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Overdue Diligence: How Failure to Keep Corporate Records Can Cost Insiders

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Although maintaining an up-to-date corporate minutebook is of vital importance to a corporation and its officers, directors and shareholders, our experience with many corporations is that maintaining the minutebook is often dangerously neglected. Frequently, entries are made at irregular intervals, if at all, and only when necessary to comply with specific banking or lending requirements for loan authorizations or other transactions.

One of the key advantages of operating as a corporation is that generally shareholders and officers are not personally liable for the debts of the corporation. This protection is only maintained, however, if the corporation observes certain formalities. If the corporation conducts its affairs as if it is an unincorporated business, the shareholders, directors, and officers may find that they can be held personally liable. There are several potential problems that may arise from the presence of outdated or nonexistent corporate records. This article will highlight some potential dangers and detail how a corporation may prevent them from occurring.

About the photo: Associate Patrick A. Sadowski at our new Findlay office.

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State Law Requirements

The most fundamental reason that a corporation should maintain its minute books is that it is illegal not to. Ohio law requires each corporation to keep correct and complete books and records of account, together with minutes of shareholders and directors meetings, and records of its shareholders showing their names and addresses and the number and class of shares issued or transferred. These requirements come into play if the records ever need to be examined, as in the proposed sale of a shareholder's interest or the sale of the corporation's assets. The corporation is required to allow a shareholder to examine the articles of the corporation, its regulations, books and records of account, minutes, and records of shareholders if the shareholder presents a written demand to do so for a reasonable and proper purpose. A due diligence request from a potential purchaser would be such a proper purpose.

The statutory penalty for failing to keep the books of account, minutes, proceedings or records of shareholders as required by law is one hundred dollars, plus after the fifth day a shareholder submits a written request that the corporation comply with the statute, ten dollars a day for every day that the violation continues. This amount is payable to every shareholder making such a request, and can be recovered from both the corporation and any officer responsible for maintaining the books simultaneously, in addition to any other remedy the court may allow. The clear lesson is to observe corporate formalities and to make sure that everything is in the minute-book that should be there.

Piercing the Corporate Veil

Potentially the most damaging financial hazard for shareholders is for a court to determine that the corporation is the mere "alter ego" of the principals, and thereby permitting a court to "pierce the corporate veil" and hold the principals personally liable for the debts and claims against the corporation. This is permissible where a shareholder's control is so complete that the corporation has no separate mind, will or existence of its own. The lack of an up-to-date minutebook may be the basis for alleging that the business was corporate in form only and not in the day-to-day operations.

The court in *Pikewood Manor, Inc. v. Monterrey Concrete Construction*, listed several factors considered in the alter ego test. Two of the relevant factors are: (1) whether corporate formalities were observed; and (2) whether corporate records were kept. In that case, the two shareholders were held individually liable because they had never held any formal meetings, maintained any corporate minute books nor taken any formal action in writing. By failing to perform the corporate formalities, not only is a shareholder or director risking the success of the business, but also, personal financial security as well.

I.R.S. Considerations

While the Internal Revenue Code does not specifically require the keeping of minutes, the Code does require the keeping of adequate records. In a closely held corporation, this requirement may become central if the corporation is ever challenged for the deduction of an officer's salary. The Code allows a business to deduct from its taxable income a "reasonable allowance" for salaries or other compensation for personal services actually rendered. The IRS could allege that the money paid to a shareholder-officer was really a taxable dividend disguised as deductible reasonable compensation, or simply that the amount paid was unreasonable. Without appropriate records, it is extremely difficult to rebut this claim. Accurate minutes can reveal the background of transactions and justify the position of the corporation upon later audit by the IRS.

How to Comply

Ohio law requires that shareholders meet at least once a year to elect directors and to consider annual financial statements. The shareholders may call special meetings as long as the required notice is given to all shareholders. If the shareholders are sufficiently informed, it may be advisable to ratify all actions of the directors which have occurred since the last shareholders' meeting. Usually the directors meet immediately following their election at the annual shareholders' meeting . At that time they elect the officers for the coming year. In most corporations, the directors will meet more frequently than the shareholders since all authority to actively conduct the business of the corporation is vested in its board of directors. The board not only elects the officers, but also, delegates specific authority to the officers. Directors actually do not carry out decisions, but they determine policies and the specific direction which the officers must follow.

A Simpler Method

Ohio Corporations have available to them a statutorily provided option of taking "action without a meeting." This permits the shareholders or the directors to take action without sending out notices of a meeting, having proof of notices, conducting roll calls and formal motions, resolutions, and votes. All the shareholders or all the directors, however, must agree on the specific action and must sign the minutes. For example, if all the shareholders agree, they may elect new directors by simply signing minutes which reflect their unanimous decisions. These must, of course, be inserted in the minutebook.

Contents of the Minutebook

What should the minutebook contain? The minutebook should contain the initial formative minutes of the incorporators (who in effect formed the corporation), the articles of incorporation (this represents its authority from the State to exist), and a Code of Regulations (adopted by the shareholders which describes the internal rules as to how the corporation will function). The board of directors may have bylaws which are not inconsistent with the Code of Regulations. Most importantly, the minutebook should contain the minutes of the annual and special shareholders' meetings and the directors' meetings.

Corporate activities that should be covered by minutes include the following:

1. election and re-election of directors and officers;
2. declaration of dividends;
3. increase or decrease in executive compensation;
4. authorization of bonuses to officers;
5. authorization of profit-sharing plan contributions
6. making tax elections;
7. decisions having tax consequences (including reasons for accumulating earnings);
8. authorization for future corporate action;
9. discussions of sound business purposes for certain corporate acts;
10. authorizations for pension and profit-sharing plans;
11. authorizations for deferred compensation plans; and
12. authorizations for loans from lending institutions.

For all of the reasons previously listed, it is important to document when the above items occur and the reasons behind them. The lack of an up-to-date minutebook with proper entries can be not only embarrassing, but costly to the officers, directors and shareholders. No matter how small or closely-held your corporation may be, and regardless of how informally it operates otherwise, the best advice is to "go by the book" when preparing minutes.

Frank D. Jacobs is a member of the Firm. His practice emphasizes estate planning, general tax planning, charitable planned giving, business structuring, business succession planning and qualified retirement plans. Mr. Jacobs is accredited by the Ohio State Bar Association as a Certified Specialist in Estate Planning, Trust & Probate Law.

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