



INCORPORATION 101

Part I: Understanding the Corporation

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These days an increasing number of small business owners are incorporating their sole proprietorships and partnerships. Most do so to take advantage of the favourable tax rates and limited liability available to corporations. There's a lot more to incorporating than meets the eye however, so for the next three weeks Legal Briefs will serve as a crash course in corporate law. This week we're getting down to basics, examining the concept of the corporation. Next week in Part II, we'll examine how to incorporate and will set out some basic terminology. Finally, Part III will focus on running a closely held corporation, and will provide tips for avoiding problems with the Canada Revenue Agency and maintaining limited liability.

What is a Corporation?

A corporation is a separate legal entity that enjoys most of the legal rights available to natural persons like you and I. For example, corporations can own property, enter into contracts, commit crimes and tortuous acts, and declare bankruptcy.

The biggest difference between a corporation and a human being, and the most unnerving, is that while all human beings eventually die, a corporation can exist forever, so long as the necessary paperwork is filed with the government.

The Corporate structure is composed of three main parties – the Shareholders, Officers and Directors. Shareholders invest money in the corporation and in return receive Shares. The money invested by Shareholders is then used by the corporation to further its business and (hopefully) to make a profit. If the corporation does make a profit some of that money may be divided amongst the Shareholders as a reward for investing in the corporation. These rewards are known as dividends. If the corporation loses money however, the value of its shares falls and its Shareholders may lose some or all of their investment.

In addition to receiving dividends, depending on the types (or classes) of shares they own Shareholders may also be entitled to receive a portion of

the corporation's value upon dissolution (winding-up), and may have the right to vote on certain matters. For example, Shareholders vote to elect and replace a corporation's Directors. Directors are responsible for managing and supervising the corporation's operations, and decide what direction the corporation will take. The Directors in turn appoint the Corporation's Officers, such as the Chief Executive Officer, Treasurer, etc., whom are responsible for the corporation's day to day operations, and implement the Directors' overarching plan for the company.

In medium to large size corporations the Shareholders, Directors and Officers are separate individuals with little to no interaction. In a small, closely held corporation however 1 person may be the sole Shareholder, Director and Officer. They may also be an employee of the corporation. Needless to say, this can become very confusing for that individual!

Because a corporation is a separate legal entity its debts,

liabilities, obligations and assets are its alone, and not those of its Shareholders, Directors or Officers. This means that if a corporation goes bankrupt or is found liable of a tortuous act, creditors or plaintiffs can only go after the corporation's assets. Creditors or plaintiffs cannot seek repayment or judgement against a Shareholder, Officer or Director personally. This means that the most a Shareholder stands to lose is their investment in the corporation. This concept is known as limited liability, and will be examined in greater detail in Part III of this series.

For a more in depth discussion of how incorporating will affect you and your business, be sure to contact your lawyer and accountant.