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# Risky Business: What You Didn't Know About Veil Piercing of Wholly Owned Subsidiaries

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## IN BRIEF

- With proper planning, wholly owned subsidiaries and their parents can rebuff veil-piercing claims in even the most hostile legal environments.
- Where separate subsidiaries are formed with the goal of minimizing risk, parties should consider the laws of jurisdictions where the subsidiary may be subject to claims in addition to where it is organized.

Companies both large and small enter new ventures all the time. Netflix was originally a DVD delivery service, Amazon sold only books until 1998, and Pixar Animation was only a computer engineering and special-effects company for more than a decade. When businesses diversify, they may seek to insulate an established line of business from the liabilities of a new venture by forming separate, wholly owned subsidiaries. Nearly all of us assume that the enterprise will be responsible for the obligations of a single subsidiary only under the most extraordinary circumstances.

Successful actions against a parent for the obligations of a subsidiary, so-called veil piercing, are relatively rare due to the high bar required by most jurisdictions. In a seminal case on the matter, *Pauley Petroleum Inc. v. Continental Oil Co.*, the Delaware Supreme Court rejected an argument that Continental Oil, a Delaware corporation, and its Mexican subsidiary should be treated as the same legal entity:

> There is, of course, no doubt that upon a proper showing corporate entities as between parent and subsidiary may be disregarded and the ultimate party in interest, the parent, be regarded in law and fact as the sole party in a particular transaction. This, however, may not be done in all cases. It may be done only in the interest of justice, when such matters as fraud, contravention of law or contract, public wrong, or where equitable consideration among members of the corporation require it, are involved.

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239 A.2d 629, 633 (Del. 1968). The Delaware Supreme Court did more than announce Delaware's high standard for veil-piercing claims, however. It applied Delaware law to the question of whether a shareholder would be responsible for the obligations of a *Mexican* entity with statutory limited liability.

This may surprise transactional lawyers, most of whom assume, as they were likely taught in law school, that the law of the jurisdiction in which an entity is formed (or whose "corporate veil" is to be pierced) governs a veil-piercing action. This is commonly referred to as the "internal

affairs" doctrine, recognized by the Supreme Court in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987), and cited in the Restatement (Second) of Conflict of Laws. Under the internal affairs doctrine, Delaware law would apply to the determination of whether to "pierce the veil" of a wholly owned subsidiary formed in Delaware, but Mexican law would apply to the potential liability of an equity owner of a business entity organized in Mexico.

Judicial consideration of choice of law is rare in veil-piercing cases, but a brief survey leads to the discovery that state courts often apply their own local laws, regardless of where the subject entities are formed. For example, the Court of Appeals of Maryland (where the authors of this article practice) applied Maryland law, without discussion, to analyze whether to pierce the veil of a New Jersey corporation in *Hildreth v. Tidewater Equipment Co., Inc.*, 838 A.2d 1204 (Md. 2003). In addition, the California Court of Appeal, Second District, applied California law in a veil-piercing claim involving a Delaware parent and two foreign, wholly owned subsidiaries (one formed in the Netherlands, and the other in Bermuda) in *Toho-Towa Co., Ltd. v. Morgan Creek Productions, Inc.*, 159 Cal. Rptr. 3d 469 (Cal. Ct. App. 2013).

Although apparently briefed on the choice of law, the U.S. District Court for the District of Delaware in *Mobil Oil Corp. v. Linear Films, Inc.* declined to "launch into a protracted choice of law analysis" and decided to analyze the applicable veil-piercing claims under Delaware law (the parent's state of incorporation), rather than Oklahoma law (the subsidiary's state of incorporation). 718 F. Supp. 260, 268 (D. Del. 1989). Moreover, the Delaware District Court has determined that Delaware courts considering a parent entity's liability for the actions of its subsidiary entity "have applied Delaware law, even in the case of foreign subsidiaries." *Japan Petroleum Co. (Nigeria) Ltd. v. Ashland Oil, Inc.*, 456 F. Supp. 831, 840 n.17 (D. Del. 1978). In *Ademiluyi v. PennyMac Mortgage Investment Trust Holdings I, LLC*, after raising the choice of law issue without briefing from the parties, the U.S. District Court for the District of Maryland concluded that Maryland law applies to veil-

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piercing cases brought in Maryland courts, regardless of the jurisdiction of formation of any of the entities in question. 929 F. Supp. 2d 502 (D. Md. 2013).

Although many courts and practitioners assume that choice of law is unimportant because the standard for veil piercing is relatively uniform across U.S. jurisdictions, this assumption may lead to unpleasant surprises. Delaware courts generally require plaintiffs to establish fraud, injustice, or a public wrong. Texas, which has adopted a statutory standard for veil piercing for limited liability companies, requires "actual fraud" and a "direct personal benefit" to the member of a limited liability company. Maryland is even more difficult: in at least one case, a court applying Maryland law refused to disregard the corporate separateness of an entity whose only corporate formality was filing articles of incorporation. *Gordon v. SS Vedalin*, 346 F. Supp. 1178 (D. Md. 1972).

Other states, such as California, impose lower burdens on plaintiffs seeking recovery from a corporate parent, applying an "alter ego" analysis of elements such as capitalization of the entity, its failure to follow corporate formalities, and the overlapping of corporate records or personnel. Indeed, Stephen B. Presser, a professor at Northwestern University School of Law, has described the veil-piercing process under California law in section 2:5 of his book *Piercing the Corporate Veil* as "relatively easy . . . particularly in the case of individually-owned corporations."

This means that businesses relying on the legal separateness of a wholly owned subsidiary to limit intracompany liabilities should be formed and operated in an effort to limit the potential for veil piercing not only in the state of formation, but also in the jurisdictions in which the subsidiary may become subject to claims. If a subsidiary is potentially subject to claims in a state such as California that imposes an "alter ego" or "instrumentality" theory of veil piercing, it should have a legal right to use the assets utilized in its business, enter into agreements in its own name, and observe all (or at least most) organizational formalities. In addition, parent entities may want to

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consider taking steps such as entering into shared services agreements regarding enterprise-wide tasks (such as human resources, accounting, or IT); accounting for enterprise-wide cash management with appropriate credits and debits between parent and subsidiary; and ensuring that the subsidiary is adequately capitalized against foreseeable liabilities, including being a named insured on the enterprise's general liability policies. Where an enterprise has extreme liability concerns, avoiding structures such as member-managed LLCs may be advisable to minimize the appearance that a subsidiary is a mere instrumentality of its parent.

Lawyers and their clients are constantly working together to ensure that risks are predictable and manageable. Veil-piercing claims are never the first item on a client's mind when discussing a new venture, but where separate subsidiaries are formed with the goal of minimizing risk, parties should consider the laws of jurisdictions where the subsidiary may be subject to claims in addition to where it is organized. With proper planning, wholly owned subsidiaries and their parents should be able to rebuff veil-piercing claims in even the most hostile legal environments.

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