Importance of Corporate Formalities

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On December 30, 2010, Judge W. Allan Sharrett of the Circuit Court of Greenville County issued a memorandum opinion in *First Community Bank v. Community Youth Center*. The opinion may provide an important wakeup call on the importance of compliance with corporate formalities.

In 2005, the Directors of Community Youth Center, Inc. ("CYC") entered into a loan agreement with First Community Bank to fund the construction of a swimming pool. CYC made numerous payments on the loan before defaulting. In 2008, faced with a claim they couldn't pay, CYC's directors sought bankruptcy protection. Only then did they learn that their charter had been terminated in 2000 for failure to pay annual fees to the State Corporation Commission. The bankruptcy petition was dismissed and the bank pursued its claim in state court.

There, Judge Sharrett found that CYC's three officer directors had not been authorized to secure the loan; that the corporation existed post-termination solely for the purpose of liquidating its assets; but that the trustees could not use the corporation's dissolved status as a shield against the claims of the bank. The judge permitted the bank to foreclose on the property of the Youth Center pursuant to its loan.

Code of Virginia §13.1-752 states that if a corporation fails to file its annual report or pay its annual fees in a timely manner, the corporation is automatically dissolved. This is not merely a theoretical possibility: in each of 2008, 2009 and 2010, the number of existing corporations that were automatically terminated for failure to comply with statutory formalities exceeded the number of newly formed corporations and far exceeded the number of voluntary and involuntary terminations combined.

Once a corporation is dissolved, it exists only for the purpose of liquidation and the assets of the corporation are held by the directors as trustees in liquidation. The trustees are prohibited from continuing the business of the entity and must instead wind the company down by using the assets to pay creditors.

The Code of Virginia provides some relief from inadvertent termination. For a limited period of time, a terminated corporation can be reinstated and if it is, its revival shall be retroactively recognized, such that it is deemed "to have continued from the date of termination." (Va Code §13.1-754). Beyond this period, the law is less generous and the sanctions the law imposes may be more difficult to avoid.

As was the case with the CYC directors, frequently a dissolved corporation's control group first learns of its forfeited charter at a critical moment. The status of the corporate charter is among the first things an auditor will check and the due diligence of an astute potential purchaser will cloud any proposed sale of the business.

Corporations must file annual reports, maintain their registered agent and office, and pay annual fees. As we saw in CYC, corporations that fail to observe these requirements will soon hear from the Corporation Commission. The risk arising from the failure to observe other requirements is more insidious because there is no warning. Therefore it's important to understand what the law requires of a corporation.

Code of Virginia §13.1-654 provides that corporations "shall" hold annual meetings when the shareholders shall, among other things, elect directors. Similarly, the required officers are elected annually by the directors. Failure to follow such steps and to maintain records reflecting their completion will likely become problematic in any future sale of the stock or assets of the business, when good standing and compliance with statutes is usually a condition of sale. Failure to comply may also lead to a creditor's claim that the corporation is a sham or a mere alter ego of the owner.

Except as delegated in its by-laws, a corporation acts through its board of directors and the corporation should have and retain signed resolutions for its actions. Absent such records, a corporation could face a claim that an act or action was not properly authorized and is therefore invalid. Officers and directors of a corporation risk personal liability if they act beyond the scope of their authority. This is particularly common in closely held corporations where owners sometimes take what they deem to be reasonable or non-controversial acts without considering the limits of their authority.

Depending on the by-laws, some corporate acts, such as the issuance of stock, specifically require board approval to be valid. Moreover, in many corporations, "pre-emptive rights" established by the governing documents entitle existing shareholders to maintain their proportionate shareholder ownership. Distribution of new shares without regard to such obligations can create significant risk of litigation and damages. A similar risk arises if a new shareholder fails to comply with prerequisite steps that may appear in by-laws or shareholders' Agreements.

Virginia directors owe fiduciary duties to the corporation and shareholders as a group. In essence, these duties require a director to act in the best interest of the company and in good faith. Self-interested financial transactions involving a director – even those undertaken without the goal of personal gain - may be problematic if not approved by disinterested directors or shareholders.

Aside from general corporate formalities applicable to all corporations, other rules apply to those entities that have elected to be taxed as pass-through S corporations. Through the S election, the IRS allows qualified corporations to avoid double taxation, but any corporation electing S status faces a grave risk if Internal Revenue Code requirements are not scrupulously observed.

These standards are inflexible and are often inadvertently breached by control group members not familiar with the requirements. For example, transfer of stock to a party not qualified to be an S shareholder is likely to result in the forfeiture of the election and an onerous tax burden. Even more insidious are financial transactions for the benefit of some but not all shareholders. S corporations may have only one class of stock and unequal payments to shareholders may be deemed implied distributions which could also jeopardize S status. Whether or not full director approval of a given corporate act is required, a full airing of the issue decreases the possibility of a costly ministerial mistake.

Corporations and their control groups have long been afforded special protections and rights by statute. For example, a corporation's shareholders are generally immune from personal liability for corporate actions. However these rights and protections are dependent on compliance with statutory requirements. If formalities are not followed, a corporation's shareholders, officers and directors could lose the liability protection afforded by corporate status through a process known as piercing the corporate veil. The corporate status provides many benefits, but it imposes coincident obligations. The savvy businessman or woman will be careful to keep these in mind.