Taking A Closer Look For Deep Pockets

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The theories surrounding successor liability and piercing the corporate veil can help you find a path to recovery in some of the toughest cases.

A CORPORATION is a legal entity created by filing certain documents with the state. It offers many benefits that are found in other entities, such as limited liability, centralized management, transferability of ownership, continuity, and taxation. On the other hand, some of these benefits pose problems for securing legal liability when the corporation is used as a shield to avoid liability or to perpetuate a fraud. In these cases, a victim may be left without any avenue of relief. Fortunately, all hope is not lost!

Courts have ignored traditional rules of liability and protection, and have held successor

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companies liable for their predecessors' actions and have pierced the corporate veil to hold parent companies, shareholders, or other persons involved with the corporation liable for the actions of the corporate entity. This article is a comprehensive overview of those doctrines and provides practical strategies for pursuing the liability of a corporation that was once wholly protected.

SUCCESSOR LIABILITY • Consider a hypothetical: Manufacturing company, Damaged Property, Inc., purchases a grinding machine at Predecessor, Inc., a corporation in the business of manufacturing these machines. Two years later, a belt comes loose in the machine, generating enough friction to cause the machine to start on fire, which in turn results in extensive damage to the plant and interrupts the plant's business for over two weeks. A subsequent investigation reveals that the belt was not properly secured in the machine, a manufacturing defect. Damaged Property, Inc. wishes to recover its losses from Predecessor, Inc. However, Predecessor, Inc. is no longer in business, but a related corporation that purchased its assets, named Successor, Inc., has been formed.

The Problem

The company or enterprise whose acts or omissions caused the injury or loss is no longer in existence, and a new corporation with similar products, shareholders, assets, and members is now in place. Are you left without a remedy?

Traditional Rules And Concepts

Historically, a successor company that merely purchased assets was not liable for the debts and liabilities, incurred before the transfer, of its predecessor. This rule applied primarily in the context of product liability actions, particularly when there were claims for defective manufacturing. The purpose of the rule was to protect the rights of persons involved in the corporation who were not directly involved with, or were opposed to, the successor corporation's acquisition. The typical fact pattern was that there was some acquisition of a company by way of a merger, with shares of stock given for consideration. In those cases, the successor would assume the liability of the predecessor. It is when the assets are purchased for cash or to escape liability that the successor will become liable.

The Exceptions

Even at the outset, there were a number of recognized exceptions to this traditional rule:

- *Express or implied agreement to assume the predecessor's liabilities.* The successor agrees to assume the predecessor's liabilities, through the purchasing agreement or by its actions;
- *De facto merger or consolidation.* There is a formal merger (or de facto merger where the parties are in the same position as if a formal merger had occurred) or consolidation of the companies;
- *Mere continuation.* The successor entity is really just a continuation of the predecessor, a theory that is discussed in greater detail below;
- *Fraudulent transaction/transfer of assets done to escape liability.* The transaction is done for the sole purpose of the predecessor escaping liability and, thus, an equitable remedy is prudent; and
- *Assets are transferred without leaving adequate consideration.* A transfer does not leave enough assets to pay existing liabilities, often in insolvency situations.

In addition, sometimes a statute (CERCLA is one example) mandates that a buyer is liable for its seller's liabilities, regardless of whether there is an agreement to do so.

THE MAJOR MODERN THEORIES OF SUCCESSOR LIABILITY RECOVERY • The exceptions to the traditional rule have evolved somewhat, and there are now several major theories of recovery against predecessor entities.

Mere Continuation

Focus is on the continuity of the directors, officers, and shareholders from the predecessor corporation to the successor corporation. Despite a change in the name or form of an entity, the substance of the entity stays the same. Therefore, privity can be established between the new entity and the person suffering the loss. The transfer is just in the corporate form because there is no change in the relationships that would justify a change in legal liabilities.

Traditionally, this theory was limited and inflexible in strict liability. Now, some jurisdictions are expanding the use of this theory. There is no bright line test followed by the courts; however, there are several factors to consider:

- *The circumstances surrounding the asset purchase.* Consider if all or most of the assets are purchased, and determine if the seller of the assets went out of business shortly thereafter; and
- *Continuity of the directors, officers, and shareholders.* This is the main distinguishing feature of this theory because the focus is on the continuation of the entity, not necessarily the operations. No exact amount of continuity is required, and a lesser degree may be enough on its own. In some jurisdictions, this factor on its own is not enough.

Case Examples

Here are some examples of how courts have applied and interpreted the mere continuation theory:

- Plaintiff sought to enforce an injunction against a purchaser of defendant's assets. The court found no mere continuation due to the asset purchase, in part because there was no real prior connection between the companies and no evidence that the purchase was done to assist the predecessor or its officers to evade the court. *Nav-Aids Ltd. v. Nav-Aids USA, Inc.*, 2002 U.S. Dist. LEXIS 23024 (N.D. Ill. Nov. 27, 2002);
- The court overturned the imposition of successor liability against the defendant for three reasons—there was only one common officer between the companies, there was no evidence that defendant's owners were "sham" owners or "mere figureheads" who collaborated with the predecessor corporation to avoid the predecessor's debts, and there was no evidence that any officer or shareholder in the predecessor corporation had any ownership interest in the successor corporation. *Grand Labs., Inc. v. Midcon Labs of Iowa*, 32 F.3d 1277, 1286 (8th Cir. 1994);
- The court found the successor firm to be a mere continuation of a predecessor firm and considered the common ownership (i.e., shares of stock) and directorship, overlap of officers, asset transfer for inadequate consideration, similarity of business conducted by both companies and day-to-day operations and overlap of clientele. *Kaiser Found. Health Plan of the Mid-Atlantic States v. Clary & Moore, P.C.*, 123 F.3d 201, 205 (4th Cir. 1997).

Continuity Of The Enterprise

Emphasis is on the entire business operation rather than on the mere continuation of the corporate entity. The focus of the inquiry is the similarity of the business operations. The rationale of the theory's application is that a new entity should not reap the benefits from the predecessor business without bearing the burdens as well. Particularly in strict liability cases, the risk of defective products should stay with the manufacturer and not be placed on the consumer. The successor who continues the enterprise is in the best position to gauge the risks of potential product defects and is the only entity that can improve the product.

Factors

There are many criteria that are considered under this theory. The lack of one does not establish that there is no continuity. The factors include:

- *Continuation of the enterprise.* Seek to establish that the key people of the predecessor are involved in the new entity, the same name, location, facilities, or product is used, the assets were bought by the new entity, and the operations are the same;
- *Dissolution/cessation of business.* The seller dissolves or ceases doing business after the sale;

Assumption of liabilities/obligations. The purchaser assumes the liabilities and obligations ordinarily necessary to continue doing business;

- *Effective continuation.* Show that the new entity holds itself out as an effective continuation of the seller; and
- *The continuity of management.* This is relevant and important, but the individuals do not need to be identical.

The two factors listed below are still considered by some jurisdictions, but are not as conclusive as they have historically been under this theory:

- The product produced by the new entity; and
- Traditionally, the predecessor business and new business had to make or sell an identical product. Now, substantial similarity is generally enough and other indicators of continuity are considered.

Case Examples

The following cases are illustrative of the factors that courts look for in assessing liability under the continuity of the enterprise theory:

- In *United States v. Carolina Transformer Co.*, 978 F.2d 832, 838 (4th Cir. 1992) (finding substantial continuity in CERCLA action in which most assets, equipment, and vehicles were transferred to a new entity, employees were the same, management of the new entity came from the old entity, common customers, differences in work being performed was very minor, and so on), the court highlighted eight factors to consider in assessing successor liability under the continuity of the enterprise theory: "(1) retention of the same employees; (2) retention of the same supervisory personnel; (3) retention of the same production facilities in the same location; (4) production of the same product; (5) retention of the same name; (6) continuity of assets; (7) continuity of general business operations; and (8) whether successor holds itself out as the continuation of the previous enterprise." The court also noted a similar test that considered three other factors: (1) if the business is the same between the old and new company; (2) if the employees are doing the same jobs in the same conditions under the same supervisors; and (3) if the new entity has the same production process;
- In *Elf Atochem N. Am. v. United States*, 908 F. Supp. 275, 283 (E.D. Pa. 1995), the court chose not to attach successor liability because only two out of the eight factors enumerated in *Carolina Transfer* were met. The court stated that, although "much of [the predecessor's] labor and equipment" belonged to the successor and the two firms shared one customer, the continuity of the enterprise theory could not be supported; and
- In *State of New York v. Nat'l Servs. Indus.*, 352 F.3d 682 (2d Cir. 2003) (noting also that the theory was not widely adopted among the states), the court elected not to adopt the continuity of the enterprise theory of recovery with respect to CERCLA cases and reasoned that "the substantial continuity doctrine is not part of general federal common law and, following *Bestfoods*, should not be used to determine whether a cor-

poration takes on CERCLA liability as the result of an asset purchase."

Product Line Doctrine

This theory is meant to deal specifically with products liability claims and, as such, is limited. It focuses on the similarity of the finished manufactured product by the new company and the old entity. It is the newest trend in successor liability and was first applied in California in 1977; however, it is the minority view.

The focus is on the specific product line of the new entity and the predecessor company, not the continuity of the business operations as a whole. Basically, the new company continues the output of the predecessor's line of products. Thus, the new entity assumes strict liability of the same product line previously manufactured if the right of action against the predecessor company is no longer available (vitiated by the sale of assets, trade name, and good will or by dissolution). The minority view is the predecessor was not required to have been manufacturing the product. Rather, the new company had to be in the same or similar general business as the predecessor.

Although some courts allow the legislature to decide which factors to consider, other active courts consider the following factors when applying the product line doctrine:

- If all of the assets are acquired, which leaves no more than a mere corporate shell of the predecessor company, courts consider the buyer's ability to spread the risk and assume the burden of the predecessor's defective products;
- If the new entity holds itself out to the public as a continuation of the predecessor by producing some of the product line under a similar name, courts consider it important that an identical or similar product is used (the old rule required the same line of products, but that has been modified to more of a uniformity requirement); and
- If the successor company is benefiting from the good will of the predecessor, the courts consider whether the successor is exploiting the reputation of the predecessor.

Case Examples

The following cases illustrate the application:

- In *Ray v. Alad Corp.*, 560 P.2d 3 (Cal. 1977) (focusing on the lack of other redress, the successor's ability to assume the risk and fairness of requiring the successor to assume responsibility), the plaintiff claimed injury by a defective ladder neither manufactured nor sold by the defendant. Before the plaintiff's injury, the defendant succeeded to the business of the ladder's manufacturer through an asset purchase. The court used the product line doctrine to find the defendant liable for plaintiff's injury;
- In *Conway v. White Trucks*, 885 F.2d 90, 97 (3d Cir. 1989) (declining to find successor liable after focusing on the first prong of the *Ray* test), the court was unsure if the Pennsylvania Supreme Court would adopt the product line exception but assumed so for analysis and held that Pennsylvania "would preclude successor liability where plaintiff failed to make any effort to assert his potentially available remedies in bankruptcy or in a pending lawsuit against the original manufacturer"; and
- In *Jordan v. Hawker Dayton Corp.*, 62 F.3d 29, 33 (1st Cir. 1995), *cert. denied*, 516 U.S. 1113 (1996) (recognizing that the product line doctrine is a minority rule and has not been adopted in Maine), the court reasoned that successor liability could not apply given the fact that the predecessor sold less than 10 percent of its assets to the successor, continued to do business after the sale, and continued to pay debts owed for 12 years.

PIERCING THE CORPORATE VEIL • Again, let's consider a hypothetical: Fitness center, Recreation Station, purchases exercise equipment from Fitness USA, Inc., a corporation in the business of manufacturing these machines, for use at its center. Two years later, a belt comes loose on one of the treadmills, generating enough friction to cause the machine to start on fire, which in turn results in extensive damage to the center and interrupts the center's business for over two weeks. A subsequent investigation reveals that the belt was not properly secured in the treadmill, and it was a manufacturing defect. Recreation Station wishes to recover its losses from Fitness USA, Inc.

The Problem

A corporation that has caused some economic, physical, or property loss has since become insolvent or its assets are insulated. This leaves the victim without any redress, unless the corporate veil, which protects the shareholders, officers, and directors from liability, is pierced and liability is imposed directly upon these persons for the acts or obligations of the corporation. Piercing the corporate veil arises when a plaintiff seeks to hold the shareholders, officers, and directors liable for the actions of the corporation or when a plaintiff seeks to hold a parent or sister company liable for actions taken by its subsidiaries.

Traditional Rules And Concepts

The traditional rule is that shareholders, directors, and officers of a corporation are liable only for obligations of the corporation to the extent of the amount invested by that individual. It is this limited liability that has made a corporation an attractive entity to form. Veil-piercing generally applies to closely held corporations and not large, publicly traded companies, but may become an issue with a limited liability company. Although veil-piercing typically arises in the context of fraud cases, it has been applied when the entity was used to circumvent the law and when there was a breach of the general fiduciary duty of loyalty and care that officers, directors, and controlling shareholders owe.

As an equitable remedy, veil-piercing disregards the notion that the corporation and its shareholders are separate and holds the shareholders responsible for the corporation's acts or obligations. Plaintiffs may wish to pierce the corporate veil with respect to corporate officers, directors, creditors, optionees, stockholders, and spouses of stockholders. Historically, the veil was pierced only with respect to shareholders, but this restriction is being challenged and the application will likely be broadened.

MODERN THEORIES FOR PIERCING THE CORPORATE VEIL • There are two situations in which courts may consider piercing the corporate veil:

- To reach shareholders, officers, or directors who are disregarding the corporation as a true legal entity and using it as a shield to protect private interests, assets, or debts; and
- A parent company that controls and dominates its subsidiary to the extent that they are essentially one entity.

Courts often use terms like "alter ego," "instrumentality," or "sham corporation" when discussing piercing the corporate veil. This generally applies to situations in which the corporation is being used as a front for individual activity or when a parent or sister company creates a subsidiary to absorb its liabilities.

Some of the defenses asserted include lack of domination or unity of interest, no harm to the plaintiff, no improper use of the corporate form by the defendant, lack of causation, lack of knowledge of the plaintiff's claim, solvency of the defendant and lack of active participation by a person in the corporation's activities.

Generally, all of the theories consider the nature of the claim (contract, tort, and statutory) and the nature of the defendant (closely held corporation, shareholder of a public corporation, or a parent or sibling company).

Alter Ego (Or Identity)

Let's go back to our above hypothetical, but with a twist: Recreation Station determines that Fitness USA, Inc. is really not a formal corporation at all but rather is a group of retired professional wrestlers that make all the decisions for the company and only pay themselves any dividends that are generated by the company. The two factors to apply would be that:

- The corporation is influenced by the owners and there is such unity of ownership that there really is no separation; and
- The facts show that adherence to a separate corporate existence would be fraud or promote injustice.

The rationale is that if the shareholders do not consider themselves a separate corporate enterprise, the law should not either. The same is true for a parent company that does not keep its subsidiaries separate. There are many factors to consider under this test, and the following are some of the most common:

- Undercapitalization;
- No observation of corporate formalities;
- Nonpayment or overpayment of dividends;
- Siphoning off of funds by dominant shareholders;
- Majority shareholders have guaranteed corporate liabilities;
- No issuance of corporate stock;
- No elections of directors or officers; and
- Commingling of personal and corporate funds.

Case Examples

Here are some cases that have applied the tests, and some of the factors that have been considered:

- Alter ego doctrine requires a determination "(1) that there is such unity of interest and ownership that the separate personalities of the corporation and the individuals no longer exist and (2) that failure to disregard the corporation would result in fraud or injustice." *Flynt Distrib. Co. v. Leon Harvey*, 734 F.2d 1389, 1393 (9th Cir. 1984) (citation omitted) (holding conversion of assets for personal use and undercapitalization were prima facie showing that veil should be pierced);
- The third circuit discussed a number of factors to consider, including gross undercapitalization, failure to observe corporate formalities, nonpayment of dividends, and so on, but noted that they were factors and not elements of a "rigid test." It also noted that its test did not require proof of actual fraud so a showing that the entity was a "façade" was not required; however, it noted that, in cases where the conduct alleged to justify piercing the corporate veil is that the corporation is a "sham" or "façade," a finding "akin" to fraud is necessary. *Trustees of Nat'l Elevator Indus. Pension, Health Benefit & Educ. Funds v. Lutyk*, 332 F.3d 188 (3d Cir. 2003) (affirming the lower court's decision to pierce the corporate veil as to the president, particularly in light of his siphoning of funds while the company was known to be deeply insolvent);
- "Improper conduct," as shown by evidence of the various transfers of money between the corporations, the marginal length of time between ceased operations at one corporation and the startup of operations at the other and statements by an officer of the corporation that the transformation was used to avoid liability, supported the district court's decision to pierce the corporate veil. *Patin v. Thoroughbred Power Boats Inc.*, 294 F.3d 640 (5th Cir. 2002) (noting that

Florida does not suggest observing corporate formalities controls assessment of alter ego status); and

- The court chose not to pierce the corporate veil for a number of reasons, including the lack of a "unity of control," mere ownership was not enough to pierce under Arizona law, the lack of evidence that the companies were sham corporations, each held itself out as separate entities, there was no evidence of neglect of corporate formalities, and it was not necessary to prevent a fraud or injustice. *Mid Am. Title Co. v. Transnation Title Ins. Co.*, 332 F.3d 494, 497 (7th Cir. 2003), *cert. denied*, 540 U.S. 1089 (2003).

Mere Instrumentality

Getting back to the hypothetical, let's assume that since the sale of the treadmill, but before this fire, Fitness USA, Inc. suffered a fire at its manufacturing plant and its parent owner, Fitness Fathers USA, Inc, collected insurance proceeds from the fire and liquidated the assets of Fitness USA, Inc., but left only the shell of Fitness USA, Inc. in place. How would the mere instrumentality theory apply?

The mere instrumentality theory generally applies when a subsidiary is so controlled or dominated by its parent that the separateness of the entities should be disregarded. However, it can also apply when a shareholder, director, or officer controls the corporation so the separateness should not be recognized. There are three primary factors that are considered under this theory:

- The corporation was a mere instrument of the shareholder or parent company;
- The shareholder or parent controlled the corporation; and
- The refusal to disregard the corporate entity would result in an unjust loss.

There is also a three-pronged test that some courts use for a prima facie showing that the relationship between a parent and subsidiary should be disregarded due to the control of the entity:

- There was complete domination so that the corporation had no mind of its own;
- The wrongdoer used this domination to commit some fraud; and
- This domination and breach caused the loss.

Case Examples

Here are examples of how courts have applied the mere instrumentality theory:

- A Colorado court identified the following factors to consider when evaluating the parent corporation's control over the subsidiary: (1) parent owns all or a majority of the capital stock of subsidiary, (2) common directors and officers, (3) parent corporation finances the subsidiary, (4) parent corporation subscribes to all stock or causes its incorporation, (5) undercapitalization, (6) parent corporation pays salaries, expenses and losses of subsidiary, (7) subsidiary has no business except with the parent or no assets except those conveyed to it by the parent corporation, (8) subsidiary is often referred to as a department or division, (9) directors and officers take direction from the parent corporation and (10) formal legal requirements are not observed. *Yoder v. Honeywell, Inc.*, 104 F.3d 1215 (10th Cir. 1997), *cert. denied*, 522 U.S. 812 (1997) (not disregarding the corporate entity when (1) the parent did not, in part, hold all of the subsidiary's stock, did not pay the subsidiary's salaries or expenses, and did not direct or control the subsidiary, (2) the entity was not undercapitalized, and (3) legal requirements of maintaining separate entities were followed);
- The Ninth Circuit recognized that, under Alaska law, the "mere instrumentality" test and the "defeats public convenience" test are "alternative means of piercing the corporate veil" and plaintiff needed only to show that the entity

was a mere instrumentality of the other. The court recognized the importance of inadequate capitalization, but, while noting that not all 11factors are required, it found a mere finding of undercapitalization alone was insufficient to warrant piercing the corporate veil. *City of Fairbanks v. Amoco Chem. Co.*, 1995 U.S. App. LEXIS 736, at *17-19 (9th Cir. Jan. 13, 1995) (finding material issues of fact sufficient to defeat summary judgment); and

• In *Hile Assocs., Inc., v. Leap Technologies, Inc.*, 1995 U.S. Dist. LEXIS 8756 (M.D.N.C. Apr. 24, 1995) the court identified additional factors to consider to pierce the corporate veil: an analysis of the parent corporation's complete control or domination over the subsidiary, whether the control was used by the parent to commit a fraud or wrong, and whether the breach of duty proximately caused the injury or unjust loss.

Equity Or Totality Of The Circumstances

So let's vary the hypothetical again: Recreation Station is successful in obtaining a judgment against Fitness USA, Inc. However, after judgment is imposed, Fitness USA, Inc. liquidates its assets and goes out of business. Nevertheless, Fitness Fathers USA, Inc. is still in business and is known to be a profitable entity. What should the plaintiff do?

The equity or totality of the circumstances theory was developed by courts that did not accept the alter ego or mere instrumentality theories and rather used their own equitable tests. Generally, courts consider all applicable factors, including:

• Undercapitalization;
• Failure to follow corporate formalities; and
• Nonpayment or overpayment of dividends.

Case Examples

The totality of the circumstances approach to piercing the corporate veil is quite similar to the alter ego or mere instrumentality theories, and some courts do not define it, but will recognize that the corporate veil may be pierced to avoid injustice. Some examples:

• One court found a sole shareholder to be liable for the debts of the corporation where there was a lack of corporate formalities (including records, minute books, written loan agreements, bylaws, elected directors, or formal meetings) and evidence demonstrated there were non-functioning officers and directors, general confusion with respect to business titles and job responsibilities and inadequate capitalization. *Plastipak Packaging, Inc. v. Fred Peter DePasquale*, 2003 U.S. App. LEXIS 18978, *4 (3d Cir. Sept. 12, 2003);

• Another court held that "there is no litmus test for determining whether a subsidiary is the alter ego of its parent. Instead we must look to the totality of the circumstances." The court noted the common "laundry list" of factors to consider (such as common stock ownership and directors or officers, consolidated tax returns, common daily operations, etc.) but also looked at additional factors, such as the connection between the parent or subsidiary and the tort or contract issue giving rise to the suit. It also noted that, while fraud is an essential element of piercing in contract cases, it does "not require a finding of fraud in tort cases." *United States v. Jon-T Chems., Inc.*, 768 F.2d 686 (5th Cir. 1985), *cert. denied*, 475 U.S. 1014 (1986) (affirming finding of alter ego and noted the existence of bounds of forming subsidiaries).

Sham To Perpetuate A Fraud

Let's vary the hypothetical this way: Recreation Station is successful in obtaining a judgment against Fitness USA, Inc, but, in an attempt to collect the judgment, it is discovered that there are no longer any assets available. An investigation reveals the assets were removed by the company and placed with a new corporation, Fitness USA and BEYOND, Inc., just days after notification of the judgment. Now what?

There are generally some obligations owed by the corporation that the shareholder does not want to pay and, thus, the assets are drained. A "sham" entity is then set up, with the same shareholders, directors and officers, so that the new entity has no corporate debt. This theory typically applies when debts incurred by an entity are well beyond the investments made and there is little to no chance they will be paid. It is used to prevent individuals from misusing corporate laws to form a sham entity to commit fraud or related misdeeds. The main considerations under this theory are the following:

- Obligations or debts are incurred by a corporation;
- Assets and revenues are transferred or sold; and
- A new entity is formed.

Case Examples

The sham to perpetuate a fraud theory, often referred to as "the shell-game," focuses on the substance, not the form, of the corporation. Here are some interpretations:

- The Sixth Circuit noted that parties may not use shell-game-like maneuvers (i.e., setting up corporate entities to serve as a "shell" and shield principals from liability) to avoid liability, as it leaves an unjust result because plaintiffs cannot recover from the corporate entities. *Hamilton v. Carell*, 243 F.3d 992, 1004 (6th Cir. 2001) (holding that entity was not a "shell" and that its corporate form should not be disregarded because plaintiffs recovered a judgment from the solvent corporation and showed no evidence that the entity could not have funded the judgment);
- The court applied the sham to perpetuate a fraud theory and found the entities to be "sham entities" created by taxpayers to evade payment of tax liabilities. The court considered the identity of trustees of the trusts, the use of the land in trust, the compensation for the transfer of the trust, the financial affairs of the trusts, and the identity of the beneficiaries of the trusts. *United States v. Scherping*, 187 F.3d 796 (8th Cir. 1999), *cert. denied*, 528 U.S. 1162 (2000) (allowed reverse piercing of the corporate veil);
- The court noted, "the sham argument will be successful at the personal jurisdiction level if the plaintiff can make out a prima facie case that the corporation is a sham 'in that it lacks assets or is defendant's alter ego.'" The court also noted that it would not rest its decision solely on undercapitalization but would consider other factors. *Torco Oil Co. v. Innovative Thermal Corp.*, 730 F. Supp. 126 (N.D. Ill. 1989) (noting that, although a close relationship between the companies is not enough, there was more than "slight blurring" between the corporations and found the corporation was merely a shell due to the common identity and undercapitalization); and
- The court chose not to pierce the corporate veil because "the corporate entity will be disregarded only under exceptional circumstances such as where the corporation is a mere shell, serving no legitimate business purpose, and is used principally as an intermediary to perpetuate fraud or promote injustice." *Bankers Life & Cas. Co., v. C.M. Kirtley*, 338 F.2d 1006, 1013 (8th Cir. 1964) (finding the business to be legitimate even though the plan to liquidate assets of the subsidiary did not work out in favor of the public stockholders).

Violation Of Public Policy

Let's consider another variation on the hypothetical: Recreation Station seeks to recovery its damages from We Deliver Fitness USA, Inc., the distributor of the treadmills. We Deliver Fitness USA, Inc. defends on the basis that it cannot be held responsible for manufacturing defects in the products it distributes. An investigation reveals the manufacturer's sole distributor for this treadmill is We Deliver Fitness USA, Inc. and all sales for this product are derived from Fitness USA, Inc., and some employees and officers are shared between the two companies.

A wrongdoer has used the corporate form to violate some public policy, which is often a statute dealing with environment, antitrust, or employment issues and an entity is formed to avoid violating a statute. This theory is limited because it applies when failure to pierce the corporate veil would contravene the principal purpose of a state or federal statute.

Case Examples

Although cases based on the violation of public policy theory are not very common, here are some examples:

- The corporate form should be disregarded when failing to do so would circumvent the purposes of the statute and evade public policy. *Hamilton*, supra, 243 F.3d at 1003 (recognizing that courts, including the Supreme Court, will ignore the corporate form when used to defeat legislative policies but did not do so in the case at hand); and
- The court did not pierce the corporate veil but recognized that, when a corporation is only a mere instrumentality or alter ego of a sole or dominant shareholder who uses that corporation to shield activities that would violate public policies or statutes, the corporate entity will be disregarded. *DeWitt v. Hutchins*, 309 F. Supp. 2d 743 (M.D.N.C. 2004).

Direct Participation Theory

And now for a final variation on our hypothetical: Recreation Station files a lawsuit against Fitness Fathers USA on the theory that its control over the daily operations of Fitness USA, Inc. included making decisions that caused Fitness USA, Inc. to limit quality control and quality assurance inspections of treadmills and belts prior to product shipment.

This theory is for a "transaction-specific" situation: Specific evidence must be presented to show the parent's actions are directly tied to the actions or decisions that are alleged to be the cause of the subsidiary's tortious conduct.

In 1929, then-professor William O. Douglas articulated that a parent could avoid liability for the actions of its subsidiary by observing four principles:

- Creation of a separate financial unit for each entity;
- Daily business of entity should be separate;
- Formal barriers between entities should be kept, such as separate meetings; and
- The entities should not be represented as being one unit.

See William O. Douglas and Carroll Shanks, *Insulation from Liability through Subsidiary Corporations*, 39 Yale L.J. 193, 196-97 (1929).

In the absence of following such formality requirements, Professor Douglas observed, "[d]irect intervention or intermeddling by the parent in the affairs of the subsidiary and more particularly 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, seems to have been determinative in same cases to holding the parent liable." *Id.* at 218.

Case Examples

The following cases illustrate the theory:

- In *United States v. Bestfoods*, 524 U.S. 51 (1998), the court held that the fact a parent company places an officer on a subsidiary company's board of directors is not sufficient, by itself, to impose liability upon a parent company for the acts of its subsidiary. Rather, liability could only be imposed if evidence is presented that the board member was acting for the benefit of the parent company, while making decisions as a board member of the subsidiary;

• The Third Circuit acknowledged this "direct participation" theory to "pierce the corporate veil" in *Pearson v. Component Technology Corp.*, 247 F.3d 471, 486-87 (3d Cir. 2001), *cert. denied*, 534 U.S. 950 (2001), although the court eventually held the parent company exercised insufficient control over the subsidiary's actions to impose liability;

• National Labor Relations Board found a parent liable after a series of transactions were undertaken by the parent to close manufacturing plants operated by its subsidiary, resulting in liability for the subsidiary's unfair labor practices. *Esmark Inc. v. National Labor Relations Board*, 887 F.2d 739 (7th Cir. 1989);

• Parent corporation can be liable for its subsidiary's tort as a "direct participant" in the subsidiary's management and business affairs. Evidence presented by estates of two deceased employees following a fire at an oil refinery established that parent company's overall business strategy for the subsidiary, included cutbacks in programs that included safety, training and maintenance, the parent's board prepared and approved of the subsidiary's reduced budget, both boards met simultaneously, and the subsidiary was directed to become a low-cost refinery through cutbacks and cost savings–all of which created unreasonable risk of employee harm. *Forsythe v. Clark USA, Inc.*, 836 N.E.2d 850 (Ill. App. Ct. 2005) (first court in Illinois to adopt the direct participation exception). Accordingly, a corporation may be liable, under the "direct participation" theory, when its interference and participation in the subsidiary's operations is directly connected to the subsidiary's tortious conduct.

CONCLUSION • When faced with a situation in which the target entity no longer exists in its original form, never assume that the recovery opportunity is lost. Begin by conducting thorough research of the history of all potential defendants, including information on subsidiaries and parent and sister companies, ownership, dividends, and finances. Analyze choice of law issues, as each jurisdiction takes a slightly different view of alternative corporate liability, and consult local counsel for a proper legal analysis. Place all potentially liable parties or their related entities on notice of the loss to avoid spoliation or notice issues. Issue pre-litigation investigation requests, when possible, to determine if another entity may have assumed the liabilities of your target defendant or another entity was controlling the actions of your target defendant such that it should assume liabilities. And when you conduct discovery, depose former officers, directors, and shareholders of the predecessor and current officers, directors, and shareholders of the successor. Ask pointed questions on work history, coworkers, and history of the company—timing of business change events can be critical. The point is that even though the entities may have changed, the plaintiff's right to recovery still exists. Other avenues of relief may be available. You just have to pull out the magnifier and look for them.