Protecting the Parent Corporation from Disregard of the Corporate Form

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September 22, 2008

More and more, non-U.S. corporations, as part of their global operations, conduct business in the United States. Through the use of subsidiaries, these corporations can manage the risk of lawsuits presented by their U.S. operations. In this advisory, we explore the variables that U.S. courts take into account when weighing questions of jurisdiction in such lawsuits; and the steps that parent corporations can take to avoid having to pay costly judgments on behalf of subsidiaries doing business in the United States.

The use of subsidiaries by non-U.S. companies doing business in the United States is prudent, as subsidiaries are a means of managing the parent company's risk from its U.S. operations. Plaintiffs in U.S. litigation, however, often seek to disregard the corporate form of a subsidiary doing business in the United States – commonly referred to as "piercing the corporate veil" – in order to hold the non-U.S. parent company directly liable. This is often done by a lawsuit against the subsidiary along with its non-U.S. parent. The plaintiffs' goals may be to reach a "deep pocket," increase settlement value or obtain broad discovery of the parent corporation. However, with proper planning and full consultation with experienced U.S. counsel, the risk that a court will disregard the corporate form is minimized.

One of the most significant factors to consider is the structure of the relationship between the parent and the subsidiary as this is the fulcrum on which the decision of the court balances. U.S. courts regularly reject attempts to pierce the corporate veil when the relationship between the parent and subsidiary has been structured with careful consideration of both U.S. personal jurisdiction rules and theories used to pierce the corporate veil. Jurisdiction is the power of a court to hear certain cases involving certain parties. A court's decision is unenforceable without jurisdiction over both the subject matter of the action – subject matter jurisdiction – and the persons or entities involved in the dispute – personal jurisdiction. Typically, subject matter jurisdiction is easier to determine because it is defined by statute or case law and does not change often.

Proving Personal Jurisdiction

Personal jurisdiction concerns the court's power to hear a case against the defendant (the plaintiff implicitly accepts personal jurisdiction by bringing the action). It is based on the facts and circumstances of each case. For corporate entities that do not reside in the in the United States, personal jurisdiction is fact-specific and not always easy to establish. Therefore, personal jurisdiction, and the hurdles it presents to a plaintiff, is an important factor to consider when formulating a plan to mitigate risk of disregard of the corporate form.

To establish personal jurisdiction over a non-resident defendant, a plaintiff must demonstrate that the defendant received proper notice and also that exercise of jurisdiction over the defendant is in accordance with the law and meets certain minimum standards of fairness. For many non-U.S. nationals, proper notice means service of process in accordance with the Hague Convention. The question of personal jurisdiction over non-resident defendants generally focuses on two issues: Is the assertion of jurisdiction authorized by a state statute? And, if authorized, is the exercise of jurisdiction under state law consistent with basic due process requirements mandated by the U.S. Constitution?

Each state has its own statutes that authorize personal jurisdiction over non-resident defendants. These statutes apply whether the action is pending in state or federal court and generally provide for both "general jurisdiction" and "specific jurisdiction" over non-residents. General jurisdiction over a defendant exists when that defendant has sufficient contacts with the state to hold that party amenable to suit for that defendant's conduct anywhere in the world. A finding of general jurisdiction requires continuous and substantial in-state activity such as doing business, selling goods, maintaining an office, employing persons in the state, etc. If a court finds that it has general jurisdiction over a defendant, that court may exercise jurisdiction over the defendant for any cause of action that falls within the court's subject matter jurisdiction.

On the other hand, specific jurisdiction, as its name implies, is related to a defendant's specific contacts with the state that gives rise to the lawsuit. Under laws commonly referred to as "long-arm statutes," states can authorize the exercise of jurisdiction over non-resident defendants when that defendant's contacts with the state rise to a level in which it is fundamentally fair to hold that defendant liable for consequences arising out of those contacts. In order to find specific jurisdiction, a plaintiff must establish a minimum level of contacts between the defendant, the forum and the litigation. Long-arm statutes vary from state to state but generally allow courts to exercise personal jurisdiction over a defendant who acts directly, or by an agent, as to a cause of action arising from business transactions in the state (e.g., breach of contract) or actions causing injury in the state (e.g., products liability actions and negligence actions). Some such statutes also permit a lawsuit to be brought for injuries occurring outside the state under certain circumstances. The long-arm statute of the particular state must be carefully examined. Therefore, as some permit suits against non-resident defendants on more liberal terms than others.

Not only must a court find the particular long-arm statute satisfied, but it must also evaluate due process when determining whether to exercise personal jurisdiction over a non-resident defendant. Due process, a test of fairness rooted in the U.S. Constitution, requires that the defendant meets three criterias: have "minimum contacts" with the state, "purposefully availed" himself or herself of the state and that exercise of jurisdiction over the non-resident defendant is otherwise "reasonable." When a lawsuit involves activities that fall squarely within the provisions of a state's long-arm statute, due process is usually – but not always – found satisfied. When the nature of the defendant's contacts with the state are disputed or when the activities at issue do not fall squarely within the terms of the state's long-arm statute, the court must conduct a comprehensive due process analysis of the non-resident defendant's contacts with the state.

In most cases, a parent corporation's only contacts with a forum state may be its ownership of the stock of a subsidiary located in the state or doing business in the state. Ownership of stock, however, is rarely sufficient by itself to establish personal jurisdiction – whether general or specific – over a foreign parent. Thus, a plaintiff will often attempt to establish jurisdiction over the non-U.S. parent by arguing that the corporate form of the subsidiary should be disregarded so that the subsidiary's actions can be imputed to the parent company.

Agency or Alter Ego: Fraudulent Intent?

Typically, to succeed in disregarding the corporate form of a subsidiary, a plaintiff must demonstrate (a) some sort of injustice to the plaintiff resulting from recognition of the corporate form and (b) that the parent exercises significant control over the subsidiary. Many, but not all, states also require the plaintiff to prove that the parent had a fraudulent intent. The arguments to pierce the corporate veil of a subsidiary typically follow one of two theories: agency or alter ego.

Under the agency theory, a plaintiff seeks to establish jurisdiction over a parent corporation on the grounds that its subsidiary was an in-state agent of the parent. To prevail on such an argument, a plaintiff must typically establish a manifestation by the parent that the subsidiary (the alleged agent) will act for it; an acceptance by the subsidiary; and, total control by the parent over the subsidiary. In some circumstances, a plaintiff needs to establish only a close connection between the cause of action and the purported agency. An agency relationship between a parent and its subsidiary need not be expressed and may be established from reasonable inferences from the evidence of the relationship. An agency relationship will not ordinarily be found absent extraordinary control of the subsidiary by the parent company. Common ownership of stock of two or more companies and common management, without additional oversight or control, will not give rise to liability on the part of a parent corporation for the acts of its subsidiary.

Under the alter ego theory of piercing the corporate veil, the presumption that a parent and its subsidiary are separate corporations may be overcome by evidence that the subsidiary is completely controlled by the parent. When determining whether a subsidiary is an alter ego of its parent, courts consider many fact-specific factors, including whether the subsidiary is adequately capitalized; whether corporate formalities are observed; whether the parent and subsidiary share corporate officers and directors; and whether the subsidiary has its own offices, employees, bank accounts, and telephone numbers. These factors are merely a few of the many considered by courts when evaluating an alter ego claim. The alter ego analysis is very fact-specific and courts have broad discretion in making decisions. The normal exercise of control by a parent does not typically result in a piercing of the corporate veil. In order to disregard the corporate form, the control must be so complete that the subsidiary has no separate mind, will or existence of its own.

Managing Risk

There are many steps that non-U.S. companies ought to take to counter agency or alter ego theories of piercing the corporate veil. Properly capitalizing and insuring the subsidiary is by far the most important step to prevent a successful piercing argument (since doing so substantially weakens a potential argument based on alleged injustice). Also, complying with corporate formalities is critical to protecting against agency and alter ego arguments. The subsidiary's articles of incorporation should be properly filed and all stock certificates should be properly issued. The subsidiary should have its own bank account, separate from the parent's. In addition, the subsidiary should document the reason for its capital structure and the level of capital used. Any loan to or from the parent company should be fully documented and contain an arm's-length interest rate. The subsidiary should keep a balance between debt and equity which is appropriate to the type of business it operates. These steps, and the many others that would be revealed after full consultation with U.S. counsel, will help to demonstrate that the subsidiary is an entity with its own existence that is separate from the parent.

Assuming adequate insurance coverage, adequate capitalization, respect for corporate formalities and full consultation with U.S. counsel, the risk that the corporate form of a U.S. subsidiary will be

disregarded is low. Failure to observe these formalities, however, or failure to properly structure a subsidiary's relationship with its non-U.S. parent, can lead to adverse consequences.

For more information on mitigating the risk of piercing the corporate veil and the appropriate structuring of the parent-subsidiary relationship, please contact:

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