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Holding Parents Liable for Their Children's Wrongs: The U.S. and EU Diverge in the Corporate Governance Context

August 12, 2010

Large, multinational companies devote significant effort to develop effective, though often Byzantine, corporate structures. Many considerations play a role in deciding how to organize a corporate family of subsidiaries, affiliates, and joint ventures, including company culture, historical accident, operational efficiency, tax implications, and power through the allocation of rights and responsibilities among joint owners. But one of the more important considerations is liability: How to insulate one arm of a multinational conglomerate from the consequences of the wrongdoing committed by another.

Obviously, in many situations the issue is academic; but in some they are not. If the affiliate is wholly owned by the parent and the amount of the fine is the same, then the question of corporate separateness may be nothing more than an accounting issue. But partially owned affiliates get into as much trouble as wholly owned ones do, which can raise complex questions of apportionment. And even if a subsidiary is wholly owned, a parent – who is able to satisfy a judgment when the subsidiary is not – may be willing to put the subsidiary into bankruptcy. Of course, this only works if the parent is not directly liable. Further, the distinction between parent and affiliate can have consequences for the amount of the fine. For example, in the European Union, the maximum fine for a violation is based on the total revenue of the entire corporate family, and a parent's fine may be enhanced for recidivism, even though the parent never did anything wrong and different affiliates were involved in different violations at different times.

Unfortunately, this issue of parental liability is not as clear cut as it may seem. Not only do different jurisdictions treat the issue of parent-affiliate liability differently, but there is a growing rift between the standards in the United States and those in the European Union. As recent cases suggest, it is becoming increasingly difficult for parents to avoid or limit liability in the EU, even when the parent engaged in no wrong-doing and where it is only a partial owner of the intransigent affiliate. These cases should be a warning call to multinational companies seeking to expand their geographic reach.

The EU's "Economic Unit" Concept and the "Decisive Influence" Test

Under U.S. law, the "fiction" of corporate identity is well established, and only breached in certain circumstances. In the EU, a different regime applies.

Under EU antitrust law, liability focuses on the activities of "undertakings," meaning an entity or *group of entities* that effectively function as a single economic unit. A parent and its affiliates will form such a unit, for example, when the parent exercises "decisive influence" over its affiliate's general operations. Once the relevant undertaking is defined, the principle of personal liability requires that judgments be addressed to specific legal persons within the undertaking. This means that liability will fall on those legal entities that engaged in wrongdoing ***or*** who exercised "decisive influence" over the undertaking.

Although the concept of "decisive influence" is not well defined, European courts appear to be taking an expansive view. This was starkly illustrated in the European Court of Justice's (ECJ) July 1, 2010 decision, *Knauf Group.*[1] In that case, several representatives from various companies within the Knauf family participated in a cartel. The EU Commission imposed a € 86M fine on Knauf Gips KG ("Gips"), based on the whole Knauf Group's turnover.[2] Gips argued on appeal that it did not exercise decisive influence over other Knauf companies, as it was not legally controlled by and did not control another affiliate within the group. In fact, there was no single legal person (or parent) in charge of the entire Knauf Group.

The ECJ rejected this argument. The court first concluded that all the companies within the Knauf group constituted a single "undertaking" because they were all involved in the plasterboard market, the shareholders were all members of the Knauf family, and they were bound by a "family contract," which aimed at ensuring a single management and direction of the Knauf companies. The ECJ then found that Gips did, in fact, exercise "*decisive influence*" over the Knauf Group even if it is not at the apex of the Group's legal structure. As the ECJ stated, "*the legal structure of a group is not decisive where that structure does not reflect the effective functioning and actual organization of the group*." According to the court, imposing liability on Gips was justified because it had the largest turnover, staff, and premises within the Group; thus, demonstrating its "predominance."

The *Knauf* decision is just the latest in an increasingly long line of cases where liability determinations transcend corporate form. In *Stora*, the court held that mere ownership – even 100 percent ownership – of a subsidiary is not sufficient to impose parental liability for a subsidiary's wrongs.[3] Nevertheless, liability can be imposed if the parent actually exercises "decisive influence," which in the case of a wholly owned subsidiary will be (rebuttably) presumed.

Such a presumption does not apply in cases of non-majority ownership. In *Rubber Chemicals*, Flexsys was formed as a full-function joint venture, operating as an autonomous economic entity in the market. In deciding not to impose liability on the parents, the commission held that "[i]n the case of a joint venture, jointly owned by its parents (and over which none of the parents has *de facto* or *de jure* sole control), the joint venture can be presumed to be autonomous from its parent companies" and "to constitute a *separate* undertaking."[4]

But even where there is no presumption, liability can still be imposed. In *Avebe*, two parents were held liable for illegal activity by their joint venture, Glucona, a mere contractual entity without separate legal status.[5] In holding the parents liable, the commission relied on the fact that (i) all the executives of Glucona *simultaneously* held operational responsibilities in the parent companies; (ii) Glucona's supervisory board was made up of two representatives of each parent company, who were jointly responsible for Glucona's policy decisions and day-to-day management; (iii) Glucona lacked its own site and was located within one of the parent's premises; and (iv) one of the parent's representatives was directly involved in, and the other parent's representatives knew of, the cartel's activities.

Extending *Avebe* but in stark contrast to *Rubber Chemicals*, the European Commission in *Chloroprene Rubber* held two joint venture parents, The Dow Chemical Company and DuPont, jointly and severally liable for the acts of their 50-50 joint venture. That decision, which is currently on appeal, did not rest on the actual knowledge of, or participation in, the wrongdoing by both parents. Instead, factors such as common employees and overall supervision of the joint ventures activities sufficed to hold both parents liable.[6]

While EU cases are often heavily fact-specific a few concepts emerge. *First*, there is a substantial risk of parental liability where the evidence suggests that the parent likely participated in or knew of the wrong-doing. *Second*, where a *wholly owned* affiliate engages in wrong-doing, there will be a presumption that the parent exercised "decisive influence." While that presumption can theoretically be overcome, doing so is difficult, and there has yet to be a recent litigated case where the parent has prevailed. *Third*, where a parent has a majority interest (or perhaps even a substantial minority interest), the courts will not hesitate to find that the parent exercised decisive influence based on such run of the mill facts as (i) significant involvement at the board level, (ii) commonality of assets or systems, and (iii) common (or revolving door) employees. *Fourth*, there is a substantial risk of liability where one entity exercises practical control over another, even if such control is not evidenced by the formal corporate legal structure.

Contrast with U.S. Law

The United States employs a different regime to decide the question of parental liability. In the States, a parent can only be held liable for the wrongs of a subsidiary if the parent is either itself a wrong-doer (*e.g.*, a direct participant in the conspiracy) or the corporate separateness between parent and subsidiary is essentially a sham, allowing courts to "pierce the corporate veil."

As the United States Supreme Court explained in *U.S. v. Best Foods*, it is a "general principle of corporate law deeply 'ingrained in our economic and legal systems' that a parent corporation … is ***not*** liable for the acts of its subsidiaries." [7] The court went on to explain that this "corporate veil may be pierced and the [parent] held liable for the [subsidiary] corporation's conduct when … the corporate form would otherwise be misused to accomplish certain wrongful purposes," or when "the parent is directly a participant in the wrong complained of."

The *Best c*ourt noted that mere ownership, common control, and active oversight of a subsidiary is *not* sufficient to pierce the separate corporate status of an LLC. As the court explained, it is a "well established principle … that directors and officers holding positions with a parent and its subsidiary's can and do 'change hats' to represent the corporations separately, despite their common ownership…. Since courts generally presume 'that the directors are wearing their 'subsidiary hats' and not their 'parent hats' when acting for the subsidiary,… it cannot be enough to establish liability here that the dual officers and directors made policy decisions and supervised the activities of the facility."

Given these pronouncements, it is doubtful that the *Knauf* and *Chlorprene Rubber* cases (among other cases) would have come out the same way had U.S. law applied.

Practical Considerations

What does this mean for companies seeking to do business in both jurisdictions? For one thing, it means that multinational companies must give more thought to structuring their operations at the outset.

If liability limitation is important, as presumably it would be when doing business through joint ventures and other non-wholly owned subsidiaries, then consideration should be given to the following:

- Whether to include express indemnification or other liability sharing provisions in the formation documents;
- Whether to set up a separate legal entity in which to conduct all relevant business;
- Whether that separate entity has its own facilities and assets, or whether it shares critical systems with its parents;
- Whether the affiliate has its own employees and management;
- Whether the affiliate holds itself out as a distinct legal entity in its dealings with third-parties, or whether it emphasizes its affiliation with its parent(s); and
- Whether there can or should be guidelines carefully delineating (or limiting) the information provided to board members who are also employed by one or more of the parents.

Finally, given the risk that a parent might be held liable for the wrongs of its affiliates, it is always prudent to consider whether additional compliance efforts could minimize risk to the entire corporate family by catching any wrong-doing before it starts.

[1] *Knauf Gips KG v. European Commission*, Case C-407/08.

[2] EU antitrust law caps the fines for anticompetitive practices at 10% of the *entire* "undertaking's turnover," and thus, includes the consolidated turnover of all the entities belonging to the same "economic unit."

[3] *Stora Kopparbergs Bergslags AB v. European Commission*, Case C-286/98.

[4] Commission Decision, *Rubber Chemicals*, Case COMP/F/38.443.

[5] Commission Decision, *Sodium Gluconate*, Case COMP/E-1.36.756; *Avebe v. Commission* Case T-314/01.

[6] Commission Decision, *Chloroprene Rubber*, Case COMP. /38.629; appeal pending , Case T-77/08.

[7] *U.S. v. Best Foods*, 524 U.S. 51 (1998).

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