The Liability of Parent Companies for the Obligations of their Subsidiaries in the context of Multinational Groups

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A multinational enterprise (MNE) can be defined as "a firm that engages in direct investment outside its home country"[1] and "usually comprise companies or other entities established in more than one country and so linked that they may coordinate their operations in various ways. While one or more of these entities may be able to exercise a significant influence over the activities of others, their degree of autonomy within the enterprise may vary widely from one multinational enterprise to another. Ownership may be private, state or mixed."[2]

In the event of harm resulting from the acts of a MNE unit like a subsidiary, with whom can liability be attached? In order to find out this essay will focus upon the extent of liability incurred by parent companies for the actions of their subsidiaries. An attempt will be made to discover whether any effective legal address exists that can contribute towards the regulation of multinational enterprises and provide recourse to those affected adversely by their actions.

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1 P. MUCHILINSKI, MULTINATIONAL ENTERPRISES AND THE LAW (Blackwell: 1999) at chapters 3, 9 and 10.

2 OECD guidelines for multinational enterprises, (June 27, 2000) "Concepts and principles" available at www.oecd.org/daf/investment/guidelines/mnetext.htmat.3

An emphasis shall be placed upon the idea of holding parent companies of such organisations liable within their home countries, which are located in the more developed part of the world and have greater level of judicial interest in the implementation of corporate law. This assumption is evident from cases as those against such multinationals as "Shell (for its alleged role in the events that led to the execution of Ken Saro-Wiwa), Chevron (for its alleged role in supporting violent government suppression of protestors on an off-shore platform in Nigeria), Unocal and Total (for allegations of using slave and forced labour in Burma) and Texaco (for claims of destroying the Ecuadorean rain forest)[3].

The multinational enterprise has expanded its activities internationally through the formation of relationships, based upon contract, equity ownership, joint ventures, informal alliances etc, with its subsidiaries and other organisations. A question as to breaches of contractual and tortious duties by a subsidiary of such enterprises being the responsibility of the parent company is to be addressed through several issues such as that of separate legal personality, limited liability, jurisdiction, ownership/ control structure of a subsidiary unit and what is known as piercing the veil of incorporation. The bearing these issues have upon such plaintiffs as minority shareholders, voluntary creditors and involuntary creditors bringing an action against a parent company for the actions of its subsidiary will be analysed in the light of the law of contract and tort.

The increasing complications in the structure and activities of multinationals has caused courts in many countries to question the problems of liability and who should it lie within the event of not only gross negligence as in Bhopal but also where loss is incurred from the mismanagement and consequent collapse of a subsidiary. According

[3] Zia Zarifi, *Applying International Law to Multinational Corporations*, CORPORATE WATCH (2000: 11).

to Muchlinski[4] this question of liability "is rooted in the realities of increased international economic integration encouraged by the transnational business practices of multinational enterprises". Such realities do give rise to what Muchlinski argues as a potential for harm to a large number of people, which may lead to such consequences as "transnational mass tort litigation"[5]. It is questionable whether the existing law is adequate to address these realities regarding liability and duty of care owed by parent companies and whether judicial decisions reflect clearly the extent of such liability for harm caused by a subsidiary in a country different to that of the parent.

Therefore, the more companies become owned as subsidiaries by a parent company instead of by an individual or shareholders, and the more litigation arises from such factors as "damage to human health and the environment caused by the processes of production and manufacture operated by multinational companies"[6], the more the need for clear legal provisions to protect those adversely affected by excesses of the corporate world.

A. Forum non Conveniens

Perhaps the first issue which arises when one considers the liability of the parent company is whether a matter which took place in the host state can be litigated in the home country of the parent company. This issue of jurisdiction is probably the first defence presented by the defendant parent company on the basis of the maxim "forum non conveniens".

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[4] P. T. Muchlinski, *Holding Multinationals to Account: Recent Developments in English Litigation and the Company Law Review*, COMPANY LAWYER (2002).
[5] Ibid.
[6] R. Meeran, *Process Liability of Multinationals: Overcoming the Forum Hurdle*, JOURNAL OF PERSONAL INJURY AND LITIGATION (1995) at pp. 170-184.

In the case of England the courts have "as of right" the jurisdiction to allow cases against English parent company by a foreign plaintiff. However, this particular jurisdiction is limited to damage which arose from an act committed within England. Therefore, as in the Cape case where the damage had occurred in South Africa and in the Bhopal case where the damage had occurred in India the correct forum for litigation was argued to be the host countries rather than the parent company's home.

The jurisdiction rule was to a certain extent made less rigid through the principles based on the decision taken in *Spiliada Maritime Corporation v. Cansulex Limited,* which require the parties to show where it's convenient to hear the case and whether justice will be served by the case being heard in a forum outside of England. These principles along with such international agreements as the Brussels and Lugano Conventions could be argued to prevent a parent company from resisting jurisdiction where an action is brought against it in the member countries (located in the developed world).

Jurisdiction for litigation being allowed in the home country of the MNE seems necessary if as according to Meeran the objective of defendant companies in raising forum non conveniens is not to obtain a more convenient forum, but to prevent the plaintiffs from obtaining a remedy not available in the host country. Such an argument is evident from studies which showed majority of cases being settled out of court once the jurisdiction was decided in favour of the home country[7].

It is further arguable that in countries where corporate governance and laws regarding duty of care are not as stringently implemented, the issue of holding a parent company liable for its subsidiary may not be accorded the same importance. The effects of

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[7] See *Forum Non Conveniens in America and England: A Rather Fantastic Fiction* in (1987) 103 LQR 398.

denying jurisdiction is illustrated by the Bhopal case, which though was decided in favour of the litigants in India, yet, it is arguable that if the case had been decided in America as the home country then the decision would have been implemented with greater degree of force then it has been. Consequence of denying jurisdiction in this matter resulted in Union Carbide settling out of court in a $470 million payout for an "industrially induced disaster"[8] which left over ten thousand dead and over half a million persons with severe health problems. Up to this day the Indian Supreme Court has been unable to obtain the trial of Union Carbide officials even after declaring one of them "as an absconder from justice"[9], which may not have been the case if the matter had been decided in America.

Therefore, the forum before which the liability of parent company for the acts of its subsidiary is to be decided holds primary importance. Although each jurisdiction functions in its own legal sphere, it is the home state of the parent MNE which may be in a better position in implementing its decision than a host state. This is arguable on the basis that once the liability of the parent is established in the home country, the problems arising from trying to implement it in a foreign jurisdiction, where courts may hesitate in implementing foreign decisions could be lessened[10].

B. *Separate Legal Entity*

The next point of this analysis shall be what is considered to be the "cornerstone of modern company law"[11], the rule of separate legal identity, which ensures that since each company exists as a separate

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[8] *Bhopal Suffering Continues,* (1997) MULTINATIONAL MONITOR Vol. 18: ½.

[9] *The Bhopal Legacy*, (1997) MULTINATIONAL MONITOR Vol. 18: 3.

[10] In Adams v. Cape, the U.S default judgement was unenforceable by British court as a foreign judgement.

[11] A. N. Mohd-Sulaiman, *Corporate Group Liability: A Malaysian Perspective*, INTERNATIONAL AND COMPARATIVE CORPORATE LAW JOURNAL (2001) Vol. 3: 1.

legal entity, and therefore, the liability of one could not possibly be associated with another. This principle is based upon *Salomon v Salomon and Co Ltd. (1897)*, which presumes that each company is an artificial legal person, therefore, it can be regarded as separate from those who created it and thus liable for its own deeds and liabilities.

In face of this rule how can one company be responsible for the acts of another company which exists as a separate entity in its own right? Further, given the highly complex organisational structure of MNEs, it is questionable as to how a parent be held liable for actions of a subsidiary that is not under a centralised managerial control and is virtually autonomous in its decision making. This particular argument has been used in the defence of *Adams v Cape Industries (1990)* and according to Muchlinski[12] a defendant parent company could with such questions "impress the court" deciding liability. Nevertheless, it is generally thought that subsidiaries are under what is known as the "headquarters effect"[13] which means that the parent company holds the reins of control and makes the crucial decisions regarding the direction of the subsidiary.

The steady appearance of MNEs which are creating commercial relationships that are aimed towards obtaining a competitive market advantage and do not involve the control mechanism existing in a single enterprise organisation will complicate issues further. However, for the present it is arguable that where a relationship based upon control through either equity ownership or that of contract between the parent and subsidiary exists, and since a parent company "has made use of its subsidiaries for its own interests"[14], then in principle it should be held liable for the acts of its subsidiary.

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[12] Mulchinski, *supra* note 4.

[13] Muchlinski, *supra* note 1 (referring to C. Lorenz, *IBM joins the ranks of "transnational,"* in Financial Times 1990).

[14] M. Franzosi, and V. Jandoli, *Liability of a Parent Company for Wrongful Acts of its Subsidiaries In Italy*, INTERNATIONAL COMPANY AND COMMERCIAL LAW REVIEW (1995), Vol. 6:6 at pp. 218-221.

Further, in some case law like *Smith, Stone and Knight Ltd v. Birmingham Corporation (1939),* a relationship of agency between parent and subsidiary has been inferred and the European Court of Justice in *Viho Europe BV v. Commission of the European Communities (1996)* went on to decided that the parent company and its subsidiaries were to be seen as "a single economic entity for the purposes of Article 85 (1) of the EC Treaty."[15] This recognition of MNE as an economic entity tends to limit the principle of separate legal entity, which is even argued as being "based on fiction."[16]

Where there could be a problem with placing liability on the parent company is when it expands through contractual relationships, in which "risk shifting clauses"[17] are used by the parent to avoid liability. Nevertheless, it is arguable that even if such a relationship does exist, this should not take away a MNE parent owing a duty of care towards the host society or the employees of the subsidiary. In recognition of this the Anglo-American and several other jurisdictions like Italy, India and Malaysia, as a matter of policy do consider the parent company to be directly liable on the basis of tort and contract, particularly where there is a case of gross negligence. There is even a suggestion by Muchlinski[18] that regardless of the organisational structure of a MNE, the control of the subsidiary by the parent and its liability could be presumed until it is rebutted through evidence to the contrary. However, such a presumption will have an impact upon the principle of limited liability.

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[15] Quoted in review of N. Hawke 'Corporate Liability' in ASIA PACIFIC LAW REVIEW, Vol. 8:2.
[16] G. Andrews, *The Veil of Incorporation – Fiction or Façade?*, BUSINESS LAW REVIEW (2004).
[17] Muchlinksi, *supra* note 4 at p. 1.
[18] Ibid at p. 2.

C. Limited Liability?

The issue of limited liability further raises questions as to how a parent owning equity in the subsidiary is liable for its harmful acts. Limited liability is a principle which was intended to provide protection to shareholders of a company in order to encourage investment. It is a concept which is argued to be an "established" and "sacred" component of company law. However, it can be used along side the concept of separate legal entity to argue that the parent company can not be held liable for the acts of a subsidiary.

Limited liability could be argued to provide protection to individual shareholders, however, whether it does or should provide protection to large corporations is a matter which requires thought. As parent companies can own shares in their subsidiaries, they could arguably be classified as shareholders, and thus come under the protection of limited liability. Such a defence could prevent a parent being held liable for the acts of its subsidiary. However, it is also arguable that the ownership of shares by large corporate entities like MNEs should not be given the same protection provided to ordinary shareholders as the law on limited liability developed when "individual shareholders were investors and were not active in the operation of the corporation"[19].

Further, it is arguable that limited liability was never intended to protect the interests of large corporations, but rather it is used by them to insulate themselves from the liabilities of their subsidiaries. Nevertheless, the abuse of limited liability was not recognised by such bodies as the Steering Committee on Company Law in England, which could not provide exceptions to the limited liability rule. Such a position can be criticised on the basis that limited liability contributes towards "making company law as cost-free as possible for

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[19] T.W. Cashel, *Review of P. I. Blumberg's Multinational Challenge to Corporation Law: The Search for a New Corporate Personality*, JOURNAL OF INTERNATIONAL BANKING LAW (1994).

corporations to improve their competitiveness,"[20] which could conflict with contractual and tortious liability arising out of such incidents as those occurring in the Bhopal, Thor Chemicals and Adams cases.

Liability of parent could arise from its presumed control of the subsidiary, however, such direct liability has so far only been recognised by India in cases where injury resulting from "ultra-hazardous industrial processes"[21] gives rise to absolute parent liability. This is criticised for interfering with the established law of limited liability, which is not necessarily a bad thing considering the fact that by not making exceptions to the rule would as Muchlinski argues be "morally repugnant" for large profit making parents to "externalise risks onto involuntary creditors, who may not be able to bear those risks, especially in poorer communities and/or in developing countries."[22]

It is further arguable that the principle of limited liability is open to abuse where the extent of the parents' duty of care arising from the negligence of subsidiaries is too great to ignore as a matter of public policy. It can be seen from case law such a *Lubbe v. Cape plc (2000)* and the Bhopal litigation that public policy has been a consideration where parent company's liability had to be decided for the acts of its subsidiary. One can argue therefore, that limited liability is not a justifiable defence against acts of subsidiaries, which have benefited and been influenced by the parent company.

The relationship existing between the parent and its subsidiary cannot possibly be equated with that of the one between shareholders and their investment. According to Gower[23] the limited liability of shareholders is not affected by providing exceptions in the case of

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[20] Ibid at page 2, note 4.
[21] Mehta v. Union of India, AIR 1987 SC 965
[22] Ibid.
[23] Muchlinski, *supra* note 4 (citing Gower, Principles of Modern Company Law).

corporate entities like MNE, since it will be the parent company's assets which could be used to meet justifiable claims of those negatively affected by the operations of its subsidiaries.

D. Legal Basis for Liability

It would appear that there are several entrenched issues which may arise when the matter of holding a parent company liable is addressed. In this situation what shall be the basis for such liability where there is damage arising from the acts of a subsidiary, and that subsidiary is unable to meet its obligations.

Under the law of tort, liability of a parent could be as that of a joint tortfeasor, who as a result of not providing a safe operational environment (or other acts of supervision) breached its duty of care when consequent damage occurs from the negligent acts of its subsidiary. If the subsidiary is regarded as an agent of the parent, then its negligent acts could be seen as those of the parent as the principle. If it can be shown that all the elements of tort i.e. duty, breach and damage exist in the act of the subsidiary, then it is arguable that damages if not obtainable from the subsidiary could be claimed from the parent. A direct liability of the parent could be argued in such cases as in Cape, in which the parent company was aware of the dangers of its operations but omitted to do anything about it. Liability of parent companies under the law of tort has a stronger basis when faced with the concept of limited liability, as where there is harm arising from the acts of the subsidiary, it would be judicious to make the parents assets (which were after all made from the profits of the subsidiary) available to those involuntary creditors who suffered damage.

Where the loss has been caused to a minority shareholder in the subsidiary from mismanagement, a parent's liability could be based upon the fiduciary duty owed by the subsidiary to its shareholders. A subsidiary like any company has a duty to protect the interests of its

shareholders; therefore, should the subsidiary act otherwise it could be seen as breaching its duty. If the directors of a subsidiary are the appointees of the parent then there is also a possibility of raising vicarious liability of a parent for the acts of these employees' directors. It is recognised in such legal jurisdictions as Germany that where a controlling company's influence causes loss to its controlled subsidiary, the controller will compensate this loss. In this case it can be argued that minority shareholders in a subsidiary can bring an action against a parent company which influences those decisions that go against their interests.

A parent company according to Muchlinski and other writers, when faced with a financial crisis would let a subsidiary fail. Although Insolvency laws govern such a situation, however, where there is a shortage of funds (under-capitalisation) and the parent allows a subsidiary to continue incurring liabilities, the parent may be liable for the loss to the creditors when the subsidiary becomes insolvent. The parent company could also be held liable as a shadow director who influences the acts of the subsidiary. For the purpose of discovering the extent of such liability, there would be a need to ascertain what the actual relationship is between the parent and subsidiary.

E. Lifting the Corporate Veil

Regardless of MNEs existing as economic units, it is felt by majority of writers on the subject that courts have generally traditionally tended not to recognise this. However, the act of lifting or piercing the corporate veil is to a limited extent used (usually in America) to discover the relationship, intentions and liability of a parent in relation to its subsidiaries. Lifting the corporate veil involves "taking account of a company's membership when deciding its rights or liabilities"[24]. Even though this method is used particularly where

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[24] Suleiman, *supra* note 11.

there is fraud committed or sham "two dollar" companies set up to avoid liability, however, it could provide evidence of a parent-subsidiary relationship as based upon control and economic interests.

Lifting the corporate veil is a discretionary measure and according to Lord Denning "judges have a discretion either to lift or pierce the veil if equity or justice demands it". However, such cases as *Turstor v Smallbone (2000)* "rejected the contention that the piercing the veil of incorporation can be justified whenever it is deemed necessary in the interests of justice"[25]. There would seem to be a disagreement amongst the judiciary as to when and how to apply the discretion and according to Dine, J[26], courts are more often likely to lift the corporate veil when it is to the advantage of the parent company.

Nevertheless, lifting the corporate veil has been considered in important case law like *Adams v Cape Industries plc* (1990), where the court did analyse the "independence" of a subsidiary along with the intentions of the parent in closing down one subsidiary whilst continuing the same business through others. The same principle was also applied in the Bhopal case against Union Carbide Corporation, in which an Indian court justified the practice as necessary due to the subsidiary having lack of assets to meet the claims by large number of injured claimants. In a New Zealand case *Olson v. CSR (1994),* the plaintiff was finally able to get a Dust Diseases Tribunal to lift the corporate veil so that CSR could be held liable for the plaintiff's injury. Such case law does provide courts with precedence to scrutinize the organisation of MNEs so that their liability is accordingly established.

The complicated nature of the parent-subsidiary relationship does require for the lifting of the corporate veil, particularly where there is question of liability arising from contractual and tortious acts.

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[25] Andrews, *supra* note 16 (quoting Sir Andrew Morritt VC).

[26] J. DINE, THE GOVERNANCE OF CORPORATE GROUPS (Cambridge: 2000).

However, it has to be realised that doing so will conflict with principles of separate legal entity and limited liability. Nevertheless, it can be argued that these particular concepts may provide a MNE with a perception that by showing hands off administration it can economically benefit from acts which are detrimental to the interests of society it exists in.

Although, the practice of lifting the corporate veil by courts has been criticised by Blumberg[27] as being too dominated by facts, but it is also arguable that particularly in America the existence of economic realities between a parent and its subsidiaries is increasingly being used in forming enterprise principles which may presume an economic relationship giving rise to obligations on part of the parent. However, for now the discretion of the court in discovering such relationship by lifting the corporate veil remains just that, a discretion.

Conclusion

There are so many issues, which arise out of the question of parent liability for a subsidiary's actions and most of them are obstacles in the way of establishing such liability. It is evident that MNEs exist in an economic reality and within that reality it develops different operational relationships. One such relationship is with its subsidiary, which operates primarily to economically benefit the parent. Nevertheless, a parent company distances it self from the consequences of a subsidiary's negligent act. The distancing is achieved through arguments based upon separate legal entity and limited liability. However, these concepts are arguably not applicable once the relationship of an economic entity is revealed by lifting the corporate veil. It is further arguable that by not using the discretion to lift the corporate veil results in a denial of an effective remedy to the plaintiff.

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[27] See Cashel, *supra* note 19.

International economic realities and growing business activity of MNE gives impetus to the argument that MNEs should use their cross border business relations to encourage higher standards of care. However, the law has as yet to adjust to this new reality that requires liability of a parent company of a MNE to arise from its failure to provide a duty of care. Rather than address liability, courts have been more concerned about jurisdiction, limited liability and separate legal entity, which are arguably nineteenth century outdated concepts that did not consider the development of MNEs or problems they could create. In fact considering concepts like jurisdiction as a priority before forming a clear presumption of parent liability only increases the burden on those injured by the acts of a subsidiary and forces them to make a compromise towards an inadequate out of court settlement. It does seems ironic that whilst sharing of a subsidiary's profits by its parent is not questioned yet sharing of its liabilities becomes a matter of scrutiny based on outdated principles, which provide an escape route to the parent even though liability may be established under principles of contract and tort.