FORMATION AND MAINTENANCE OF A U.S. SUBSIDIARY CORPORATION

The formation of a U.S. corporation is faster, easier and less expensive than the formation of many types of companies with limited liability under other legal systems. However, the special characteristics of U.S. corporations are still important to their proper operation.

CHOICE OF LAW. A U.S. corporation is formed pursuant to the law of a particular state. This means that the party forming the corporation can select from among 50 states and the District of Columbia. In contrast to many countries, there is no nation-wide, unified corporation law. A corporation is often formed pursuant to the law of the state in which it will have its main office. However, it can also be formed pursuant to the law of any other state. This is possible even if the corporation has no connection to the state of incorporation. Here the state of Delaware deserves special mention. While the differences among the 51 corporate laws are generally minor, the law of Delaware still plays a special role. Its use for the formation of corporations is particularly widespread. Delaware law is "user-friendly" and the state tries to attract the formation of corporations. Delaware judges are especially experienced with questions of corporate law and in particular with the legal relationship and duties between management and shareholders. This special expertise plays a minor role in case of a 100%-owned subsidiary, but even such subsidiaries enjoy another advantage, namely that U.S. lawyers, wherever they practice law, are generally quite familiar with the corporate law of Delaware. The general commercial law of Delaware does not offer this same advantage.

The concept of "corporate headquarters" has little importance in the U.S. legal system. The movement of the headquarters is not a significant legal event. One minor exception is with respect to so-called "foreign" corporations. A corporation must register itself as a "foreign" corporation in a U.S. state if it has an office, property or employees in one state but was formed under the law of another. The designation "foreign" corporation has nothing to do with its possible formation pursuant to the law of some other country. For example, a corporation formed under the law of Delaware but operating in New York is obliged to qualify as a "foreign" corporation in New York. For internal questions, the law of the state of formation is applicable.

FORMATION. The formation of a U.S. corporation is very simple. It can, if necessary, be carried out in a day. The formation procedure is as follows:

1. First, the name of the corporation and a few alternatives should be determined. The name itself can be fanciful and need not indicate the actual activities of the corporation or the name of the owner. An important part of the name is the word "Corporation" or "Incorporation" or "Limited" or an abbreviation of one of these words. Without one of these words, a creditor can claim that the shareholder of the corporation is liable without limitation for the obligations of the corporation. In selecting a name, the shareholder should be certain that it is not already used by another firm. This applies both to the state in which the corporation will be formed as well as the states in which the corporation will operate and be registered as a "foreign" corporation. Some words, such as "federal," "bank" or "insurance" can be used in the name only in limited

circumstances. Some few words cannot be used at all. These vary from state to state. A proposed name, if available, can usually be reserved for a limited period by payment of a small fee.

2. Next, the “Articles of Incorporation” or the “Certificate of Incorporation” – they refer to the same document in different states - is prepared. Normally these are only two to three pages long and set forth the name of the corporation and the class(es) of stock. If the corporation is to have only one shareholder, the classes of stock play no role. A corporation can have almost any number of authorized shares of stock, for example 10 million shares. Nevertheless, the corporation may decide to issue only one share of the millions of shares authorized. The others are held in reserve and need never be issued. Shares of stock are normally issued in the name of the owner (as opposed to bearer shares). The Articles are signed by the incorporator and submitted to the Secretary of State of the state of incorporation. The incorporator need not be one of the intended shareholders and is generally unimportant. Often the incorporator is a lawyer or even a clerk or secretary of the law firm carrying out the incorporation. Assuming that the Articles are in accordance with the applicable law and the normally small fees are paid, the corporation is formed. Submission of the forms may be by telefax or e-mail and are often handled by service companies, such as Corporation Service Company. The corporation usually has a corporate seal, but it is seldom used and has little importance.

3. The incorporator then signs the so-called “Initial Actions in Lieu of Meeting of Shareholder.” In this document the incorporator names the initial “Board of Directors” and adopts the corporate “By-Laws” which are discussed below. This is the extent of the duties of the incorporator.

4. The “Board of Directors” then approves some basic incorporation activities, such as approving the sale of stock to the shareholder(s), the opening of a bank account and, if appropriate, the registration of the corporation as a “foreign” corporation. The board names the officers of the corporation. With this step, the corporation is capable of action.

The corporation next:

5. Obtains its so-called “EIN” or “Federal Employer Identification Number” - a taxpayer number on the federal (as opposed to state or local) level. The number is issued by the Internal Revenue Service (IRS) and is a precondition to opening a bank account. If an officer of the corporation makes the call to the IRS, this number can be issued by telephone and the process can take as little as 10 minutes. But it can also take substantially longer if the IRS authorities are overworked and the telephone line is busy. In some forms, the EIN is also referred to as a “tax ID.”

6. Obtains taxpayer identification number on the state level.

7. Registers itself as a “foreign” corporation in one or more states.

8. Opens a bank account. This has become much more difficult due to procedures to discourage money laundering.

All of these steps except opening a bank account can, if necessary, be carried out in a matter of hours and cost in total perhaps $3,000 to $5,000.

CAPITALIZATION. The U.S. legal system puts little emphasis on the question whether a corporation has been adequately capitalized or can fulfill its payment obligations. The goal of U.S. corporate law is more to protect the shareholders and limit their risks and not to protect the interests of the creditors. Therefore, capitalization plays a subordinate role. Every creditor has to determine itself the credit-worthiness of the corporation. If the creditor has doubts, it has to try to obtain a personal guaranty of the shareholder or demand a bank guaranty. To our knowledge, no state law sets forth minimum capital requirements of a corporation. However, to the extent the capitalization for the intended corporate purposes proves to be much too small and the corporation quickly goes bankrupt, these circumstances can serve as evidence of fraud. Also the reduction of capital and its repayment to the shareholders is quite simple. The capitalization itself is not registered anywhere and reduction of capital does not require a public notice. From a tax point of view, the relationship of debt and equity is more important. A rule of thumb is that the debt-equity ratio should not go beyond 3:1. In case of bankruptcy, the distinction between shareholder capital and loans will not be honored. Third party creditors will have priority over shareholder loans.

If a corporation is no longer able to pay its debts, it is not obligated to disclose this fact. It can continue its business until it either earns a profit or voluntarily requests bankruptcy court protection from creditors. A corporation goes into involuntary bankruptcy only if enough creditors having large enough claims request the assistance of the bankruptcy court in protecting their claims. The fact that a corporation's balance sheet shows more liabilities than assets or that the corporation cannot fulfill its obligations as they arise is of little legal significance.

The par value of stock is also seldom important. The shareholder is personally liable up to the par value to the extent the shareholder has not paid at least this amount upon acquiring the shares. The corporation cannot pay back the par value of the stock to the shareholder without a special proceeding. But par value is often only pennies a share.

The number of authorized shares is significant only insofar as the corporation cannot issue more shares than are authorized. However, this number is easily increased.

As a practical matter, the parent corporation often capitalizes the subsidiary as follows:

1. The parent corporation transfers enough funds to permit payment of the costs for the first six months. A portion of this sum is specified to be the purchase price of the stock. This amount covers at least the par value. The board of directors authorizes this transaction in a resolution.

2. In the course of the year the parent corporation transfers additional funds as needed.

3. Shortly before such a transfer, the management of the parent corporation consults with its tax advisor regarding the decision as to what portion of the funds should be treated as equity and what portion as debt.

4. The Board passes a resolution in which the equity and the debt are determined and the details of the loan, in particular its amount, term and interest rate. As long as the corporation has only one stockholder, it is not important whether the increase in capital is evidenced by the issuance of further stock certificates. The sole stockholder owns all the shares in any event.

Note that some states tax corporations based on their capital and the corporation has to notify the state of such changes. The repayment of capital and the payment of dividends are significantly more expensive and complicated than the repayment of loans and the payment of interest. In some circumstances, the IRS will ignore the designation of payments as debt, treat it as equity and tax it accordingly.

FOREIGN CORPORATION. The registration of a corporation as a "foreign" corporation is already discussed in the Section *CHOICE OF LAW*. The registration itself is very simple. As a result of the registration, the corporation must submit a tax return in the state where it is registered and, if indicated, pay taxes. The total sum which is to be paid is not necessarily greater than otherwise and could even be reduced. If a corporation is no longer active in a state, the withdrawal from that state is more complicated. If a corporation is active in a state, it must register there as a "foreign" corporation before it can appear before the courts of that state. In most cases it is possible to cure the failure to register. However the corporation may possibly have to pay a fine. Upon registration of a corporation as a "foreign corporation" it is subject to suit in the courts of that state.

ORGANIZATIONAL STRUCTURE OF THE CORPORATION. The organizational structure of a U.S. corporation varies from that of other countries in several aspects. Basically it has four sources:

1. the law of the state in which the corporation was formed.
2. the Articles of Incorporation or the Certificate of Incorporation.
3. the By-Laws of the corporation.
4. the resolutions of the board.

The law of the state itself gives the corporation a great deal of flexibility. So too do the Articles or Certificate and the By-Laws.

Usually only the following rules require special notice in the operation of a 100% subsidiary.

A. If not all the board members take part in a meeting, they must either be timely notified – in writing – of the meeting or (before or after the meeting) waive notice.

B. Enough of the board members must take part in the meeting to have a quorum. The number necessary for a quorum is at least a majority of the board members, but can also be set higher in the By-Laws, Articles or Certificate.

C. Of those who take part in the meeting, at least a simple majority must vote for the resolution for it to be adopted and effective.

D. A board meeting can take place telephonically, provided that all the members of the board can hear each other.

E. Board resolutions can be adopted by unanimous written agreement in lieu of a meeting.

A combination of a telephonic meeting and a written consent is not possible. A board member who cannot take part in a telephonic meting can however waive notice of the meeting and simply not participate. In this case, board resolutions can be adopted if a quorum takes part in the meeting.

F. Contrary to English law, a board member may not give his vote to another by way of proxy or power of attorney.

In a 100% owned subsidiary, major disputes at the board level occur very seldom. One example could be if the President of the corporation is also a member of the board. To hold a board meeting to authorize the President's termination can produce such a dispute. Note that the President does not have to be a member of the board.

The By-Laws often list a series of decisions which can be made only by the board. In other words, the officers of the corporation cannot make these decisions without the agreement of the board. These restrictions are valid, however, only internally. They are not publicly registered and are not effective to protect the corporation from obligations to third parties which an officer enters without authority.

Besides these internal, organic procedures and restrictions, a corporation can also agree with a third party, often a lending bank, to operate according to provisions set forth in a contract.

Contrary to the corporate legal systems of some countries, where one form of company is formed when it is small and has few owners and then is transformed into another form of company when it becomes large and publicly traded, in the United States both types of companies are usually simply corporations. In the United States, a corporation can start small, with only one shareholder, and then grow into a huge enterprise with thousands of shareholders, using the same legal form. The Securities Exchange Commission ("SEC") regulates the additional complexities which come with size and many shareholders.

The transfer of shares of a corporation in the United States is usually quite simple. The owner must only sign the reverse side of the stock certificate and hand it over to the buyer or the buyer's representative. In many cases the signature requires a bank guaranty or authenticity. The transfer is not noted in any official, public register. The whole procedure can be handled by the corporation itself.

Although the functions of the three corporate organs – shareholder, board and officers – are strictly separated, the same persons can play roles in all three organs. The shareholders have the greatest rights. In the final analysis, they can make all decisions regarding the corporation, but only indirectly. Usually the shareholders of a publicly-held corporation are interested only in the value of their shares and not in the policies of the corporation. This is different in the case of a shareholder of a 100% subsidiary. In either case, the shareholder elects the board of directors of the corporation. The approval of the shareholder is otherwise seldom required, for example in the sale of substantially all the assets of the corporation or the amendment of the Articles or Certificate. The shareholder cannot represent the corporation in its relations with third parties. In particular, the shareholders cannot sign contracts on behalf of the corporation, even if the shareholders act unanimously or all of them sign the contract. Such action could make them personally liable.

The areas of competence of the board of directors are similarly limited. Like the shareholders, the board – which may consist of any number of directors – cannot legally bind the corporation with respect to third parties, even in the case of unanimous action. The board acts only as an internal gremium and mainly sets the policies of the corporation. In this capacity, the board determines which contracts should be signed on behalf of the corporation. However a board member is not competent to sign the contract him or herself. For this function, the board members elect and empower the officers of the corporation.

The officers are the persons who act on behalf of the corporation. They sign contracts in the name of the corporation. They may also be shareholders or board members of the corporation. However these three areas of competency are separate and independent of each other. Even the President of the corporation has no right to participate in meetings of the board. Of course the board may invite the President to attend the board meeting. In this case, however, the President still has no vote and may address the board only when requested. The President needs no special authority from the board for the daily management of the corporation. But if he is to sign a material agreement on behalf of the corporation, he has to first obtain a board resolution.

The normal, minimum officers of a corporation are the President and Secretary. A corporation often also has Vice Presidents, Assistant Secretaries, a Treasurer and Assistant Treasurers. More and more often officers have the additional title “Chief Executive Officer” (“CEO”), “Chief Operating Officer” (“COO”) and “Chief Financial Officer” (“CFO”). Other titles are seldom used and create uncertainty. The title “Managing Director”, “General Manager” and similar titles should be avoided. They do not have any clear significance in the U.S. legal system. The title “CEO” is actually only important if the corporation also has a “Chairman of the Board.” The question can then arise who the superior person is, the President or the Chairman. The title “CEO” provides the answer.

As noted, the board can consist of any number of persons. The number can be even or odd. In the case of a wholly-owned subsidiary, the number is not important. But if the corporation has two or more shareholders, then the size of the board can be significant.

Creating a committee of the board can be advantageous. The committee consists of one or more of the members of the board. If a member of the committee is not available – on vacation for example – a substitute can act in his or her absence. This person must have been named as the substitute by the board in advance, however. The board thereby gains flexibility but also gives up some control, at least as to smaller decisions which nevertheless require board approval – such as changes in banking relationships or automobile leases. The area in which the committee may act can be either large or small, as the board decides when setting up the committee. Multiple committees are also possible, with varying areas of competency.

To help assure that the corporation is respected as such (and not treated as an extension of the shareholder), it is best to hold at least annual meetings of the shareholders and the board. The shareholder should elect the board at least yearly. In the United States it is neither required nor normal for the board of a wholly owned subsidiary to approve the financial statements or approve the actions of the officers taken in the previous year.

Immediately after the shareholder's meeting, the board should elect the officers of the corporation. If the corporation takes important action without board approval, the board can ratify the action after the fact.

As mentioned above, both "meetings" can be handled by unanimous written consent.

COMMERCIAL REGISTER. None of the 51 U.S. jurisdictions has a commercial register. As a general rule, it is not possible to tell, officially or unofficially, who the shareholders, directors or officers are of a corporation. The transfer of shares, the election of directors and the election of officers are not listed anywhere or publicized. This is also true as to the extent of authority of an officer. From these facts arises the question how a third person can know whether the person with whom he or she deals has the necessary authority. The answer is somewhat complex.

In normal transactions of a corporation, the third person can assume that the President or Vice President has the necessary authority to act for the corporation. If this turns out not to be true, it is an internal matter for the corporation. The corporation is bound by the signature of the officer. It is another question whether the corporation has rights against the President or Vice President who acted without authority.

In the case of unusual transactions, the following steps can be taken to protect the third party against unauthorized actions by an officer.

1. The contract itself can contain a representation and warranty of the corporation that the person who signs for the corporation has the necessary authority. However this representation and warranty does not help if the signer is the only manager of the corporation who knows about the agreement.

2. The Secretary of the corporation signs the contract together with the President (or a Vice President). This way it can at least be seen that two members of management are informed of the contract.

3. The Secretary of the corporation provides his or her certificate in which
    a. the officers of the corporation are listed,
    b. the signatures of the officers are confirmed,
    c. attached Articles of Incorporation or the Certificate of Incorporation are certified as correct (which can also be done more officially by the Secretary of State),
    d. attached By-Laws of the corporation are certified (which cannot be done by the Secretary of State) and

e. attached resolutions approving the contract and authorizing the officer(s) to sign on behalf of the corporation are certified as correct.

4. The law firm which represents the corporation can provide its legal opinion in which it confirms that the contract has been approved by the board and that the President (or some other officer) is authorized to sign. By such an opinion the contract partner is assured that the law firm has carefully examined the contract and the documents of the corporation and that the corporation cannot later claim that the President was not authorized to sign. The opinion can also cover other aspects of the contract.

SUMMARY. As noted above, one encounters countless differences between the U.S. legal system and that of other countries when forming and managing a U.S. corporate subsidiary. U.S. law can offer great flexibility, but one must still note that certain formalities have to be honored. This article is intended to make these differences easy to recognize and comply with.

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