

---

October 2004

# How to Form a Subsidiary

\* \* \*

## Isolating the risks of your products

By Dirk Bartram

A subsidiary company can substantially reduce the overall risk of any enterprise that operates two or more divisions. Forming a subsidiary requires planning and diligence, but is relatively straightforward.

Let's consider a hypothetical manufacturing company located in Washington called Carlson Electronics, Inc. It began business by manufacturing electronic components for commercial marine applications. It later got into the business of manufacturing electronic components for aircraft. Though no claims have arisen from the aircraft business, the management team thinks that it's a riskier enterprise than the marine business. The team figures that insurance may not fully cover the risks, and wants a strategy to reduce risk.

**Step 1. Plan the corporate structure.** As the company is currently structured, a creditor can reach the marine business assets to satisfy liabilities from the aircraft business. The reason is that all of the assets are owned by the same legal person—Carlson Electronics. Management decides to insulate the marine business from the liabilities of the aircraft business. To accomplish this, Carlson Electronics will form a subsidiary corporation called Carlson Air, Inc. and transfer the aircraft business to it. Carlson Air will then operate the aircraft business, with Carlson Electronics as its parent company.

**Step 2. Discuss the plan with lenders and customers.** Carlson Electronics' bank loan is secured by the corporation's assets, so Carlson Electronics discusses its reorganization plan with its banker. The banker likes the idea of insulating assets from liability, and authorizes the transfer of the aircraft division down to Carlson Air. Carlson Electronics agrees that the bank will keep its security interest in the aircraft division assets.

Carlson Electronics also has a contract with a major customer to supply aircraft electronics. The customer agrees that the contract may be assigned to Carlson Air, provided that Carlson Electronics continues to guarantee performance of the contract. Management knows that this guarantee will cause the parent company to remain liable under the contract, but it's willing to agree to keep the customer happy. Carlson Electronics will try to avoid signing performance guarantees for Carlson Air in future contracts.

**Step 3. Form the subsidiary.** Carlson Electronics has its legal team draft articles of incorporation for the subsidiary and file them with the state. It signs and adopts bylaws and initial resolutions. Carlson Air issues all of its stock to Carlson Electronics, making Carlson Electronics the parent company of Carlson Air. As Carlson Air's sole shareholder, Carlson Electronics elects directors to Carlson Air's board of directors. The board then selects Carlson Air's officers. Carlson Air obtains a new federal tax identification number and secures the necessary local licenses.

**Step 4. Transfer the business.** At the same time that Carlson Electronics receives all of the subsidiary's stock, Carlson Electronics transfers the aircraft business to the subsidiary. This includes manufacturing equipment and inventories, and would also typically include accounts receivable and accounts payable. Carlson

Electronics also assigns to Carlson Air the registered trademarks and patents used in the aircraft business, and Carlson Air registers those assignments with the U.S. Patent and Trademark Office. Carlson Electronics contributes \$200,000 to Carlson Air to be used as working capital. Carlson Air grants to Carlson Electronics' bank a security interest in its newly transferred assets.

**Step 5. Establish the books.** Carlson Air establishes a new accounting system so that it can produce its own separate income statements, balance sheets and other financials.

Carlson Air is now set up for business. The marine business is now better protected from the aircraft business liabilities, because the aircraft business is owned by a separate legal person—Carlson Air.

### ***How to insulate both businesses from each other***

But what if management also wished to protect the aircraft business from future marine business liabilities? Would the structure it set up above accomplish that goal? No. The reason is that Carlson Electronics, which owns the marine business, also owns all of Carlson Air's stock. Plaintiffs who are harmed by Carlson Electronics' marine business can reach all of Carlson Electronics' assets, including the Carlson Air stock.

A different structure should be created to insulate both businesses from the liabilities of each other. To accomplish this, Carlson Electronics would set up another subsidiary called Carlson Marine, Inc. and follow steps 2 through 5 above to put the marine business into Carlson Marine. At the end of Step 5, Carlson would be only a holding company, and Carlson Marine and Carlson Air would be its wholly owned subsidiaries. With this structure in place, Carlson Air will be better protected from liability arising out of the marine electronics operation.

### ***Bad Conduct and Taxes***

As you might imagine, the formation of subsidiaries won't insulate against wrongful or abusive conduct. For instance, if a subsidiary is created to evade liability that has already arisen, a court will probably ignore the existence of the subsidiary when fashioning an award for the plaintiff.

Also note that not every corporate reorganization is tax-free. Consult a tax advisor before reorganizing your business.

© 2004 Henke Bartram PLLC

*All articles are intended for general information purposes only and should not be construed as legal advice. You should contact us or your attorney to obtain advice on any particular issue or situation.*