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Business Law Information Memo

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Bond, Schoeneck & King, PLLC
New York
Albany ▪ 518-533-3000
Buffalo ▪ 716-566-2800
Ithaca ▪ 607-330-4000
Long Island ▪ 516-267-6300
New York City ▪ 646-253-2300
Oswego ▪ 315-343-9116
Syracuse ▪ 315-218-8000
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Kansas
Overland Park ▪ 913-234-4400

Bond, Schoeneck & King, P.A.
Florida
Bonita Springs ▪ 239-390-5000
Naples ▪ 239-659-3800

CORPORATE FORMALITIES CAN BE INDISPENSABLE

The Delaware Supreme Court issued a recent decision which illustrates the importance of complying with corporate formalities. Reddy v. MBKS Company Limited, et al. (March 3, 2008). Many businesses are incorporated in Delaware, and corporate law decisions by Delaware courts are often influential in other states.

Background. In the Delaware litigation, an individual claimed that he was the owner of stock in two Delaware corporations. The parties to the litigation did not dispute that agreements were made intending to change the authorized capital of the corporations, that Boards of Directors' resolutions were adopted to cancel shares of stock and to issue stock to the individual, that the word "Cancelled" was written across stock certificates intended to be cancelled, and that new stock certificates were issued to the individual.

The Delaware Supreme Court ruled that the attempted cancellation of stock was not legally effective since the required formalities under Delaware law were not followed. The Court explained that in order to change the authorized capital of a Delaware corporation, Delaware law requires that (1) the Board of Directors must authorize an amendment to the charter of the corporation, (2) the stockholders must approve the amendment, and (3) the amendment must be filed with the Delaware Secretary of State. Since all of these requirements were not satisfied, the cancellation was not legally effective. The Court concluded that the individual did not own any stock in the Delaware corporations.

While the Reddy decision was based on Delaware law, the same result would occur under New York law. In order to change a New York corporation's authorized capital, the Board and the stockholders must approve an amendment of the charter to the corporation, and the amendment must be filed with the New York Secretary of State.

Significance. The recent Delaware Supreme Court decision is a reminder that the officers and the directors of corporations should assure that corporate formalities are followed. If corporate formalities are not followed, the desired result may not be implemented. For example, if a corporation decides to change its capital structure, usually, both the Board and the stockholders must formally agree to the change, and the change must be documented in the corporation's charter filed with the Secretary of State. Other examples of corporate formalities are holding regular Board meetings and stockholders meetings, and keeping accurate meeting minutes.

"Piercing the Corporate Veil". In addition to complying with corporate formalities in order to effectuate desired changes, there is another compelling reason to be sure that corporate formalities are followed. As a general principle, a corporation exists independently of its stockholders, and the stockholders are not normally liable for the corporation's debts. However, a court may allow creditors and claimants to disregard the corporation and hold the stockholders personally liable for the corporation's debts by "piercing the corporate veil" protecting the stockholders. An important factor which a court considers in deciding whether the limited liability protection should be pierced (ignored) is whether corporate formalities have been followed in the operation of the corporation and in its documentation.

Limited liability for stockholders is a bedrock of corporate law – absent fraud or a failure to follow corporate formalities, stockholders, in most cases, are only at risk for the amounts invested in the corporation. But, if corporate formalities have not been followed, stockholders can be at risk that creditors and claimants may be able to pierce the shield of limited liability and reach the stockholders' personal assets to satisfy corporate debt.

Complying with corporate formalities is also important to assure that related, affiliated, and/or sister corporate entities are liable only for debts incurred by each separate corporate entity. In situations where related corporate entities are encountering financial distress and creditor pressures, it is essential that each entity complies with corporate formalities. In certain situations, where formalities have not been complied with, including transfers of assets between related corporations without regard to the separate nature of each entity, courts have pierced (ignored) the separate corporate entities and merged or "substantially consolidated" separate corporate entities making the one consolidated corporate entity liable for all debts incurred by each of the previously separate corporate entities. Essentially, a court can pool the assets of the consolidated entities making them available to all creditors.

Compliance with corporate formalities can be indispensable to achieving intended results such as a change in capital structure, avoiding the risk that stockholders will be liable for corporate debt by "piercing the corporate veil," and avoiding the risk that separate but related corporate entities could be held liable for the debts of all the corporate entities.

If you have any questions or desire more information about required corporate formalities, please contact your BSK attorney or one of the attorneys listed below.

In Central New York, call 315-218-8000 or e-mail:

Ronald C. Berger	rberger@bsk.com
Stephen A. Donato	sdonato@bsk.com
David M. Hayes	dhayes@bsk.com
Thomas L. Kennedy	tkennedy@bsk.com

In the New York Metro area, call 646-253-2300 or e-mail:

Louis P. DiLorenzo	ldilorenzo@bsk.com

In the Capital District, call 518-533-3000 or e-mail:

Gregory J. Champion	gchampion@bsk.com

In Western New York, call 716-566-2800 or e-mail:

Robert A. Doren	rdoren@bsk.com