Blakley Justice
DOMESTIC & INTERNATIONAL LAW

LIMITING LIABILITY IN FORMING A SUBSIDIARY IN THE UNITED STATES

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Background and Issue

Alan Blakley, Esq.

Blakley Justice, LLC
916 S. Main St.,
suite 201
Longmont, CO 80501
+1.303.557.6488

Many companies in other countries decide that they wish to take advantage of business opportunities in the United States. Colorado seems particularly appealing with its location, ease of air travel and quality of life. For business and tax reasons, many of those companies create subsidiaries in Colorado. The parent corporation typically creates a subsidiary with fewer resources and fewer assets than the parent. Consequently, the parent corporation should not wish to incur any liability under United States or Colorado law. Moreover, it should be careful to avoid having to prove that it doesn't even belong as part of a lawsuit here. When they set up their business, remarkably few foreign parent corporations, consider the possibility of their liability for their subsidiary's acts or even expensive attorneys' fees and other litigation costs in avoiding even remaining in a lawsuit.

However, the parent and the subsidiary should give careful consideration to the possibility of the parent's having to defend itself in a foreign venue, such as Colorado. Even if it eventually shows it should not share in the liability of the subsidiary, the parent's legal costs to avoid liability could be expensive. If the subsidiary is not set up correctly and, after beginning its new existence, does not observe proper formalities, the parent corporation may well be brought into court in the United States. Because it has more assets, someone will want to bring it into the litigation as a "deep pocket." It will at least need to pay legal fees to get out of the case. Set up properly, it may not be named in the lawsuit at all, but, even if named, will likely get dismissed quickly.

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Distinct U.S. and Colorado Law

The employment laws in many countries arenot the same as the employment laws in the United States. Consequently, a parent corporation abroad may be liable for the subsidiary's violations of employment law in the United States. Manufacturing and pharmaceutical companies should be very concerned about liability in the United States. Products liability laws may be much broader than in other countries and allow much higher dollar recoveries. Class action lawsuits in the United States are much easier to bring. A company may be liable under environmental laws in the United States. For instance, under the Superfund law (Comprehensive Environmental Response, Compensation, and Liability Act of 1980 – CERCLA) liability can arise from mere ownership of land where a previous owner has created an environmental hazard, and the new owner knows nothing about the hazard and did not contribute to it.

During litigation in the United States, discovery can lead to much greater expense than in the home jurisdiction. Discovery of electronic information can cost hundreds of thousands of dollars. Moreover, attorneys in the United States sometimes uncover additional potential lawsuits against a company through discovery. In many countries, discovery is not allowed at all. In some, only very limited discovery, nothing nearly as broad as the discovery allowed in the United States.

United States companies are justifiably afraid of the United States jury system. All civil litigation can be brought before a jury rather than a judge for a verdict and damage award. Along with the fact that many foreign countries have limits on the amount of damages and most jurisdictions in the United States have no limits, foreign companies should be concerned about extremely high jury awards.

For all of these reasons, parent corporations from outside the United States are advised to consider carefully how they will create their United States subsidiary. Parent corporations should analyze the potential of being held liable for extremely high damage awards. Moreover, they should not forget the potential of being required to defend a lawsuit in the United States due to failure to create their subsidiaries properly. Subsidiaries in the United States need to be careful that their actions do not create liability, or even jurisdiction over their parents.

Personal Jurisdiction

The standard to acquire jurisdiction over a parent corporation in the United States is lower than to make it liable for the actions of the subsidiary. Moreover, personal jurisdiction, even without eventual liability, can cost the parent corporation significant legal expenses in a forum far away from its home country. If subsidiaries are not created carefully, courts can consider them the parent's agent. In Colorado, when a non-United States corporation carries on continuous and systematic business through its agents, there can be jurisdiction over the subsidiary *and the parent* for an unrelated cause of action. The fundamental question in Colorado is whether the subsidiary is carrying on the business of the parent corporation. To determine this, courts in Colorado look at the amount of actual control exercised by the parent over the internal affairs of its subsidiary. Courts disregard any self-serving niceties that do not show a difference in substance. Courts frequently talk about "substance over form."

In *SGI Air Holdings II LLC v. Novartis Int'l AG*, 239 F. Supp. 2d 1161 (D. Colo. 2003), the court explained the amount of control a parent needs to exert over a subsidiary. The court described an alter ego theory, as well as the theory of agency. The judge examined capital investment decisions, personnel decisions, and business and management decisions. The court found that standardized policies on investment decisions and financial reports showed that the parent exercised complete control over the subsidiary's internal affairs as to capital investment decisions. It also determined that the parent exercised control over the subsidiary's major and minor personnel decisions. Furthermore, the parent dictated business and management decisions.

Surprisingly, the *SGI Air Holdings* case did not actually concern the core business of either the subsidiary or the parent. The lawsuit that brought both the parent and subsidiary into court arose from the purchase of a corporate jet. The parent had no contact with Colorado. Yet, because the parent exercised significant control over a Colorado subsidiary the parent was required to appear in court in Colorado and defend the lawsuit in Colorado. The parent had to defend in Colorado even though the Colorado subsidiary had nothing to do with purchasing the jet. Consequently, for personal jurisdiction purposes, it is not even necessary that the litigation involve subject matter that is central to the business of either the parent or the Colorado subsidiary.

Further Liability

In many cases the United States government, state governments or other parties can bring the parent corporation into court and access its assets. Courts in Colorado consider ten factors to determine whether to disregard the separation of parent and subsidiary, making the parent liable for the subsidiary's actions.

1. The parent corporation owns all or the majority of the capital stock of the subsidiary;
2. The parent and subsidiary have common directors or officers;
3. The parent finances the subsidiary;
4. The parent subscribes to all the capital stock of the subsidiary, or otherwise causes its incorporation;
5. The subsidiary has grossly inadequate capital;
6. The parent pays the salaries or expenses or losses of the subsidiary;
7. The subsidiary has substantially no business except with the parent or no assets except those conveyed to it by the parent;
8. In the papers of the parent and in the statements of its board or officers, the subsidiary is referred to as a subsidiary or as a department or division;
9. The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent;
10. The formal legal requirements of the subsidiary as a separate and independent corporation are not observed.

These factors can be found in *Great Neck Plaza L.P. v. Le Peep Rests. LLC*, 37 P. 3d 485 (Colo. App. 2001) and *U.S. ex rel. Johnson Pugh Mach, Inc. v. Landmark Constr. Corp.*, 318 F. Supp. 2d. 1057 (D. Colo. 2004). As with any time that courts talk about "factors," all factors need not be found in a particular case for liability to attach to the parent.

In *Great Neck Plaza*, the question was whether the parent could have its assets garnished to satisfy the debt of a subsidiary and whether the parent and subsidiary should be considered insiders for purposes of fraudulent transfers. That Colorado court analyzed the facts and found the subsidiary was merely the alter ego of the parent. While it found that membership interest and stock ownership alone were not enough, it found the corporate entities were interchangeable and that assets had been moved from one to the other with no rhyme or reason. Also, the president of the parent was the president of the subsidiary and personally financed both the parent and the subsidiary.

As an example of a parent corporation, Holly Corporation, that *avoided* liability in the employment setting, there is *Florez v. Holly Corp.*, 154 Fed. App'x. 707 (10th Cir. 2005). Mr. Florez brought a complaint under the federal Americans with Disabilities Act and the federal Family and Medical Leave Act against both the parent, Holly Corporation, and its subsidiary Navajo Refining Company.

That court considered four factors to determine whether an employment relationship existed between the two related entities and those two related entities were in fact a single employer:

1. Interrelations of operations;
2. Common management;
3. Centralized control of labor relations;
4. Common ownership and financial control.

It thought the most important fact was that the subsidiary made all final decisions regarding employment matters relating to the person claiming discrimination. Again, common ownership alone was not enough. Even the existence of a common manager or officer was not enough. That court decided that Holly would not be liable. However, employers should be aware that to get to this point, because jurisdiction *was* found, Holly *still* had to go through discovery, summary judgment and an appeal to the Tenth Circuit, costing it a significant amount of time and money.

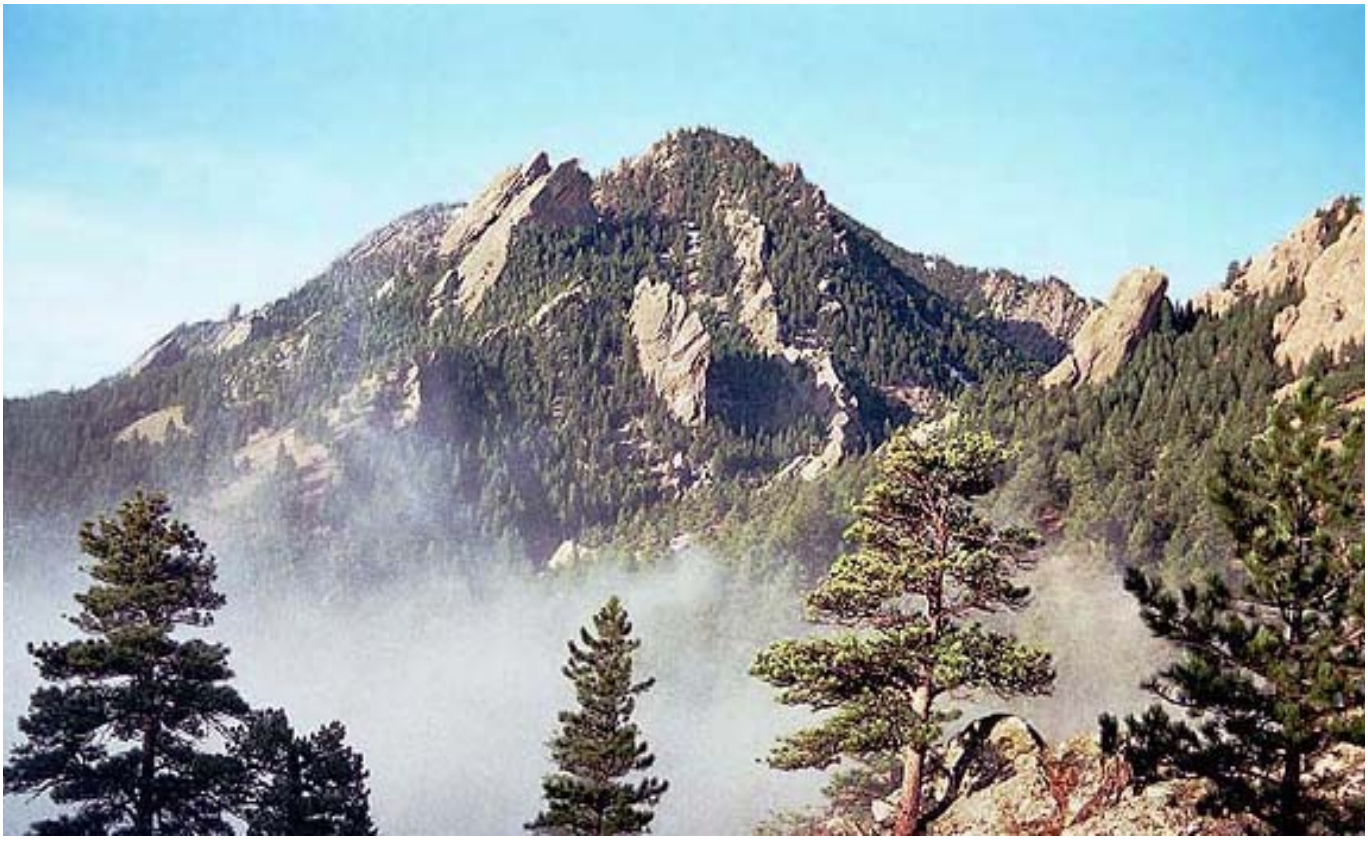
In *U.S. ex rel. Johnson Pugh Mach., Inc.*, Johnson Pugh had asked for $1,158,239.99 plus interest based on payment bonds executed by another company. The court, after analyzing the ten factors listed above, determined that Johnson Pugh was the alter ego of its subsidiary. And, the subsidiary was the company that was to indemnify the company executing the bond. Consequently, because the company asking for payment from the bond, Johnson Pugh, and the company that would need to pay the bond (through indemnification) was in essence the same company, the claim was not allowed. This is a significant loss of the attorneys fees and costs of litigation, in addition to interest and principal, based upon not carefully creating and maintaining separate entities.

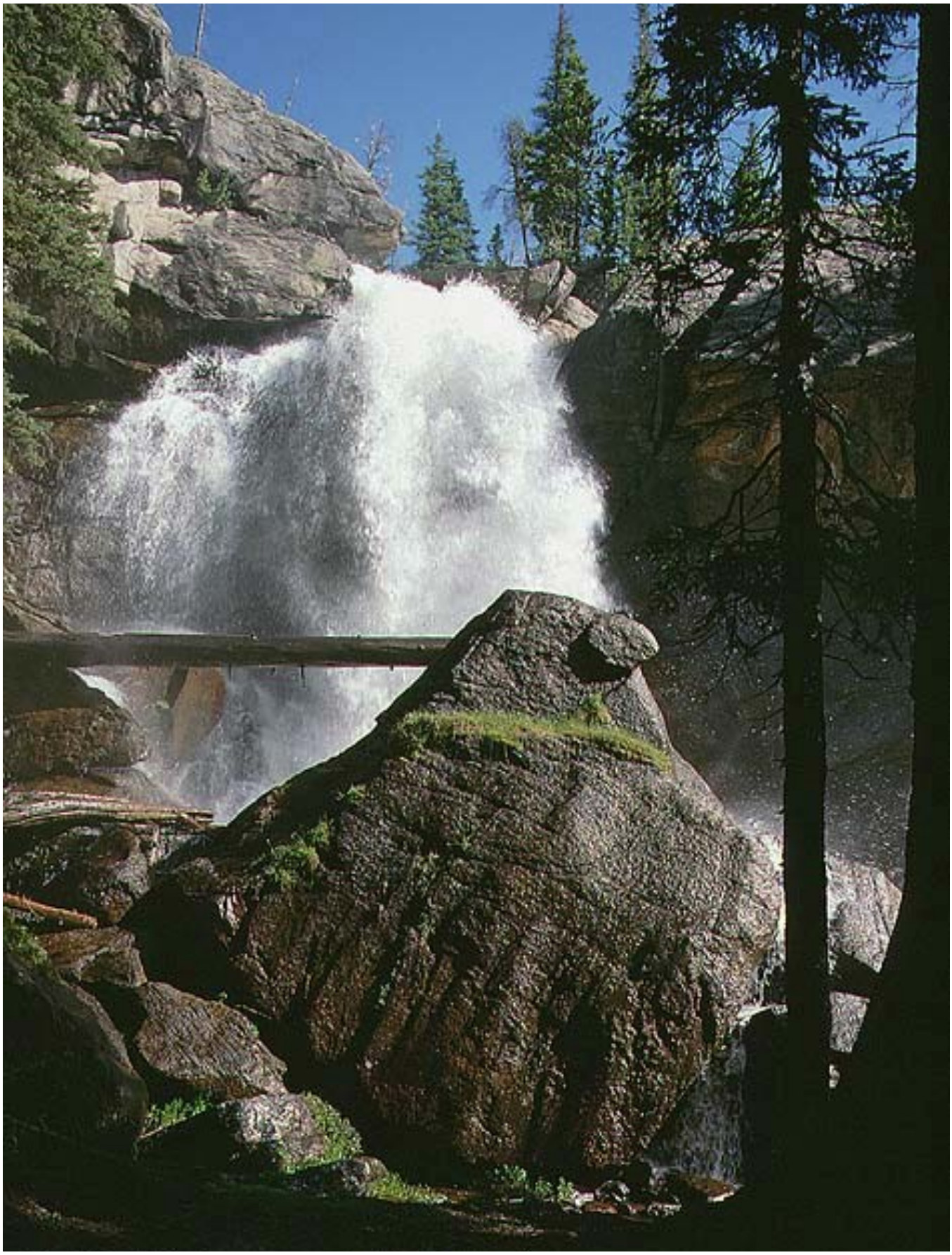
As most companies in the United States are aware, liability for environmental cleanup under CERCLA, the Superfund law, does not depend on causing an environmental problem. Liability for expensive environmental cleanup can come from merely owning real property or being anywhere in the chain of title. In a case based on CERCLA, the court in Colorado considered the ten factors listed above and determined that the parent should be liable for cleanup as an owner or operator for the environmental damage its subsidiary had caused. The court found that this liability could be based either on active participation or on disregarding the separation of the two entities. *U. S. v. Friedland,* 173 F. Supp. 2d 1077 (D. Colo. 2001).

Avoiding Jurisdiction and Liability

Some courts seem intent on finding jurisdiction some would say torturing the law to do so. Parent corporations can take steps prior to creating subsidiaries and both they, and their subsidiaries, can plan and follow through with strategies after creation to lessen the likelihood of being brought into court in Colorado. These same plans will lessen the likelihood of having parent liability through subsidiaries. If the parent can avoid personal jurisdiction, the parent will certainly avoid liability. Consequently, the best practice is creating a subsidiary in a way that avoids personal jurisdiction. The time to plan is when setting up the subsidiary. It must be clear that the parent is not the alter ego of the subsidiary, in that it does not exercise significant control over the subsidiary. As the court in *SGI Air Holdings* held, there are three areas of concern with respect to the question of who is really conducting the business, capital investment decisions, personnel decisions, and business and management decisions. Moreover, the parent and subsidiary must create a plan for the ongoing business of the subsidiary *and follow the plan*, to maintain separation.

Every parent will want to have some relationship with the subsidiary, otherwise it would not want to have a subsidiary. Consequently, there will always be some activities in common. There may even be some overlap in officers and employees. However, the more overlap there is, the more common activities, the more likely it is that there will be personal jurisdiction. The parent could even be liable for the acts of the subsidiary. An independent board of directors is almost essential. That independent board of directors should determine capital investment decisions. An independent personnel department should be created to make independent personnel decisions. Finally, the officers and directors should as much as possible be different.





Conclusion

Most companies know that opening a subsidiary in a different country requires the assistance of a business planning and tax professional to determine the best structure, but it also requires the assistance of a lawyer who is versed in both corporate structure and limiting opportunities for the parent to be brought into litigation, and potentially held liable for the subsidiary's acts in the new country.

Contact Us

for more information

Blakley Justice LLC
916 South Main Street
Suite 201
Longmont, CO 80501

(303) 557.6488

Alan Blakley, Esq.
ab@b-and-jlaw.com

Courtney Justice, Esq.
c.justice@b-and-jlaw.com

Shih-Kuei Chen, LLM
skchen@b-and-jlaw.com

Tyler Rauert, Esq.
tyler.rauert@b-and-jlaw.com

Visit us on the web at
www.blakleyjustice.com

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Blakley Justice, LLC
916 South Main Street, suite 201
Longmont, CO 80501

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