

Parent Companies – Safe, Or Not, When Bad Things Happen At Subsidiaries?

Traditional dogma is that unless a plaintiff can carry the tough burden of piercing the corporate veil, parent or intermediate holding companies are safe from attack regarding adverse events that occur at subsidiaries. Dogma has its place, but the rule is not so simple in the real world. Knowing the real rule is important for companies that want to avoid creating liabilities. Knowing

KIRK T. HARTLEY
MINDY A. FINNIGAN
KEVIN J. MUELLER

the applicable rule also enables acquirers and sellers of businesses to better structure due diligence, representations and warranties, and financial protections.

The actual rule of law is that veil piercing is not required to attack parent companies when bad things happen at subsidiaries. Instead, decades ago, the venerable Justice William O. Douglas described a simpler path to attack a parent for events that occur at subsidiaries. The path is to plead allegations that invoke the “direct participation” rule.

What is the “direct participation” rule? To quote a current case that relied on the article by Justice Douglas, the “direct participation” rule is that liability arises from: ‘[d]irect intervention or intermeddling by the parent in the affairs of the subsidiary and more particularly in the transaction involved, to the disregard of the normal and orderly procedure of corporate control carried out through the election of the desired directors and officers of the subsidiary and the handling by them of the direction of its affairs.’

Forsythe v. Clark USA, Inc., 361 Ill. App. 3d 642, 648, 836 N.E.2d 850, 855-56 (1st Dist. 2005) (appeal granted) (citing *Esmark, Inc. v. Nat'l Labor Relations Bd.*, 887 F.2d 739, 755 (7th Cir. 1989) (quoting Douglas and Shanks, *Insulation from Liability through Subsidiary Corporations*, 39 Yale L.J. 193, 196-97 (1929))).

Current Application of the Rule

The “direct participation” rule is currently at issue in Illinois in *Forsythe v. Clark USA, Inc.*, 361 Ill. App. 3d 642, 836

N.E.2d 850 (1st Dist. 2005), now on a successful discretionary appeal to the Illinois Supreme Court. *Forsythe* arose from an explosion and resulting deaths at an oil refinery operated as its own entity, with a holding company above it owning 100% of the stock. After plaintiffs collected workers compensation benefits from the operating subsidiary, they filed a lawsuit naming the holding company as a defendant. In essence plaintiffs alleged the explosion occurred because untrained refinery workers were allowed to perform a dangerous activity, and the use of untrained workers allegedly resulted from budget cuts imposed by the parent corporation. More specifically, according to the appellate court:

Plaintiffs here alleged that defendant was a proximate cause of the decedent's deaths via its own direct conduct, i.e., by mandating that Clark Refinery operate the refinery at “survival mode” and by reducing the capital expenditures to the “minimum sustainable level,” defendant created conditions within the refinery which posed an unreasonable risk of harm to refinery employees like the decedents.

The defendant sought summary judgment. Plaintiffs responded with corporate memos and other facts reminiscent of press releases or articles that appear routinely in the financial press. Thus, according to the appellate court:

[p]laintiffs relied on evidence that defendant's directors drew up and approved Clark Refining's budget; the boards of both defendant and Clark Refining often met simultaneously; according to defendant's 1995 strategic business plan, defendant mandated that Clark Refining “position itself as a low cost refiner and marketer”; and defendant strove to “replenish the strategic cash reserve [of defendant] to \$200 million” by “decreas[ing] capital spending * * * to minimum sustainable levels” and instituting a “survival mode” philosophy to its 1995 business plan. (361 Ill. App. 3d at 646, 836 N.E.2d at 853)

Results of a Google Search

We ran a Google search a plaintiff might use to find evidence to support allegations for a direct participation claim. Accordingly, we searched for the phrase “company wide cost reduction.” Google returned 702 hits. On changing the search to use both the phrase “company wide” and the phrase “cost reduction,” Google returned 117,000,000 results. The numbers suggest there is fertile ground to plow when plaintiffs seek press releases or articles to support “direct participation” claims against corporations.

The Direct Participation Rule - The Key to U.S. Courthouses?

Back to dogma. Some lawyers tell corporate parents they are safe from claims arising from separate operating companies scattered around the world. That dogma, however, is wrong. If the facts are available, plaintiffs may invoke the “direct participation” rule as a means for opening U.S. courthouse doors to a variety of lawsuits.

Consider the following two hypothetical patterns. Suppose, for example, a parent issues a global order for all subsidiaries to reduce expenses by 30%. Suppose the company-wide budget reduction is followed by an increase in product failures that stimulate breach of warranty or consumer fraud claims. In that setting, a direct participation claim may open the door to suits in the U.S. against overseas parent corporations alleged to have directly participated in acts that produced product failures in the U.S. This result might help U.S. corporate or individual plaintiffs as against overseas entities.

Alternatively, suppose a U.S. parent issued orders that allegedly resulted in personal injury or property damage events at subsidiaries in other countries. The “direct participation” rule may act as the key for opening the door to a suit in the U.S. against the corporate parent.

In both hypotheticals, filing suit in the U.S. may offer perceived advantages to the plaintiff. First, the plaintiff may thereby gain a jury, discovery rights and other results not likely in some other countries. In addition, the alleged “direct participation” of the parent probably means that U.S. based discovery will be demanded, and the direct participation claim also may be cited as a reason why claims should remain in U.S. courts even if the injury was suffered overseas.

Direct Participation Rule Could Be Applied to Many Types of Claims

The direct participation rule is not limited to bodily injury claims, and it is easy to imagine plaintiffs invoking the rule in claims involving financial matters. Suppose a holding company sets a company-wide dividend policy. Suppose one of the subsidiaries could not meet the policy unless it took on debt. Suppose that after three years of taking on debt and then paying dividends, the subsidiary filed for Chapter 11 when it could no longer support its debt load. This and other scenarios may offer fertile ground for “direct participation” claims.

Indemnities and Insurance

Claims against holding companies also could create thorny issues related to traditional insurance, “D&O” insurance, and even for traditional non-insurance indemnities between buyer and seller. One set of issues would arise from potential sharing of applicable commercial insurance policies. If there is a direct participation claim, who gets the policy limits - the parent, the subsidiary, or both? Is there anything left for directors and officers?

Yet other issues will arise regarding non-insurance indemnities. Suppose an asset sale includes an indemnity that applies to claims “arising from the business” that was sold. If the claim is of the sort raised in *Forsythe*, does that conduct arise from “the business” of the parent or the subsidiary? Or, does it arise from both?

Conclusion

Dogma is dangerous when it leads to complacency or outright error in structuring and conducting the affairs of corporations. When dogma is set aside, the real world “direct participation” rule creates risks and opportunities that need attention and management, especially as the Internet shrinks the world at an ever faster pace.

Kirk T. Hartley is a partner of, and Mindy A. Finnigan and Kevin J. Mueller are associates with, Butler Ruben Saltarelli & Boyd LLP, a Chicago litigation boutique. All three lawyers are members of the firm's Legacy Liability practice group. The views expressed are personal to the authors.