regularly to ensure that the shareholders understand corporate governance and economic matters.
- Amend the Control Agreement as provisions.

4. Ingress and Egress = Buy-Sell Agreement

The Buy-Sell Agreement addresses the ways to exit a business, each highly customizable based on the desires of the parties:

- When and how shareholders can transfer their ownership interests.
- The events that will give rise to an option or an obligation by shareholders or the company to purchase a shareholder's interest. Typical triggering events are death, a proposed transfer to a third party, and involuntary transfer events, such as bankruptcy. If the shareholders are actively involved in the business, disability and termination of employment may be desirable triggering events for a buyout.
- The purchase terms in the event of an option. Specifically, a Buy-Sell Agreement will include provisions for determining the purchase price. Different approaches include a pre-agreed value that is updated on an annual basis, an appraisal, a formula, or some combination of these.
- The Buy-Sell Agreement can also include more tailored provisions, including rights of minority shareholders to participate in a sale of the business by the majority, or forced sale provisions in the event a shareholder wants to exit the company.

In a business, it is crucial to clearly establish how a shareholder exits the company, whether voluntarily or involuntarily. The failure to clearly establish exit procedures on the front end may result in shareholders punching their way out of the business, or being squeezed or forced out. Without clear procedures, exits can be messy and expensive.

When moving into a house with roommates, one knows them, may trust them, and likely wants to live with them – but not necessarily with their families or their creditors. A properly drafted Buy-Sell Agreement also prevents shareholders from being forced into a business relationship with someone through death, bankruptcy, or voluntary transfer.

Maintenance Items

- Review the Buy-Sell Agreement regularly for events that trigger a purchase option or obligation and the procedures that apply to such events.
- Review any purchase price formulas to ensure that the business's operations or financial structure has not changed in such a way to render the formula obsolete or unworkable to determine true value.
- Coordinate insurance coverage with buy-out obligations.

5. Roof = Liability Shield

If the roof of a house is not properly installed and maintained, it will spring a leak, causing much damage to the interior. The roof of a corporation is the liability shield, which protects the owners from the rough winds of operating an active business.

When determining whether to pierce the liability shield of a corporation, among other things, courts consider whether corporate formalities, such as abiding by the Bylaws, have been observed; whether adequate corporate records are being kept; and whether shareholders treat the corporation as a

separate entity from their personal affairs. If a corporation is not properly designed and maintained, the liability shield will fail, exposing shareholders to personal liability for the business's debts and liabilities. This can be disastrous.

Maintenance Items

- Always use the full legal name of the corporation including, for example, "Inc." or "Corp.," or use a validly registered assumed name. This puts the world on notice that your entity has a liability shield in place.
- Hold meetings or execute written actions, as appropriate, to re-elect directors and officers annually.
- Authorize or ratify any distributions in a written action affirming that the corporation has sufficient assets to pay its debts after making the distribution.
- Ensure that assets used in the business are properly titled in the name of the business. Related entities utilizing the same assets or personnel should do so by agreement. The key to preserving the liability shield is to treat related companies as separate businesses from each other and from the owners.
- For actions outside of the ordinary course of business, consult with legal counsel as to whether resolutions of the board or the shareholders are appropriate.
- Understand and observe the procedures established under the Bylaws and the Control Agreement.
- Keep good corporate records showing a clear delineation among the shareholders, the business, and any related businesses.

This article focuses on corporations, although the analogy to a house is useful for virtually any type of business entity. A business with a solid foundation and regular maintenance is a business built to last.

Practice Areas

Business Law