CHAPTER IX

PARENT-AFFILIATE RELATIONS AND RESPONSIBILITIES

A. The parent-affiliate dichotomy

The foundation of parent-affiliate jurisprudence is the concept of individual corporate personality, sometimes referred to as "entity law". The recognition of the personality of a corporation, separate from that of the shareholder or investor, is a central feature of all market-oriented legal systems (OECD, 1990).

In those countries that espouse entity law, the traditional view is that, within a group of affiliated companies, each affiliate is a separate legal entity with its own rights and responsibilities. But, as a matter of economic reality, the different affiliates may be engaged in one and the same business, often conducted under a single company logo; the concept of separate corporate personality may therefore strike the observer as somewhat artificial. It raises complications, however, in the attribution of liability to individual members of the corporate group.

Although such complications may arise in any type of corporate group, they are multiplied when a domestic corporate group expands into a transnational corporation (TNC). The legal relationships among corporate affiliates of a TNC traditionally reflect the idea that each is a "native within the country of its incorporation" (Aronofsky, 1985, p. 33). But that approach raises several critical jurisdictional and procedural problems that a strictly domestic company would not encounter (Wallace, 1993). For example, a court must decide whether to exercise jurisdiction over a dispute involving a TNC; whether foreign or domestic law, or some combination, should apply; and what procedure to follow on venue and service of process.

The issue of TNC parent-affiliate relations is taking on new dimensions in the emerging world of globalizing firms and industries. Integrated international production, as discussed in chapter V, is turning stand-alone foreign affiliates into parts of larger corporate systems in which each has a specific role to play within an increasingly

sophisticated transnational intra-firm division of labour. In the process, the affiliate may lose part of its autonomy over managerial and operational questions. To the extent that loss of affiliate autonomy does occur, the issue of whether there should be more "parental responsibility" needs to be discussed.

On the other hand, as discussed in chapter VI, intra-firm integration is also producing a network structure, in which the concept of the parent firm can take on a different, more limited meaning, to the extent that the parent becomes more of a coordinating agency for certain corporate activities. The spread of decision-making powers in a TNC is complicating traditional tests for determining which corporate unit is responsible for decisions that have been traditionally associated with the parent company—and thus which firm has parental responsibility. The right issue to consider may therefore be "group responsibility"—the relations and responsibilities among all parts of the group rather than the more familiar parent-affiliate relations and responsibilities. International law is little help to courts adjudicating legal actions involving the allocation of responsibility or liability among a TNC's various parts. Traditionally, of course, "when a state has a recognized basis for prescribing rules to govern a person or activity, international law is usually neutral" (Park, 1978, p. 1,646). It may now be time to reconsider the validity of that approach.

B. National legislative and judicial approaches

1. The traditional approach

The growing discord between legal theory and commercial reality has its roots in history. For many years, it was the original shareholder (who was also the ultimate investor), who granted legal authorization for the development of the corporate structure. Today, the shareholder of one corporation can actually be another company whose ultimate investors were not directly involved in the formation of the new company.

The defining feature of corporate personality is that the corporation is a legal entity distinct from its members. It follows that any personal liability of the members for the acts of the corporation is limited to the extent expressly provided. As originally envisaged, limited liability provided crucial economic advantages to the investors. It allowed them to avoid dangerous exposure to business risks that came from a decision-making process in which they played little or no part. They were therefore able to diversify their portfolios. The management, on the other hand, was encouraged to take appropriate business risks without the constraints of shareholder exposure (Blumberg, 1987).

When corporations themselves were legally authorized to hold the shares of other corporations, however, the distinction between the investor and management began to blur. That raised the spectre of an investor with the powers to manipulate managerial control to the detriment of other parties, particularly creditors, while avoiding responsibility by invoking limited liability. None the less, most jurisdictions around the world stuck to the concept that each corporation in a group is a separate legal entity. Thus, a principle originally designed to distinguish between the ultimate investor and the enterprise was applied for the protection of constituents of the

enterprise, even though the ultimate investors of the enterprise were not directly involved in the formation of those constituents (Blumberg, 1987).

In order to deal with the possibility that managerial control by parent companies might be inappropriately used, corporate law again turned to traditional principles. It relied on certain exceptions to the norm originally designed for the traditional investor who became entangled in the management structure. Exceptions to the limited liability rule had long existed to prevent shareholders from achieving illegal or socially intolerable results through the use of a corporate structure. The application of any of those exceptions is commonly referred to as piercing (or lifting) the corporate veil.

In deciding whether to pierce the corporate veil, courts generally review the identities, formalities and status of the corporate affiliates to see how far they are subject to parental control (box IX.1). However, under the same traditional principles, a finding of such control will justify piercing the veil only if, in addition, the court determines that control has resulted in illegality, fraud or injustice. This "analysis-by-checklist", accompanied by the search for fraud or injustice, has increasingly been criticized, because it seems that there are few, if any, rational criteria to guide it (Aronofsky, 1985, p. 39).

Box IX.1. Checklist for veil-piercing

Factors that courts take into account to signify parental control include:

- stock ownership;
- directors and officers common to both parent firm and subsidiary;
- the financial relationship between parent firm and subsidiary, and whether the latter is economically autonomous from the former;
- whether the parent firm incorporated the subsidiary;
- whether the subsidiary is grossly undercapitalized;
- whether the parent firm pays salaries and expenses of subsidiary operations;
- whether the parent firm guarantees or covers any of the subsidiary's financial losses;
- whether the subsidiary has any business apart from that with the parent firm, and whether the subsidiary maintains any separate assets;
- whether the parent firm treats the subsidiary as an unincorporated division or department;
- whether subsidiary directors and officers have any autonomy from parental authority;
- whether the formal legal prerequisites for separate incorporation are observed by the parent firm;
- whether the parent firm treats the subsidiary's assets and property as its own.

Source: Barber, 1981, p. 398.

2. Piercing the veil of the transnational corporation

A reassessment of the adequacy of the traditional liability and veil-piercing concepts has been advocated for a long time, and some judicial systems are beginning to reject the traditional checklist approach. However, change has happened only in those areas of the law where the courts or the lawmakers have found it particularly difficult to achieve appropriate results with traditional concepts. This has been so in bankruptcy, taxation, anti-trust law and tort law. Thus:

- Courts are anxious to establish whether the failure of an affiliate was caused by instructions from central management, and whether the parent company has used its dominating influence to secure itself a position as a privileged creditor in subsequent bankruptcy proceedings. To prevent this happening, the bankruptcy law of some countries automatically disallows any transactions between connected companies which were carried out in a specified period preceding insolvency.[1]
- Although separate taxation of each company is still the general rule in many legal systems, it is qualified by certain exceptions, which are designed to strike a balance between protecting the revenue of a Government and the need to alleviate the tax burden of the corporate group as whole.
- In applying anti-trust law, many courts look at the economic unity of related companies to determine the market power of an enterprise or the abuse of a dominant position.
- It is in tort law that the greatest advances in overcoming limited liability constraints have been made. In particular, tort law in product liability cases has expanded to the point where liability can be imposed on any parts of a group participating in any stage of the interconnected process of designing, manufacturing, distributing, selling or installing dangerously defective products. In some cases, recognition of the effect of integrated international production seems to take the process even further. The degree of economic and operational integration of affiliate operations and the fact that the parent firm may control an affiliate's decision-making processes have sometimes provided a basis for a court to say that the parent firm was directly involved in the offending action.

C. Options for consideration

Despite the trend away from traditional veil-piercing principles, the solutions dealing with parent/affiliate relationships reflect only the specific legal problems that are meant to be tackled. Solutions reached in one area of law are not necessarily applied to other areas, so they do not seem to lead to a uniform concept of parental responsibility. Furthermore, the degree of change varies widely from country to country. To bring a common approach closer, two ideas may be relevant for dealing with the responsibility of the parent firm in the special context of integrated international production: the first is the notion of a TNC's "duty-to-manage responsibly" and the second is group liability for a TNC.

Under traditional veil-piercing jurisprudence, it is the intrusion of the parent firm into the management of the affiliate that justifies piercing the corporate veil of the parent. Underlying this approach is the assumption that the affiliate had the autonomy and the ability to manage its own affairs, but the parent overruled it. However, the autonomy of foreign affiliates is being eroded in several functional areas. It may therefore be better to consider not how much responsibility for affiliates should be attributed to the parent firm because of its intrusion, but rather how much responsibility should be borne by the parent because of an affiliate's limited capacity to manage itself. Cases of environmental disasters illustrate that the moral (and perhaps the legal) charge facing the parent company may not be that it interfered in the affairs of the affiliate, but rather the opposite: that it failed to supervise and control its affiliate management and to minimize risk.[2] It is in that context that the theory of a parent firm's "duty-to-manage responsibly" has been suggested (Westbrook, 1985, p. 326). The idea is to impose a legal duty upon parent firms to manage their affiliates in accordance with some standard of responsible international investment and management.[3]

Such standards would best apply under an international convention that would define and impose them on an agreed basis. As no such convention exists, it will probably be left to the courts to find the "duty-to-manage responsibly" in the investment contracts that TNCs enter into with host countries. For example, many investment agreements provide for an overhead charge for supervisory services provided by the TNC headquarters. Although such clauses are rarely specific about parent company guarantees, they could be construed to include a duty to ensure that the affiliate is managed responsibly. However, it is worth noting that the Governments of host countries sometimes *de facto* constrain the exercise of responsibility by parent firms. For example, they may impose limitations on the import of certain technologies or the employment of expatriates deemed necessary by parent firms.

Accepting that a parent firm has a role in the management of a group of companies is a notion that is already used in veil-piercing law. Indeed, the recent laws of several countries (particularly in Europe) build on the legitimate involvement of parent companies in affiliate affairs (Hofstetter, 1990); Germany, for example, has enacted detailed and comprehensive laws specifically on this issue (box IX.2). Its legislation not only explicitly recognizes the right of a dominating enterprise to direct the activities of companies under its control; it also establishes special responsibilities and safeguards in order to protect the interests of the parties concerned.

If, however, integrated international production blurs the identity of the parent firm (see chapter VIII), and leads to a dispersion of authority within a TNC, then looking for increased parental responsibility may prove increasingly difficult in the future. Instead, an approach that builds upon existing group-liability principles may offer better solutions. Group responsibility, according to legal literature (Hofstetter, 1990), presumes a disregard of the corporate veil for the liability of individual entities in a corporate group, once it is established that there has been common ownership, direction and unity of economic purpose and operation among the affiliates. To overcome this presumption, each of the units would have to show that its conduct and economic status within a TNC system are unrelated to the dispute before a court.

Concepts akin to group liability apply to corporations in several countries. In the United States, for example, the Bank Holding Company Act, the Securities Acts of 1933 and 1934, the Investment Company Act, the Federal Communications Act, the Export Administration Act, the Foreign Boycott Act and the Foreign Corrupt Practices

Act impose some statutory burdens on the group as a whole. In those instances, they tend to brush aside the separate corporate identity of the various components of the group.

In each of those statutes, and in statutes of other legal systems that have adopted some form of group responsibility, the concept of "control" is central to determining whether group responsibility applies. Typically, the test of control is a benchmark of stock ownership. As an alternative, these statutes use a *de facto* or functional standard defined in terms of whether there was a power to "control" or even to exercise a "controlling influence" over management policies and decisions. The statutes concentrate not only on the "controlling company" and the "controlled company" relationship, but also on the relationship of all companies under "common control".

Box IX.2. Special rules of responsibility for parent companies: the case of Germany

German law accepts the principle that each individual company is legally independent and that its liabilities are covered only by its own assets. However, it allows some exceptions to this principle; different provisions apply, depending on whether the subsidiary is a joint stock company *Aktiengesellschaft* (AG) or a private company limited by shares *Gesellschaft mit beschränkter Haftung* (GmbH).

(a) If the subsidiary company is an AG, the provisions of the Joint Stock Companies Act governing groups of enterprises apply. They contain several exceptions to the principle of legal independence:

- Where one company has been fully integrated into another, under Section 322 of the Joint Stock Companies Act, the main company is accountable jointly and severally with the integrated subsidiary for the latter's liabilities.
- Where the connection between enterprises is weaker—i.e., where a contract of domination or a contract providing for the transfer of profits exists—the creditors of the subsidiary company are indirectly protected by the fact that the parent is obliged to compensate for any loss under Section 302 of the Joint Stock Companies Act. Where a contract of domination or a contract providing for the transfer of profits is terminated, the creditors of the subsidiary company can claim from the parent company direct and demand security from it under Section 303 of the Joint Stock Companies Act.
- If what exists between two enterprises is not a contract of domination or a contract providing for the transfer of profits but merely some dependency, the parent company is obliged under Section 311 of the Joint Stock Companies Act to compensate for a subsidiary's financial loss resulting from the fact that disadvantageous directives were given.
- Over and above this, in the case of a contract of domination or a contract providing for the transfer of profits, as well as in the case of a dependency, the law provides for direct claims of the subsidiary company's creditors against transfer of profits. Claims are admissible only if the parent company or its legal representative has caused damage to the subsidiary in violation of their duty and if the creditors of the subsidiary are unable to obtain satisfaction from the latter (Section 309 (4)).

(b) Where the subsidiary company is a GmbH, these provisions of the Joint Stock Companies Act do not apply. But the courts have tried to establish some law appropriate for groups of enterprises. According to their line of decisions, a parent company holding the majority of shares of the subsidiary (GmbH) has a duty of loyalty towards the GmbH. If it breaches that duty, e.g., by giving the GmbH disadvantageous directives, it becomes liable in damages to the minority of shareholders.

Source: OECD, 1990.

Despite those changes, the concept of limited liability of entities within a corporate group is firmly established in law. As a result, public opinion and corporate goodwill may well turn out to be the driving forces behind a greater acceptance by parent firms of some responsibility for their affiliates.

D. Public opinion and corporate good will

Transnational corporations are in business chiefly to earn profits for their shareholders. However, a TNC recognizes the need to be a responsible member of the society in which it operates. Such social responsibility therefore involves more than conformity with the minimum requirements of the law. It implies the acceptance of a "moral imperative" to recognize duties and obligations arising from a TNC's relationship with creditors, suppliers, customers, employees and society at large. Much of the debate about the responsibility of parent firms turns on this question of balance between what is a legal requirement and what the public perceives as a moral obligation. It is not unusual for parent firms to accept a moral obligation while denying legal responsibility.

For example, although neither Union Carbide Corporation in the United States, nor Union Carbide India, Ltd. admitted "legal" guilt for the Bhopal disaster in 1984, Union Carbide Corporation undertook various self-imposed relief measures of an immediate and long-term nature. Its staff visited Bhopal. It sent medical relief teams and supplied medicine and equipment. Its long-term relief efforts were aimed at meeting the health and welfare needs of the survivors. Union Carbide offered to build dwellings, job training centres and schools. The company contributed $1 million to the Victims' Relief Fund (Wilcox, Ault and Agee, 1986, p. 386).

In increasingly global markets, a substantial change in the reputation of an affiliate can significantly affect (for better or worse) the reputation of the parent firm. In the public's mind, the business of a parent company and that of its affiliates is one and the same. For their part, TNCs recognize the potential danger of ignoring such perceptions, so they sometimes translate social or moral responsibility into financial responsibility. Even though they have refused to accept legal responsibility for the actions of their affiliates, they have been actively involved in out-of-court settlements of lawsuits brought against these affiliates, especially in cases concerning environmental catastrophes. For instance, Union Carbide's management said after the Bhopal disaster that a "quick and fair settlement of the legal claims of the victims would serve the company's [Union Carbide's] needs far better than prolonged and expensive litigation" (Trotter, Day and Love, 1989, p. 445).

E. Conclusions

In analysing issues related to group or parental responsibilities, two fundamental factors must be taken into account. First, any proposal for changes in the traditional approach, if they are to be workable and generally acceptable, would have to deal not just with the question of whether a single economic entity really exists; it would also have to consider the extent to which TNCs themselves would benefit from new legal concepts. Transnational corporations have to judge when courts in different countries would impose liability on the parent

firm, or on the group, or on neither of them. With a more consistent body of law, their ability to make that judgement might well improve.

The second fundamental factor to keep in mind is that any change must be influenced by the objectives of different areas of the law. Wholesale change could do a great disservice to the issue of corporate liability. The law in action does not deal with problems in terms of a universal conceptualized doctrine. On the contrary, in every field of the law there has to be a separate determination of what best serves its particular objectives.

The increasingly integrated nature of international production might result in a growing number of laws based on enterprise or group concepts. If and when that occurs, the change would inevitably differ from jurisdiction to jurisdiction. That, in turn, could lead to an increase in the conflicting requirements being imposed on TNCs by States—conflicts which international law is currently ill-equipped to handle.

It may be useful, therefore, if those countries already experimenting with aspects of enterprise law and group liability would cooperate in those areas of law where some uniformity is possible. For example, it should be possible to secure common approaches towards such matters as antitrust regulations and provisions for disclosure of information; and common accounting principles and regulations for environmental protection could also be feasible. Given the complexity of the issues involved, considerably more research is needed on the impact of integrated international production on parent-affiliate relations. In the meantime, in those cases that society deems especially deserving, public opinion and corporate goodwill may bring about solutions very akin to international solutions.

Notes

1 The French Bankruptcy Act of 1967 has more far-reaching implications. According to Article 99 of this Act, a parent company that has, in fact, assumed the management of an affiliate can be held accountable for the difference between the assets and debts of the affiliate unless it can prove that it has applied the care of a diligent manager (reversal of the burden of proof). Furthermore, under Article 101 of the Act, which confirms an earlier judicial practice, courts may extend the affiliate's bankruptcy to the parent company if the latter has abused the bankrupt enterprise as a cloak or facade for conducting its own operations or abusively disposed of the affiliate's assets. In Belgium and Italy, case law provides for a similar approach. In the United States, the law invalidates *all* transfers to "insiders" (including all affiliated companies) made within one year of bankruptcy, whether or not the individual case represents any thing otherwise unfair or prejudicial to creditors. For example, this extends to repayments of intercompany indebtedness representing cash advanced and fully recorded and disclosed.

2 See, e.g., "Inspector calls Indian plant below U.S. standard", *The New York Times*, 12 December 1984; "Union Carbide admits problems were known", *Manchester Guardian*, 16 December 1984.

3 In proposing "multinational management responsibility", Westbrook argued: "Whenever a difficult choice is presented, it is natural to look for an accommodating resolution between the poles. One that might be suggested by the Bhopal tragedy would be a theory of "multinational management responsibility". The idea would be to impose a legal duty upon multinationals to manage their subsidiaries—at least those in emerging countries—in accordance with some standard of responsible international investment and management. The duty would include responsibility for training and supervising local management and providing regularly updated technology, at least that technology which is related to safety" (Westbrook, 1985, p. 326).