PERKINS LAW PLLC

Compliance Tips for Virginia Business Startups

Once your business entity formation filing has been approved by the Virginia State Corporation Commission ("SCC"), there are a variety of requirements and "best practices" that will help maintain your company's status as a separate business entity under Virginia law. Failure to comply with proper business entity formalities can result in a wide variety of problems, including termination of an entity's existence and individual liability to the owners.

General Legal Considerations

1. Read and understand your company's organizational documents. For a corporation, this generally includes Articles of Incorporation and Bylaws. For a limited liability company ("LLC"), this generally includes Articles of Organization and an Operating Agreement. These documents govern the overall operation and management of the company. By all means, keep your governance documents organized and stored in a safe place.

2. Obtain a state sales tax permit if the company will engage in retail, rental, or other business activities requiring a sales tax permit under Virginia law.

3. Depending on the type of business or activity that your company may be engaged in, it may be subject to certain state licensing requirements or be required to pay certain fees or occupational taxes.

4. Be familiar with the company's employer identification number (referred to as a federal "EIN" or taxpayer identification number), as it will be needed for a variety of business and tax reasons (e.g., opening a bank account for the business).

5. Funds collected by the company for income tax, social security, and other withholding taxes must be paid according to the provisions under the Internal Revenue Code and state and local tax regulations. Otherwise, persons who are responsible for the withholding and deposits can be held personally liable for nonpayment. This liability is separate and distinct from the liability imposed upon the company as employer, and is perhaps the most common source of major trouble for small business owners. For most small businesses, it is advisable and cost-effective to outsource payroll tax withholding responsibilities to a third

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party firm. Check with your accountant or us for recommendations on payroll service providers in the area.

6. The SCC imposes an annual registration fee and annual report filing requirements on corporations (LLCs must pay an annual registration fee but are not subject to an annual report filing requirement) for the privilege of doing business in Virginia. If your company fails to timely satisfy these requirements (both of which can be administered online), the SCC will impose penalties and, following a grace period of several months, terminate the company's existence as a matter of law. Reducing this risk is one reason business owners often retain Perkins Law for registered agent/entity maintenance service. For an annual fee, Perkins Law will serve as registered agent for your company and coordinate payment of SCC annual fees and filing of SCC annual reports.

7. If your company will be known as, or transact business under, any name other than the exact entity name as stated in its Articles, then it must file a trade name or fictitious name certificate at both the local and state levels. The filing fees typically are under $15.

8. Observe proper formalities concerning compensation paid to its shareholders. The Internal Revenue Service ("IRS") has the power to disallow deductions of the corporation for monies paid in excess of what is considered as "reasonable compensation" paid to shareholders based on the person's efforts and contributions to the business. While LLCs offer greater flexibility relating to corporate formalities, separate business entity formalities remain important to demonstrate the separate legal existence of the LLC separate and apart from its owners. Company actions should be approved in accordance with its governing documents, signature blocks should be carefully and accurately prepared, and company funds should not be commingled with personal funds of the owners. In other words, always respect the separate legal existence of your business entity.

9. At a minimum, corporations should hold a shareholders meeting and directors meeting each year. The corporation's Bylaws usually specify the date for the annual meeting or give the discretion to the Board of Directors to set a date for the annual meeting. You should discuss and review the business activities that have transpired during the previous year at the annual meeting, and you should approve any necessary resolutions regarding corporate actions. You may also find it necessary to hold additional shareholder and director meetings during the year. Instead of actual meetings, it is far more common for small business owners to memorialize official actions by the written consent of the shareholders or directors. Minutes of these meetings and the actions by written consent, setting forth the resolutions approved and other matters, should be kept in the company's official minute book. As part of its flat fee business entity maintenance service package, Perkins Law will assist with the preparation of the requisite resolutions, consents, and minutes as needed.

10. You should at all times do business under the entity name exactly as specified in the Articles and not deviate from this name unless an appropriate fictitious name certificate has been filed at the local and state level. Accordingly, letterhead, business cards, invoices, receipts, and other company documents should reflect the legal name of the company.

11. Whenever a person signs on behalf of the company, he or she should add his or her title next to the signature so that it will be clear that the individual is acting on behalf of the entity rather than in his or her individual capacity. For instance, if you sign a contract and fail to state your relationship to the entity next to your name in the contract, it is possible that you will risk personal liability for that contract. Typically, only the corporation's officers are authorized to bind the corporation. An example of a typical signature block for a Virginia corporation would be:

    Worldwide Pants, Inc., a Virginia corporation

    By: _____
    David Letterman, President

12. The business entity's bank accounts should be opened in the legal name of the entity. Any loans or banking activities should be conducted in the name of the entity rather than your individual name or you may risk personal liability for those obligations. If a loan is made, you should have the loan approved by the owners or directors, as provided in the entity's governing documents, and reflect the approval in an appropriately drafted resolution that is adopted and inserted into the official minute book. This is particularly important if the lender requires you to endorse or guarantee the loan personally.

13. All leases, contracts, and other arrangements regarding the company's equipment, office premises, and furniture should be in the name of the company.

14. All significant business transactions should be approved by the owners or directors per the company's governance documents, and adopted pursuant to a properly prepared resolution that is adopted and inserted into the company's minute book. Examples of items which should be so approved include such things as employment contracts, buy-sell agreements, profit sharing and pension plans, trust agreements, loans, certain leases, major purchases, the issuance of additional shares of stock (for a corporation) or membership interests (for an LLC), and important decisions that could materially affect the capital structure or finances of the company.

15. If the corporation opens an office, acquires property, or conducts substantial activities in another state, it may be required to qualify as a foreign entity for authority to do business in that state. This typically entails filing an application, designating a registered agent in that

state, and paying initial and annual fees in that state. Failure to qualify may prohibit the company from suing to enforce its contracts in that state, or from receiving actual notice in the event the entity is sued in that state.

Working with an Accountant

An accountant with an active practice representing entrepreneurs and small businesses will be a valuable part of your advisory team. The sooner such a relationship is established in the life of a new business entity, the better.

Ideally, an accountant will be involved with choice of entity (e.g., corporation versus LLC) decision and regarding all of your entity's important business activities, such as tax elections, transfers of accounts receivable, and the payment of accounts payable. All assets transferred by you or other owners to the company should be appropriately entered upon the company's books by its accountant.

Your accountant should advise you if the company's first fiscal year should end on a date other than the calendar year-end, whether to use the cash or accrual accounting method, and of all matters related to the preparation and filing of tax returns.

Miscellaneous Issues to Consider

1. If the business was previously operated as a sole proprietorship or other form of business entity, any loans made in the business should be transferred to and assumed by the new company, when and if your accountant determines that no material adverse tax consequences will result from such assumption of liability.

2. New loans made after you commence business as an LLC or corporation should be made in the name of the company, even though you may be required to serve as a personal guarantor for the obligation. Small business owners typically are required to personally guarantee significant loans and other contractual obligations.

3. Whenever such a loan is made, it should be approved by a meeting or written consent of the owners in accordance with the company's governance documents, and the appropriate resolution adopted and inserted in the official minute book of the company.

Personal Liability Issues

One of the major advantages of conducting business activities through a separate legal entity is the limited liability protection afforded to the owners of the entity. Owners of an LLC or corporation will not normally be personally liable for debts and obligations of the business beyond the amounts invested in the company. Preservation of the owner's limited liability

protection depends to a large extent, however, on the proper observation of business entity formalities.

If the activities of a business entity are conducted without the requisite approvals, procedures, and documentation, if accurate records are not maintained, or if an owner carelessly commingles personal assets with those of the business, an adverse party may be able to successfully "pierce the corporate veil" and a court may choose to disregard the separate existence of the business entity and hold its owners personally liable for the company's obligations. If this happens, creditors of and claimants against the business entity could reach the personal assets of the business owners.

To demonstrate observance of proper business entity formalities, it is important that all significant business transactions be reflected in minutes of meetings or written consents/resolutions of company owners or authorized representatives, as applicable, even where there is only one shareholder, director, manager, or member.

LLC and Corporate Terminology

The owners of a Virginia stock corporation are referred to as shareholders, while owners of a Virginia LLC are referred to as members. As a general matter, directors control the policy of a corporation, and officers and staff put that policy into effect. For LLCs, either the members control the policy and day-to-day activities of the company (also known as a "member-managed" LLC) or certain authority is delegated by the members to one or more managers or managing members of the LLC (also known as a "manager-managed" LLC). LLC owners are also free to appoint officers to act on behalf of the LLC, so a business owner has tremendous flexibility in structuring a management and governance structure for the company.

Principles of corporate governance for Virginia corporations are relatively more stringent and bolstered by a developed body of case law and legislative history. For example, a corporate director may not delegate his or her authority (e.g., a director may not give someone else his or her proxy to vote at a meeting of the directors). However, an officer may delegate his or her responsibility and authority, unless the company's governance documents specifically provide otherwise.

Corporate shareholders elect the directors, and then the board of directors appoints the officers. The officers of a corporation serve at the pleasure of the directors. Even though an officer may have an employment contract that provides him or her with rights to compensation, he or she may be removed from office at any time by the directors, notwithstanding the fact that he or she may continue as an employee. A director, on the other hand, may be removed only upon the action of the shareholders or directors under specific and special procedures. A director or officer may resign at any time. The corporation's Bylaws will, to the extent necessary, set

forth the rules and process for the election, appointment, removal, resignation, and replacement of directors and officers.

Shareholders or directors have the power to declare dividends, not officers. Directors establish salaries for the officers, not the shareholders. Before declaring dividends, however, it would be wise to consult with your accountant since there are complicated tax factors that must be taken into consideration upon the declaration of dividends, particularly if the company is taxed as an "S" corporation.

Statutory Liabilities of Corporate Shareholders

Set forth below are several statutory obligations of corporate shareholders under the Virginia Stock Corporation Act:

1. Improper Dividend. A shareholder who knowingly receives any dividend, distribution, or payment made contrary to law or the corporation's Articles of Incorporation is liable to the corporation for the amount received in excess of the amount that could have been paid or distributed without violation of law or the articles.

2. Post Corporation Acts. A shareholder exercising corporate rights, privileges, and authority under the Articles of Incorporation after the Articles have been cancelled or after the corporation has been dissolved may be subject to personal liability for any such obligations incurred.

3. Sale of Stock. A seller of shares may be personally liable for the recovery of the purchase price and punitive damages if the sale of such shares is in violation of applicable securities laws. A shareholder may not sell shares in an insolvent corporation without disclosing the financial condition of that corporation.

4. Sales and Use Taxes. In certain situations, a shareholder having control of more than one-third of the shares of a corporation may be held responsible if the corporation fails to report and remit any required state sales and use taxes.

5. Environmental Hazards. The federal Comprehensive Environmental Response Compensation and Liability Act ("CERCLA") imposes a liability on "owners and operators" for the clean-up costs associated with spills, discharges and releases of hazardous substances. It has been the practice for the United States Environmental Protection Agency ("EPA") to consider shareholders to be "owners," especially if these individuals are active in the business. While some courts have not accepted this position, it should be noted that it is a potential statutory liability. The courts and the federal EPA have imposed liability for environmental clean-up on controlling directors and officers.

In addition to these statutory liabilities, liabilities can be imposed upon shareholders by virtue of being directors or officers in charge of certain functions. The responsibilities and liabilities of directors and officers are addressed later in this letter.

Common Law Liabilities of Corporate Shareholders and LLC Members

In addition to the statutory liabilities, courts in certain situations have imposed upon a shareholder liability for corporate obligations. To render a shareholder liable, a court must hold that the corporate form is being used to perpetrate a fraud or a wrongful or dishonest act. This so-called "piercing of the corporate veil" is often used where the shareholder so dominates the corporation that the corporation is considered by a court to be merely an extension or "alter ego" of the shareholder. Unfortunately, many small businesses may fit this description; but such dominance is just one factor, not the determining factor. Courts generally will apply a similar analysis when considering LLCs and "piercing the LLC veil" to impose personally liability on LLC members or managers.

Fiduciary Duty of Corporate Shareholders

In addition to the potential liability of a shareholder for a corporate obligation, courts have imposed upon a majority shareholder a fiduciary obligation in dealing with other shareholders. The powers exercised by dominant shareholders must be for the benefit of the corporation and ALL shareholders—not just himself or herself. This fiduciary relationship among the shareholders is characterized by the good faith of the majority shareholder. This does not mean that majority shareholders are required to follow the directions or cater to the whims of the other shareholders, there are some benefits of majority ownership. However, a majority shareholder is required to follow the best interests of the corporation and to act in good faith. Courts will intervene where there is an absence of good faith and improper conduct by a majority owner to oppress a minority shareholder. Ultimately, the message to controlling owners of a small business is simple: Do NOT abuse your power and oppress your business partners.

Director and Officer Responsibilities

Responsibility for the day-to-day management of a Virginia corporation resides with the corporation's directors and officers. The Virginia Stock Corporation Act offers more flexibility than most people realize, however, to structure the management and governance of a Virginia corporation. In effect, this is an attempt to keep the corporate statute "competitive" with the flexibility afforded to LLCs under the Virginia LLC statute.

Corporate directors and officers must be mindful of the following duties and responsibilities:

1. Paying Employees. Those officers responsible for the payment of salaries must see that those salaries are paid by the company.

2. Payroll Taxes. All payroll taxes must be timely paid. Neglecting this obligation may result in personal, civil or criminal liability to responsible parties. A few minutes of online research will produce a slew of tragic tales of desperate and misguided business owners and executives who tried to solve cash flow problems by not paying the required payroll taxes…PLEASE DO NOT let yourself fall into that trap.

3. Other Taxes. State law imposes personal liability on the persons responsible for reporting and paying any required withholding tax and sales and use taxes.

4. Duty to Inspect. A director has the absolute right to inspect all corporate record books, records, documents, and property at any time. If he or she does not exercise that right, he or she may be held liable for negligence if the corporation suffers loss or its creditors suffer loss by reason of failure to exercise reasonable diligence in such matters.

5. Other Liabilities. The directors of a corporation must be concerned with other sources of liability, which include: failure to act in good faith for the corporation's best interests; improper payment of dividends; improper distributions; improper purchase or redemption of the corporation's stock; improper loan to a shareholder, director, or officer of the corporation; fraudulent entries in the corporate books or reports; and failure to properly supervise the operations of the corporation.

Duties of Corporate Directors

A corporate director is required under Virginia law to perform his or her duties as a director "in good faith, in a manner the director believes to be in or not opposed to the best interests of the corporation, and with the care that an ordinarily prudent person in a like position would use under similar circumstances."

A director may not compete with his or her own corporation or take business opportunities from the corporation for his or her own benefit. In any event, all such transactions will probably have to be disclosed, as a general matter, to the shareholders or other directors of the corporation in any corporation where the officers and directors, on the one hand, and the shareholders on the other, are not the same individuals.

Specific care must be taken in transactions between the corporation and its directors or officers. A director's or officer's interest in any company contract, action, or transaction must be disclosed to the directors. Disinterested directors can approve such action, as can a majority vote of disinterested shareholders. Each conflict of interest situation should be reviewed by legal counsel to ensure that proper disclosure is made and appropriate approval obtained.

A director is ordinarily not entitled to compensation for his or her services as a director unless the compensation is provided for by contract, by an appropriate regulation, or by a corporate resolution. Remember that the directors have the additional power to fix the salary of each and all of the officers.

With respect to LLCs, managers or officers will owe similar duties of care and loyalty to the company, but these obligations are often addressed in the company's Operating Agreement—these duties may be expanded, clarified, minimized, or altogether eliminated depending upon the owners' objectives. Such flexibility is one of the advantages LLCs offer business owners and entrepreneurs; but on the other hand, there is relatively less case law interpreting these concepts in the LLC setting, and such uncertainty is discomforting to some business owners and their advisors.

Conclusion

This is not meant to be an exhaustive list of all rights, responsibilities, and duties in connection with owning and operating a Virginia business entity, but I hope it will provide helpful guidance in maintaining your company's status as an independent business entity under Virginia law. Please contact us anytime with questions or concerns.