



AN INTRODUCTION TO VIRGINIA LIMITED LIABILITY COMPANIES

Introduction

The limited liability company ("LLC") is a type of business entity that has been recognized under Virginia law since 1991. For many business owners, the LLC form offers a combination of important tax and non-tax benefits that no other type of business organization can provide.

This overview presents, in a question-and-answer format, a summary of the primary features of the Virginia LLC form. While businesses located in Virginia typically file as a Virginia LLC, it is possible for a business with a principal place of business in Virginia to file as an LLC under, and be governed by, the laws of another state (commonly Delaware).

This material is provided with the understanding that it is for general information purposes only. Accordingly, it is not intended to serve as legal advice regarding any specific client's particular situation or needs. Also, because of the rapidly changing law in this area, the information contained in this outline may become outdated. For these and other reasons, please consult with us as to how an LLC's benefits and drawbacks relate to your particular situation.

1. What is an LLC? What requirements must it meet to legally exist?

A Virginia LLC is a business organization that has been formed under the Virginia Limited Liability Company Act (the "LLC Act"). An LLC comes into existence when "Articles of Organization" are filed with the State Corporation Commission ("SCC") along with the required filing fee in the amount of \$100. Anyone can sign the Articles of Organization as the "organizer" of the LLC. Anyone can serve as organizer of an LLC, except that for a professional services LLC, such as a medical practice, a licensed professional must sign. If the Articles of Organization are accepted by the SCC, a Certificate of Organization is issued to the new LLC as evidence of its legal existence.

Although not legally required under the LLC Act, LLC members (the owners of an LLC are referred as "members" just as the owners of a corporation are referred to as "shareholders") should also have a written agreement among themselves concerning the management, operation and economics of the LLC. This agreement is called an "operating agreement" and is similar in its function to the bylaws and shareholder agreement of a corporation. Failure to have such a

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Perkins Law, PLLC

Eric C. Perkins, Esq.

4870 Sadler Road, Suite 300 Glen Allen, VA 23060

eric@ericperkinslaw.com www.ericperkinslaw.com

Office (804) 205-5162 Mobile: (804) 332-3648 Fax (804) 482-2835

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written agreement could lead to problems if and when disputes arise among members about their respective rights and duties.

LLCs are very flexible in terms of management structure and operation. They can be structured similar to:

- general partnerships (for LLCs in which all members participate in management);
- corporations or limited partnerships (for LLCs in which some members do not participate in management); or
- sole proprietorships (for single-member LLCs).

All sole proprietors and general partners have unlimited personal liability for company obligations, while LLC members, like corporate shareholders, have the important benefit of only limited liability for LLC obligations. In general, a member's personal assets are not at risk for these obligations unless such debts or obligations result from a member's own personal negligence or misconduct, or the member has contractually agreed to be responsible.

Although an LLC is not required to file an annual report with the SCC (unlike a corporation), it is required to pay an annual registration fee (currently \$50). Failure to pay the annual registration fee following a notice of delinquency from the SCC will result in the cancellation of its registration. However, such cancellation for failure to pay the annual registration fee does not result in the members or managers becoming personally liable for the obligations of the LLC.

2. What are the main attributes of LLCs?

LLCs are not corporations. They are "unincorporated business associations." However, they have the following attributes, which resemble corporations in many ways:

- a. Status as entities. LLCs are legal entities. This means that they can conduct business in their own name, rather than having to obtain the signature of each owner on each relevant contract (unless the operating agreement or Articles of Organization require otherwise).
- b. Permitted types of business activities. LLCs can engage in practically any kind of lawful business or activity.
- c. Powers. LLCs have the legal powers necessary to conduct their business. For example, they can own and sell real estate and other property, borrow money, and hire and fire employees.
- d. Types and numbers of owners. LLCs can have any kind and number of owners.

- e. Limited liability. LLCs provide their owners with limited liability protection from debts and obligations of the entity.
- f. Equity. LLCs issue equity units. These equity units typically are called "membership interests" or "membership units", but other terms could be used such as "shares." LLC equity can be issued in different classes or series, the rights of which differ from each other.
- g. Payment for equity. LLCs can accept different kinds of consideration for equity (e.g., cash, property, or services).

3. What are the main differences between LLCs and corporations?

The main differences between corporations and LLCs include the following:

- a. "Centralized" vs. "decentralized" management. A corporation typically must have a board of directors, and only their directors and officers may manage the business of the corporation. The role of corporate shareholders is limited to approval of major corporate actions, such as merger or dissolution. By contrast, LLCs may be managed by all of their members ("decentralized" or "member-managed" LLCs) or, in the alternative, LLCs may be managed by fewer than all members or even by outsiders ("centralized" LLCs managed by "member-managers" or by "non-member managers"). The form of management of an LLC is up to its owners.
- b. Differences in VSCA and LLC Act "default" rules. Both the Virginia Stock Corporation Act (the "VSCA") and the LLC Act contain numerous "default" statutory rules (i.e., rules that apply to a business organization unless its owners expressly provide otherwise in the operating documents). However, the LLC Act contains many default rules that are very different from corresponding VSCA default rules, some of which are described below:
 - (1) Free transferability of interests. Under the VSCA, a corporation generally can issue stock to new shareholders whenever the board desires, and shareholders can sell their stock to third parties whenever they want unless there is a shareholder agreement to the contrary. Under the LLC Act, an LLC may admit as a member a party that has been issued a membership interest directly by the LLC only if a majority of the existing members (or a majority of the managers in a manager-managed LLC) agree. A member may assign his economic interest in the LLC to a third party (an "Assignee") without other members' consent, but the Assignee cannot become a member (allowing the member to vote and otherwise participate in the management of the LLC) without the consent of a majority of the existing members.

- (2) Decision-making formalities. Under the VSCA, corporations must maintain minute books and comply with numerous formalities, especially regarding shareholder and director decision making. If a corporation fails to comply with these formalities, its business decisions may, in certain extraordinary situations, be invalid and its creditors may be able to "pierce its corporate veil." (See discussion about "veil-piercing" in Section 6 below.)

LLCs are not subject to such statutory formalities. The LLC Act offers significantly more flexibility in establishing an LLC. LLCs are much more flexible in structure and management procedures, and, in general, may be less subject to veil-piercing problems. Most LLC Act default rules can be changed by an LLC's operating agreement.

4. How are LLCs and their members taxed?

If an LLC is properly organized in accordance with IRS rules, it will be treated for federal income tax purposes as a partnership or as a sole proprietorship in the case of a single-member LLC. This means that LLCs are "pass-through" entities. The LLC itself, unlike a C corporation, will not be subject to income tax. However, this means its members will be taxed on their share of LLC income even if the income isn't distributed to them. Thus, unless an operating agreement provides for distributions to pay taxes, members may be liable for federal income taxes on their LLC income without the cash to pay them. By contrast, the income of a C corporation is taxed twice -- once to the corporation itself when earned, and again to shareholders when distributed to them.

5. What are the main legal rights and duties of LLC members?

The main legal rights and duties of LLC members are as follows:

- a. Sharing in LLC profits. LLC members generally share in the profits of their LLC in proportion to the amount of their capital contributions. In addition, LLC members who work for their LLCs can receive salaries and other compensation (often called "guaranteed payments").
- b. Management rights. In member-managed LLCs, all members can be given a right to vote on all LLC matters, including day-to-day business matters, and all of them can be allowed to act on behalf of the LLC (e.g., signing contracts) unless otherwise provided in the LLC's organizational documents.

In manager-managed LLCs, the rights of members are generally similar to those of corporate shareholders. In other words, members may vote on extraordinary LLC matters such as mergers and dissolutions, but they do not participate in the LLC's day-to-day business.

- c. Member and manager duties of loyalty and care. In LLCs, all managers and members engaging in management activities have legal duties of loyalty and care toward one another and the entity. They must perform their duties with "good faith business judgment" in the "best interests" of the LLC. This means that members and managers must put the LLC's interests ahead of their own personal interests. If they violate their duties of loyalty or care, they could be held liable to the LLC or the other members. It is possible to expand or restrict such legal duties in the LLC's organizational documents. A member not participating in the management of an LLC does not owe fiduciary duties to the other members, absent provisions in the LLC's articles of organization or operating agreement.

6. LLCs and Veil-Piercing.

A plaintiff who sues an LLC may try to "pierce its veil" to recover damages from the owner of the LLC. In other words, the plaintiff will try to persuade the judge that the LLC's members should be personally liable for the obligations of the LLC. LLCs members should take the following measures to minimize this risk:

- a. Tell the world you are doing business as an LLC. LLC stationery, invoices, and other documentation should make it clear that you are conducting business through a separate legal entity. No member should ever state or imply to anyone that they are or will be personally liable for LLC obligations unless they have specifically agreed to such personal liability.
- b. Have adequate capital. The members should ensure that the LLC has adequate capital (in the form of cash or other liquid assets, operating cash flow, and insurance) to pay all of its obligations as they become due.
- c. Maintain the LLC as a separate entity. The members should maintain the LLC as an entity separate from themselves and from other business entities. For example, they should avoid using LLC cash and property for personal purposes and they should maintain a separate checking account for the LLC.
- d. No sweetheart deals. The members should avoid transactions between LLC members or managers and the LLC in which the members or managers enjoy business terms that no third party could reasonably expect to obtain.
- e. No illegal or unethical activities. The members should ensure that the LLC and its members and managers avoid illegal and unethical activities on behalf of the LLC. The members and managers should not use the entity to avoid personal obligations, perpetuate a fraud or crime, commit injustice or gain unfair advantage.