

FREQUENTLY ASKED QUESTIONS (F.A.Q.)

Regarding

Business & Commerce

by David Linville



1. What is a sole proprietorship?

A sole proprietorship is an individual person doing business under their own name or a trade name. For example, John Doe opens a store that sells cosmetics. The name of the store is Doe Cosmetics, or ACME Beauty Supply, etc. The person can either register a trade name (ACME Beauty Supply) or not. A sole proprietor can do business under their own name or that of a trade name. Whichever way the proprietorship goes, the proprietorship is still a single individual person. Although they necessitate the least amount of work to create and do not require any particular formalities to operate, a sole proprietorship is a form of business that affords the least amount of asset protection. Individuals doing business as a sole proprietorship are personally liable for all debts and liabilities incurred in the course of doing business. This means that anything you do in business as a sole proprietorship exposes your personal assets. There is no personal liability protection for acts done while doing business as a sole proprietorship. Given a sole proprietorship's liability exposure, individuals doing business in this capacity should consult with their lawyer to make sure that operating in this form makes good business sense.

2. What business structures are available for my company, and how are they different from one another?

You may operate your business or organization under any one of several organizational structures. Each type of structure has certain advantages and disadvantages that should be considered. You should contact an attorney or other business or legal advisor to determine which form is most suitable for your business or organization.

A Sole Proprietorship is one individual or married couple in business alone. Sole proprietorships are the most common form of business structure. This type of business is simple to form and operate, and may enjoy greater flexibility of management and fewer legal controls. However, the business owner is personally liable for all debts incurred by the business.

A General Partnership is composed of two or more persons (usually not a married couple) who agree to contribute money, labor, and/or skill to a business. Each partner shares the profits, losses, and management of the business, and each partner is personally and equally liable for debts of the partnership. Formal terms of the partnership are usually contained in a written partnership agreement.

A Limited Partnership* is composed of one or more general partners and one or more limited partners. The general partners manage the business and share full in its profits and losses. Limited partners share in the profits of the business, but their losses are limited to the extent of their investment. Limited partners are usually not involved in the day-to-day operations of the business.

A Corporation* is a more complex business structure. As a chartered legal entity, a corporation has certain rights, privileges, and liabilities beyond those of an individual. Doing business as a corporation may yield tax or financial benefits, but these can be offset by other considerations, such as increased licensing fees or decreased personal control. Corporations may be formed for profit or nonprofit purposes.

The Limited Liability Company (LLC)* and the Limited Liability Partnership (LLP)* are the newest forms of business structure in Washington. An LLC or LLP is formed by one or more individuals or entities through a special written agreement. The agreement details the organization of the LLC or LLP, including: provisions for management, assignability of interests, and distribution of profits or losses. Limited liability companies and limited liability partnerships are permitted to engage in any lawful, for profit business or activity other than banking or insurance.

*Registers with the Secretary of State

3. What are the advantages and disadvantages of setting my business up as a Limited Liability Company (LLC)?

A Limited Liability Company (LLC) is a hybrid form of business entity that combines attributes of both partnerships and corporations. Like a corporation, the owners, known as members, of a Limited Liability Company (LLC) are not individually liable for the obligations or liabilities of the company. However, if properly structured, a Limited Liability Company (LLC) avoids corporate-level taxation by passing through income and loss to its members. A member is an owner of an interest and a party to the contract generally known as the operating agreement. Articles of Organization must be filed with the Secretary of State. They contain certain basic provisions that govern the operation of the Limited Liability Company (LLC). To properly form a Limited Liability Company (LLC), the members must also have an Operating Agreement which sets forth the members respective rights and duties. It is a cross between a partnership agreement and corporate bylaws. A written operating agreement should be used for practical purposes and for purposes of taxation.

4. What are the registration and renewal requirements for limited liability entities in Washington State?

The following is a summary of registration and renewal requirements for Corporations, Limited Partnerships, Limited Liability Partnerships and Limited Liability Companies. For specific statutes governing these entities, see Title 23 and Title 23B RCW (profit corporations), Title 24 RCW (nonprofit corporations), and Title 25 RCW (partnerships & limited liability companies). Please remember, state law holds the corporation or other business entity responsible for the timely completion of all paperwork. You can avoid delinquency notices and costly penalty fees by completing all reports

by the required deadlines.

General Requirements

Domestic organizations (those formed in Washington) must file organizing documents with the Corporations Division at the Secretary of State's Office for review and approval before legal existence can begin. Two copies of the organizing documents (one with original signature) and fees should be sent directly to the Corporations Division.

Foreign organizations (those formed in a state other than Washington or in a foreign country) must submit two completed copies of an application for a Certificate of Authority to do Business in Washington. The application must be accompanied by proof of good standing issued by the state or other jurisdiction where the organization was originally formed.

A nonprofit corporation, such as a religious, social, charitable, or educational organization, must file two sets of Articles of Incorporation with the Corporations Division.

Limited partnerships beginning business in Washington must file a Certificate of Limited Partnership with the Corporations Division. Previous corporate and partnership certificates issued by county clerk's offices throughout the state have been transferred to the Secretary of State for centralized filing and access.

Registered Agent. All corporations and limited liability companies, and out of state limited liability partnerships doing business in Washington, must have a registered agent with a Washington State address. The registered agent may be an individual or any other organization registered by the Corporations Division to do business in Washington. The registered agent receives license renewals and other notices and forwards them to the organization. The agent also accepts legal papers served on the business entity. The organizing documents or application to do business in Washington must contain or be accompanied by a statement signed by the registered agent indicating consent to serve.

Licensing, Renewals, and Fees. The majority of organizations registered with the Secretary of State must pay an annual report fee and/or submit a list of officers and directors to the Corporations Division. For corporations that are for profit, the annual corporate license renewal/annual report fee is \$50 plus a handling fee of \$9. For nonprofit corporations, there is no annual corporate license renewal fee, but there is an annual report fee of \$10. Limited liability companies must annually pay a license fee and file a list of members and managers. Limited liability partnerships must annually pay a license fee of \$50.

5. For what acts of my employees am I responsible?

"Respondeat superior" is a legal principle that holds that the principal or employer is liable for harms done by agents or employees while acting within the scope of their agency or employment. The rationale of this doctrine is based on the master/servant theory of liability. A person who carries out his business activities through the use of employees should be liable for their tortious conduct in carrying out the business purposes for which they were employed. It is the price

the employer pays for enlarging the scope of his business activities. It does not matter how carefully the employer selected the employee if in fact that employee tortiously injured a third person while engaged in the business of the employer. Frequently, both principal/employer and employee are defendants in the same suit. If the employee is not held liable, the principal/employer is not liable. A principal/employer who is held liable for their employee's tort has a right of indemnification against the employee, which is the right to be reimbursed for the amount that the principal/employer was required to pay as a result of the employee's wrongful act. Frequently, an employee is not able to reimburse his employer, and the principal must bear the brunt of the liability. Oftentimes, the question of whether or not a particular act of an employee falls within the "scope" of the business does not yield a precise answer. For example, if an employee is on a delivery run, stops to take a lunch break at a local deli and gets into a fight with a patron, is the employer liable? What if the employee accidentally wrecks the employer's car while delivering the product? In deciding whether the employer is deemed vicariously responsible for the harm caused by its employee, Washington courts will look at the type of harm committed, and ask whether or not it is the type of harm that the employer has (or should have) control over. The Restatement of the Law (Third) Agency, Section 2.04, Respondeat Superior, describes the employer's responsibility for its employees as, "An employer is subject to liability for torts committed by employees while acting in the scope of their employment."

6. Why are employment contracts a good idea? Will a court enforce a Covenant Not to Compete?

Employment contracts are a great tool to afford the employer some protection against employee defections. From the employee's viewpoint, the employment contract provides the security of a guaranteed salary and benefits for a period of time, as long as the employee fulfills his employment duties. The contract would most likely contain a list of items which would constitute reasonable cause to terminate an employee prior to the expiration of the employment term, and would provide for liquidated damages where an employee is prematurely terminated without reasonable cause. The employer can also be afforded protection in the contract in exchange for the employer's commitment to compensate the employee for a specified period of time. This protection can include covenants of non-competition, prohibition of the employee's solicitation of customers or other employees, confidentiality obligations regarding trade secrets, and provisions which vest ownership of any inventions by the employee in the employer. Covenants not to compete are highly scrutinized by Washington courts and will be unenforceable if they do not strictly comply with the requirements of law. Essentially, covenants not to compete must be reasonable. The scope of a covenant can only reasonably limit the scope of the employee's right to compete (geographically and for a period of time). Noncompete agreements will only be enforced to the degree that they are deemed by Washington law to be fair. An attorney experienced in drafting and negotiation of employment contracts should be consulted prior to signing such an agreement.

7. I am engaging in a joint business arrangement with another person. What are my liabilities?

You should always use caution when entering a business arrangement. You should use double caution if you are entering a business venture with another person. The Uniform Partnership Act (1997) describes how a partnership is formed in Section 202 (FORMATION OF PARTNERSHIP) as, "the association of two or more persons to carry on as co-owners of a business for profit forms a partnership, whether or not the persons intend to form a partnership." Thus, by default, under

the law of partnership, two individuals carrying out a business together will most likely be characterized as doing business under a partnership, and partnership rules will apply. Written articles of formation, government licenses, registration, and other formalities that are required for other business entities are not required to form a general partnership. Two people doing business together will be deemed to be doing business under a partnership by default. Partners in a partnership are personally liable for the liabilities of the partnership, liabilities of their own, and for the liabilities created by the other partners (that were incurred during the course of partnership operation). That means that you may have to pay for your partner's mistakes. Given the liability exposure of the partner's personal assets, it may be wise to consult your attorney for advice on how to set up a limited liability entity.

8. I am in the process of setting up a limited liability entity. Am I personally liable to others during this process?

Yes. For all limited liability entities, pre-incorporation liability exists. Incorporation of a business occurs when the articles of incorporation are filed with the Secretary of State. Before the articles are filed, oftentimes, the principal of an entity that does not yet exist must perform necessary housekeeping tasks. Such tasks may include securing a lease, purchasing machinery, supplies, and equipment, and in some cases, perhaps signing a contract with an anticipated client. All of these acts, when performed by the principal of a company that is not yet officially incorporated, may expose the principal's personal assets. In essence, the principal will be deemed to have been operating under a sole proprietorship and the law regarding sole proprietorships will apply. Even after that date of incorporation, pre-incorporation liability exists for acts committed before the date of incorporation. Therefore, be careful when engaging in pre-incorporation activities, and avoid pre-incorporation engagements/contracts where possible. Your attorney can provide you with counsel if you are in the process of setting up a limited liability entity and you must attend to a particular business transaction.

9. How do I value my business?

Valuing a business is not a simple task. A good place to start is with the landmark Internal Revenue Service pronouncement found at Revenue Ruling 59-60. Many years ago, the IRS came up with eight basic factors which it still considers to be fundamental to the determination of the fair market value of any closely held business.

These eight factors are:

- the nature of the business and the history of the enterprise from its inception;
- the general economic outlook and the condition and outlook of the specific industry in particular;
- the book value of the stock and the financial condition of the business;
- the company's earning capacity;
- its dividend-paying capacity;
- the existence or absence of goodwill or other intangible assets;
- sales of the stock and the size of the block of the stock to be valued;
- the market price of stocks of corporations engaged in the same or similar lines of business, having their stock actively traded in the free and open market, either on an exchange or over-the-counter.

A specialist in the field of tax law can help you determine a fair value for your business.

10. Are written contracts really necessary to protect my business?

In offering goods for sale or providing services, it is often necessary to have an appropriate customer contract in place. These contracts typically include material provisions including terms, pricing, and schedule of payment. A good contract will not stop there. A customer contract should include a section on warranties of the goods and/or services provided, including a clarification of what is and is not included in the warranty. For contracts involving the sale of goods, a provision should exist that covers the allocation of transportation costs and the risk of loss for goods in transit.

11. What is the difference between civil and criminal liability in business?

Civil liability in business arises out of the relations between a business and the people it deals with and is governed by the laws of contract and tort. Cases against a business, for example, for breach of contract or negligence have to be taken by the people directly concerned. Criminal liability in business, on the other hand, involves a business committing a crime against the state and cases against a business are brought by public officials on behalf of society as a whole. Criminal law applies across many business activities and is especially important in areas such as the proper description and pricing of goods and services and the safety of goods and services, particularly food.

12. What is "piercing the corporate veil?"

Sometimes, courts will allow plaintiffs to receive compensation from corporate officers or directors for damages rather than limiting recovery to corporate resources. This procedure avoids the usual corporate immunity for organizational wrongdoing, and may be imposed in a variety of situations. If a business is indistinguishable from its owners in practical terms, however, courts will not allow owners to benefit from limited liability. For example: Fred's Tractors and Fred share the same banking account. Fred signs business contracts in his own name. Fred may be liable for breaching a business contract because he and his company are legally indistinct. If a corporation is formed for fraudulent purposes, courts will allow recourse to the owners. If a business fails to follow corporate formalities in areas such as record-keeping and decision-making procedures, a court may impose liability on the individuals controlling the business. The potential for personal liability encourages businesses to observe legal requirements and to avoid damage to third parties.

13. What types of legal procedures should corporations maintain?

Once incorporators establish a new business, the directors must ensure that it retains its legal status. Depending on the business form, certain legal formalities must be followed for this purpose. Once incorporated, an ongoing business's obligations include:

- Obtaining federal and state tax identification numbers for the business, and filing needed tax returns annually;
- Issuing shares of stock as mandated by the articles of incorporation and securities laws;
- Establishing and maintaining corporate books and records, including accounting ledgers, shareholder records, and corporate minute books;
- Calling and conducting an initial meeting of the board of directors or shareholders as required in the articles of incorporation;
- Holding future meetings at least as often as required by applicable business laws;
- Conforming all decisions and internal procedures to the outline set forth by the articles of incorporation;
- Recording all actions and decisions of the board of directors in the corporate minute book; and
- Maintaining annual registration with the state government as required by law.

Additionally, some businesses must comply with licensing requirements or professional standards to preserve their status. These businesses may need to maintain further records or use special procedures or equipment based on rules for their specific industries. In many situations, a failure to honor these and other corporate obligations can result in personal liability for directors, officers, or shareholders for business obligations and debts. Because of these harsh consequences and because the specific legal requirements vary depending on the business's location and form, businesses should seek professional legal assistance.