# Common Errors

*German and other foreign businessmen increasingly fear substantial damage awards and even personal liability in the United States in light of the passage of the post-Enron Sarbanes Oxley Act. At the same time, however, they continue to ignore basic U.S. corporate formalities which have been required for decades and which, from the U.S. point of view, are simple and inexpensive to honor. Failure to honor them can make the foreign parent company liable for the debts of the U.S. subsidiary, can subject the foreign parent to U.S. taxes, can pull foreign companies and managers into U.S. litigation and can subject employees to claims of personal liability. Any deviation from standard U.S. procedure, however innocent and otherwise unimportant, gives a plaintiff's attorney food for thought and an opportunity to become creative. Running the U.S. subsidiary like a normal U.S. company forecloses this temptation. The most common of these oft ignored formalities are discussed here.*

*by Rudolph S. Houck*

#### Annual Resolutions

German businessmen understand that U.S. law entails fewer formalities than its German counterpart, such as a commercial registry or minimum capital. A U.S. corporation (formed, of course, under state law) can be created overnight, at low cost. This relative simplicity may be the reason that shareholders' and directors' meetings are so infrequently held. While not a legal requirement, good practice requires that the board and shareholder pass resolutions at least annually. Of course this can be done by unanimous consent and a physical meeting is not required. Also, the discharge ("Entlastung") of management is not required.

#### Form of Resolutions

Even if meetings are held, minutes may not be made or, if they are, they may not conform to standard U.S. form. Directors may be described by their German titles. The minutes may be prepared on German letterhead by a German secretary or translator who thinks of the document as a document of the German employer.

#### Roles of Shareholder and Directors

German businessmen also understand that U.S. corporations do not have the German two tier management structure. Still, they often do not under-

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stand or respect the relationship between (a) the shareholder and the board and (b) the board and the officers. Simply stated, U.S. law requires the shareholder to elect the board and approve extraordinary corporate transactions (such as sale of substantially all the company's assets, mergers and dissolution) and very little else. The board sets policy of the corporation, approves major transactions and elects the officers. Individual board members do not have authority to sign for the U.S. corporation. (Of course a board member may also be an officer and sign in that capacity.)

#### Unauthorized Signatories

Worse than permitting a director to sign an agreement on behalf of the corporation, a manager of the parent company, often the head of human resources and not an officer of the U.S. corporation at all, signs contracts such as employment agreements on behalf of the U.S. subsidiary. This is a clear request by the parent company to be held liable for the obligations of the subsidiary and to be made subject to U.S. jurisdiction and pre-trial discovery.

Because directors often do not act as they should under U.S. law, officers are often not properly elected and authorized. Employees with no official executive title are permitted to sign legally binding documents on behalf of the company. They face some risk of personal liability if the corporation does not honor its obligations under the agreement. And - as in all these instances - the limited liability of the shareholder is less likely to be honored. This risk frequently arises in the context of granting signing authority on a bank account. U.S. managers cannot bother the board for approval of the required resolutions every time a bank signatory changes. So they certify the adoption of resolutions which have not in fact been adopted. The solution to this administrative burden is to form a one- or two-person committee of the board to approve these resolutions.

#### Improper Certification

Similarly, if the corporation has a non-lawyer as corporate secretary, that person may certify the adoption of resolutions which were never in-fact approved by the board.

#### Odd Titles

Many German companies have difficulty giving standard U.S. officers' titles to the managers of their U.S. subsidiaries. They try to find titles similar to the ones they give in Germany. The only standard U.S. titles are Chairman, President and Vice President, with some minor variations, such as Executive, Senior or Assistant Vice President. The Treasurer and Secretary are also officers, but they are seldom expected to sign contracts on behalf of the corporation. Germans often name their executives "Manager", "Managing Director", "Director of Sales" and similar names. Although state law may permit a corporation to create non-standard titles, the company's by-laws should be amended to provide for these offices, with a description of their duties. Even if these formalities are followed, a thoughtful third party will not accept a contract signed by a person with such a title without additional evidence of authority. This adds to delay, costs and uncertainty. Germans also pay great attention to the designations CEO and COO. These are legally important only if there might be confusion as to what other officer might have the greatest overall power. For example, if the company has a strong Chairman of the Board, then he or the President might be thought to be the CEO.

#### Title Grant

If a manager has one of the titles listed above, that title has to be bestowed by the Board of Directors, by official action. The employee cannot be simply issued a business card with the title "Vice President." Regardless of whether the offi-

cial action is taken, a third party reasonably believing that the person is a Vice President may rely on his authority to bind the company in most normal transaction. The manager's authority may be limited by the board, but only internally. If the manager acts beyond his authority but the third party reasonably relies, the corporation is bound.

#### Parent Support

If the U.S. corporation does not have a long track record or a strong balance sheet, the German parent may have to back its subsidiary financially. However, this must be done in a way that honors the separate identity of the two companies. Simply adding a signature line for the parent at the end of an agreement entered by the subsidiary and a third party unnecessarily blurs the lines between the parent and subsidiary entities.

#### Stationery

The parent company may view the U.S. subsidiary as a very junior partner. To give the subsidiary more presence or merely to save money on stationery, the subsidiary may use stationery of the parent. Or the subsidiary's stationery may include the parent company's name without explaining the relationship between the parent and subsidiary. This practice can be used by a third party to show that the parent was the contracting party or that there is no distinction between the two.

#### Make Up of Board

Especially during the start up phase, the board of the subsidiary and its officers may be identical with the management of the German parent. There may be no Americans on the board or in U.S. management at all. Sometimes this cannot be avoided. However when possible, it should be, to help create substance to the formality of the distinction between the parent and subsidiary. In litigation, a German manager of both U.S. and German companies will not be able to limit his answers to his knowledge of the U.S. company, and the German entity will more readily be dragged into the litigation.

#### Reporting

Officers of the U.S. subsidiary often report directly to managers of the German parent, with no reporting to U.S. officers or the U.S. board of directors. U.S. officers may properly share information with their foreign counterparts and cooperate with them, but formal responsibility and reporting should go us a chain to the board of directors of the U.S. corporation.

#### Firing

Similarly, if an officer or employee of the U.S. subsidiary is to be fired, the decision must be made at the U.S. board or executive officer level and carried out by a person holding his authority from the U.S. entity, not from the foreign company. Of course the decision may first be made at the foreign owner level on an informal basis. But then the U.S. formalities have to be honored. This procedure is more difficult if the officer being fired is also a member of the U.S. board. A simple solution to this problem is once again to have a committee of the board which does not include the officer to be fired. Alternatively, the firing can be ratified after the fact, when the person being fired is no longer a member of the board. In either event, attention must be paid to who in fact does the firing. To have a manager from the German parent fire the U.S. officer again muddies the relationship between the two entities. If only the German manager is available, he should be specifically authorized by the U.S. board or committee of the board.

#### Capital

A normal basis for piercing the corporate veil is the egregious under-capitalization of the corporation. However, a German company entering the U.S. market seldom forms a U.S. subsidiary without enough capital to keep it alive for at least a year. The funds need not all be contributed shortly after the corporation is formed. There is no clear measure of what constitutes under-capitalization and this risk is not significant. Likewise, the U.S. corporation almost always has its own bank accounts and the funds of the parent and the subsidiary are not commingled. However, the subsidiary

should pass the proper resolutions accepting additional capital when it is contributed, indicating whether it is debt or equity, and declaring dividends when they are paid to the parent. If the capital is in the form of a loan, promissory notes should be issued and interest charged at reasonable rates, but these formalities are of secondary importance except for tax purposes. If the German parent has multiple U.S. subsidiaries, then the temptation to move money from one subsidiary to the other without proper regard for formalities is greater and more dangerous.

#### Payments

Similarly, the debts of the subsidiary should be paid by the subsidiary, not by the parent. Invoices for legal fees, for example, should be issued to the subsidiary and paid by it. A more complicated system is possible, with payment by the parent, but then the trail should be documented to show that the payment by the parent is on behalf of the subsidiary and a contribution to capital of the subsidiary or a loan.

#### Parent Operations

As a general comment, the existence of the U.S. subsidiary should be recognized and transactions in the United States should be run through the subsidiary. If the parent operates in its own name in the United States, such as by accepting purchase orders here, it subjects itself to suit here and puts its foreign assets at risk. Similarly, the Internal Revenue Service may demand payment of taxes here and the right to inspect the books and records of the parent company.

#### Deviations Generally

Finally, and as a general rule, any deviation from the standard U.S. business and corporate procedure because "that's how we do it in Germany" may simplify the internal operation of the U.S.-German companies, but gives a potential plaintiff reason to think about that deviation and try to turn it to his or her advantage. Even if the subsidiary succeeds in defeating the attempt, it will be at the cost of legal fees which could have been avoided.

No one of these errors is likely to be fatal to the separateness of the U.S. subsidiary. However they tend to be committed in groups and to reflect a general casual attitude about adherence to U.S. corporate law. Even if a foreign owned company violates all these rules, its management and the subsidiary itself may be able to avoid liability. But each violation raises the risks and, as noted, can be easily avoided. The legal fees generated by having to defeat a plaintiff's claims based on these violations will greatly outweigh the costs of compliance.

#### About the Author

Rudolph S. Houck, Partner, New York Office, Alston & Bird is chair of the firm's International Group. His practice is concentrated on international business matters, in particular representing businesses from German-speaking countries in the United States. Typical transactions involve the acquisition of stock or assets of American companies on behalf of leading European firms in industries such as fine chemicals, pharmaceuticals, cosmetics, fashion, publishing, software, metals and precision machinery. He also frequently structures and negotiates joint ventures, long term licenses, supply agreements and other important contracts. At the same time, he often counsels the families who own these businesses. Increasingly, his clients are listed on various German and U.S. stock exchanges. Mr. Houck is a member of the board of the German American Partnership Program and the Deutscher Verein. He is a member of the Business Advisory Board of the American Council on Germany and a member of the Atlantik-Brücke. He is the editor of "The Legal Climate for Foreign Direct Investment in the United States," Georgetown University Press. Mr. Houck received his LL.M. from Georgetown University Law Center in 1980, where he was a Kronstein Fellow. He received his J.D. degree in 1972 from the University of Chicago Law School and his B.A. degree, cum laude, Plan II in 1969 from The University of Texas at Austin. He studied twice in Germany, at the Universities in Munich and Frankfurt. He practiced with two leading Frankfurt law firms. Mr. Houck is admitted to practice in the States of New York and Pennsylvania.