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Parent corporation liability for acts of its subsidiary

By Professor Charles W. Murdock, Loyola University Chicago School of Law

When we think of the potential liability of a parent corporation for the acts of its subsidiary, we normally think of the situation in which the corporate veil of a subsidiary is sought to be pierced in order to hold the parent liable. In order to pierce the veil of the subsidiary, it is normally necessary to show that the subsidiary was undercapitalized or that corporate rituals were not followed so as to be able to distinguish the separate existence of the parent and the subsidiary. But what if the subsidiary is adequately capitalized and corporate rituals are followed. In this situation there is another theory on which a parent corporation can be liable in a parent-subsidiary context. This is the "direct participant" theory of liability in which the parent is liable, not because the separate existence of the subsidiary is disregarded but rather because of the parent's own actions.

Such an approach to liability makes legal sense. Since an individual can form a corporation and be protected from personal liability based upon the entity's liabilities, it arguably follows that a corporation could form a subsidiary and be shielded from the liabilities of such entity. On the other hand, it is well settled that when a individual who has formed a corporation performs a wrongful deed, such individual is not protected by having formed a corporation. When a shareholder actively participates in the wrongful conduct of a corporation, the shareholder will be personally liable for such "active participation."[1]

It logically follows that, if an individual shareholder can be personally liable when the shareholder actively participates in the wrongdoing, so also should a parent corporation be personally liable when it actively participates in the wrongdoing of its subsidiary. A corporate parent should have no more insulation from liability than should an individual shareholder. In fact, since the individual shareholders of the parent still retain insulation from liability, a fortiorari, the parent should be liable when it actively participates in the wrongdoing. This is the essence of the "direct participation" theory.

Justice (then professor) William O. Douglas, in his seminal article on parent/subsidiary liability, observed that. "[t]here is a group of cases where liability is imposed upon the parent for torts of the subsidiary"[2] even though the traditional grounds for ignoring the separate existence of the subsidiary were not met.[3] According to Justice Douglas:

> [This would occur in] instances were the parent is directly a participant in the wrong complained of. The parent has been held liable in a tort action for inducing the subsidiary by means of its own stock ownership to breach a contract with the plaintiff. Stock ownership was not enough. But the use of the latent power incident to stock ownership to accomplish a specific result made the parent a participator in or doer of the act. Again, there was interference in the internal management of the subsidiary; an overriding of the discretion of the managers of the subsidiary.[4]

The "direct participant" theory was recently recognized by the U.S. Supreme Court, in *U.S. v. Best Foods*,[5] and by the Seventh Circuit, in *Esmark Inc. v. NLRB*.[6]

The direct participation doctrine was relied upon by the court in *Forsythe v. Clark USA, Inc.*,[7] a case brought by the estates of two employees of Clark Refining who were burned to death when other employees attempted to replace a valve on an Isomax unit without insuring that flammable materials within the pipe had been depressurized. The employees who sought to replace the valve were not maintenance employees and were not trained or qualified to do the work in question. Plaintiffs alleged that defendant Clark USA (the parent) breached its duty to plaintiff by:

> (1) "requiring [Clark Refining] to minimize operating costs including costs for training, maintenance, supervision and

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safety." (2) "requiring [Clark Refining] to limit capital investments to those which would generate cash for the refinery thereby preventing [Clark Refining] from adequately reinforcing the walls of the lunch room or relocating the lunch room to safe position within the refinery," and (3) "failing to adequately evaluate the safety and training procedures in place at the Blue Island Refinery."[8]

Plaintiffs relied on the following evidence:

> [D]efendant'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";[9]

Defendant argued that "as a mere holding company where the only connection to Clark Refining was its status as sole shareholder, it owed no duty to either deceased."[10] It further argued it had no control over day to day operations. However, the primary role of a shareholder is to elect directors and then to let the directors manage the corporation. Adopting a budget is a function of the board of directors of the subsidiary, not the parent shareholder. It is also up to the board of directors of the subsidiary to determine capital expenditures and staffing levels, not the parent shareholder. Accordingly, when the parent shareholder usurps the role of the board of directors of the subsidiary, it then assumes responsibility for the consequences of its actions.

While courts have recognized that the mere fact that the board of the parent and the board of the subsidiary overlap is not a basis for piercing the corporate veil of the subsidiary, a parent takes such action at its own risk. When there is an identity of directors, it is difficult to determine in whose interest the directors are acting; in fact, the presumption should be that they are acting in the best interest of the parent. The individuals in question are not directors of the parent because they are directors of the subsidiary; rather they are directors of the subsidiary because they are directors of the parent!

According to the dissent, "plaintiff have not presented sufficient evidence to overcome the presumption that the director wore their 'subsidiary hats' and not their 'parent hats' when making the decision that allegedly led to the injuries here."[11] But, as stated above, such a presumption is irrational. The directors are directors of the subsidiary because they are directors of the parent, not vice versa. The purpose of having them serve as director of the subsidiary is to enable the parent to exercise additional control over the subsidiary. As the United States Supreme Court stated, in *Consolidated Rock Products Co. v. DuBois:*

> It is well settled that where a holding company directly intervenes in the management of its subsidiaries so as to treat them as mere departments of its own enterprise, it is responsible for the obligations of those subsidiaries incurred or arising during its management ... A holding company which assumes to treat the properties of its subsidiaries as its own cannot take the benefits of direct management without the burdens.[12]

The loyalties of persons who are directors of both the parent corporation and its subsidiary is illustrated by the case of *Weinberger v. UOP, Inc*, 457 A. 2d 701 (Del. 1983), where directors who sat on both boards utilized information that they received as members of the subsidiary in connection with a study they did for the parent to determine how much the parent would offer to buy out the remaining shareholders of the subsidiary. The study was disclosed neither to the members of the board of the subsidiary who were not connected to the parent nor to the minority shareholders of the subsidiary.

In addition to overlapping directors, Paul Melnuk was both president of defendant Clark USA and CEO of Clark Refining. According to the dissent, "[m]ost notably, plaintiffs have not alleged any negligent acts committed by persons who served solely as officers of defendant and not also as officers or directors of Clark Refining.[13] In effect, the dissent has the cart before the house. There is no requirements that the parent have its president also serve as CEO of the subsidiary. Similar to the director situation, the presumption should not be that the person in question is acting for the best interests of the subsidiary, rather than this best interest of the parent. Rather, the opposite is generally the case. If the president had a choice, would it be better for the parent to fail or for the subsidiary to fail. Obviously, the executive's first loyalty is to the parent. If the parent goes down, the overall entity is lost. If the subsidiary fails, only a piece of the overall entity is lost.

This is illustrated by the facts in Clark USA. The 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.[14] The desire to generate cash was for the benefit of the parent, not the subsidiary. When Melnucks, the president of Clark USA and CEO of Clark Refining, instructed the employees of Clark Refining to reduce the budget they proposed by 25 percent, he was acting in the best interests of Clark USA (by building up its cash reserve), not in the best interests of Clark Refining (which had its capital budget decreased and suffered "a series of cutbacks at the Blue Island refinery that undermined safety, training, maintenance there and, in turn, created an unreasonable risk of harm to others including the employees of Clark Refining.[15]

Consequently, when Clark USA "directly intervene[d] in the management of its subsidiaries so as to treat them as mere departments of its own enterprise,"[16] it became liable for the consequences of its actions.

This article was adapted from 7 Murdock, Illinois Practice – Business organizations 6.19A "Direct Participant" Liability for a Parent Corporation

1. See infra § 8.22
2. Douglas and Shanks, Insulation from Liability through Subsidiary Corporations," 39 Yale L.J. 193, 205 (1929).
3. For example, undercapitalization and commingling if funds are frequently found when a court pierces the corporate veil; controversial, adequate militate against piercing the corporate veil. See infra §8.19. On the other hand, adequate capitalization of the subsidiary would be irrelevant when the parent corporation is guilty of direct participation in the wrongdoing.
4. Id. At 208-209
5. 524 U.S. 51, 61 (1998)
6. 887 F. 2d 739, 755 (7th Cur. 1989)
7. 836 N.S. 2d 850 (2005)
8. Id. at 852
9. Id. at 853
10. Id. at 852
11. Id. at 862
13. 836 N.E. 2d at 863
14. Id. at 853
15.Id.
16. Consolidated Rock Products, 312 U.S. at 510.