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When Is The Parent Company Liable?
A Lesson In Corporations, Subsidiaries and Environmental Problems
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Related Article:
Risk Management Strategies For Corporate Counsel

It's not easy being a parent these days.

For corporate officers, in-house counsel and strategic planners, the recent crises at companies like Worldcom, Enron, Arthur Andersen and Tyco underscore the mandate that the message of good corporate governance be heard among the legions of corporate directors and senior management.

However, in the rush to return to the traditional principles of corporate responsibility, it is more important than ever for the entire enterprise to be mindful of the potential environmental risk of exposure that could arise from failure to coordinate corporate governance practices with proper environmental risk management — notwithstanding the best intentions.

The interaction of common corporate functions and activities with certain environmental laws can potentially impose future environmental obligations on a parent corporation with respect to its subsidiary's operations. With forethought and vigilance, a parent corporation may take some preventive measures so as to permit key business objectives to be realized while minimizing its potential future environmental exposure.

Concurrently, a parent corporation must also be cognizant of the emerging disclosure requirements placed on publicly traded companies to issue periodic reports required to be filed with the Securities and Exchange Commission, effectively charting a course of enterprise growth balancing between environmental disclosure and the potential for securities violations.

Nothing is more fundamental than the fact that, to grow an enterprise, a parent corporation often provides fiscal and managerial support. Arguably, it is one of a parent corporation's fiduciary obligations. Indeed, to facilitate coordination, consistency and the sharing of key skills and institutional know-how, many corporate parents have, at one time or another:

- appointed a common slate of officers and directors to operate one or more subsidiaries and strategically place (that is, loan) employees to help jump start or expand a fledgling subsidiary;
- signed environmental permits, hazardous waste manifests or property transfer documents on behalf of a subsidiary;
- selected off-site hazardous waste treatment, storage and disposal facilities or undertaken remedial obligations of a subsidiary, following either a corporate master purchase agreement or a uniform corporate sourcing policy intended to enhance corporate social responsibility objectives;
- provided loans, letters of credits, support agreements or corporate guarantees to support environmental permit requirements or underwrite a subsidiary's access to capital or business opportunities with major customers or suppliers;
- transferred contaminated assets into parent corporation-created special purpose entities (SPEs) to facilitate the subsidiary's consummation of a business transaction;
- allowed a subsidiary to use real and personal property on favorable (that is, noncommercial) terms, either through inter-company transfers, assignments, leases or sub-leases; and
- extended insurance coverage to a subsidiary by allowing the subsidiary to become an additional insured on policies that blanket the property and casualty risk of the consolidated enterprise.

In addition to the traditional corporate parent functions, in this age of environmentalism and globalization, corporate performance and stock value are often judged by more than quarterly earnings or compliance with applicable laws. They are also judged on the tenets of "corporate citizenship." (See, for example, the initiatives established by the Organization for Economic Cooperation and Development's Corporate Social Responsibility Guidelines, the United Nations Environment Programme's Financial Services and Insurance Initiatives, the U.N.'s Secretary General Kofi Annan's Global Compact, the Dow Jones Sustainability Group Index as well as the advent of the "triple-bottom-line" approach to corporate performance.)

Accordingly, many socially minded corporations seek to "do good and do well" by fostering competitive advantage and enhance the reputation of the enterprise. Increasingly, principles of good corporate governance may also encompass the establishment of:

- corporate-wide environmental, health and safety (EHS) audit programs or environmental management systems (EMS), such as ISO 14001, as a part of the overall quality assurance or business management program. (Mid-market manufacturers that supply large corporations may find that, as a condition of doing business with large corporations with ISO 14001-types of EMS, they too must implement a comparable EMS or undertake voluntary disclosure of their EHS performance.) To ensure proper implementation of such programs, parent corporations often appoint one or more officers or a committee at the parent level (reporting directly to the parent board of directors) to develop quality standards and audit subsidiaries' EHS performance — some parents even prepare and sign permit applications;
- corporate-wide environmental due diligence guidelines to be followed by all subsidiaries in connection with U.S.-based and cross-border mergers or acquisitions; and
- a policy of voluntary disclosure of EHS performance either in annual reports or other corporate publications (which is predicated on the corporate-wide collection of key environmental data, including that pertaining to the subsidiaries).

As more fully discussed below, in many of these instances, a corporate parent's risk of incurring environmental liability under U.S. law because of participation in or control of its subsidiaries' environmental operations, or because the parent made corporate resources available to its subsidiaries, the use of such resources would be extended to pay for an environmental cleanup at the subsidiary level. Just as likely, corporate parents can face potential risk of exposure for the activities of their corporate subsidiaries located outside of the United States.

To understand why seemingly salutary and progressive corporate practices should even give rise to concerns about potential environmental risk at the parent company level, the recent case law on environmental "owner/operator liability" jurisprudence as well some state statutes governing the transfer of industrial facilities offer insight.

The leading case remains the U.S. Supreme Court's 1998 decision in *U.S. v. Bestfoods* (524 U.S. 51), in which the court held that a parent corporation could be derivatively liable under the Comprehensive Environmental Response, Compensation and Liability Act, 42 USC § 9701 *et seq*. (CERCLA, or the Superfund) as an owner through veil piercing or directly liable as an operator, for the environmental harm caused by its subsidiary, if it sufficiently controls a polluting subsidiary.

Thus, prior to undertaking any corporate parent-support activities or implementing a corporate-level EMS, it is important for senior management to work closely with both corporate counsel and the corporate EHS manager to assess whether any of the contemplated activities could be (mis)construed, later, as evidence of the corporate parent's direct operational involvement in the subsidiary's environmental affairs.

The transformation of accepted corporate governance practices into a source of potentially significant risk for the corporate parent is best seen in the arena of environmental litigation (whether for noncompliance with environmental laws or recovery of cleanup costs), especially as environmental regulators use increasingly creative enforcement strategies to target industry, requiring even greater vigilance in respecting good governance up and down the corporate chain.

While a proactive approach to corporate governance can usually avoid liability climbing the corporate ladder, a reactive approach is doomed to fail — by the time the enforcement action or cost-recovery litigation is set in motion, the crucial corporate governance facts cannot be changed. To wit, if you fail to plan, you can plan to fail.

Under certain circumstances, it is also possible for state property transfer statutes, such as Connecticut's Transfer Act or New Jersey's Industrial Site Recovery Act (ISRA), to impose environmental obligations on parent corporations following ordinary business combinations, strategic alliances or corporate reorganizations. That could happen if the parent had previously undertaken certain corporate governance activities that would make such a law applicable under circumstances where the law would ordinarily not be applicable.

For example, according to the Connecticut Transfer Act, in the heat of a deal, parent corporations can get pressured into executing (as a certifying party) certain documents on behalf of a subsidiary that obligate the parent to fund a remedial investigation and, if necessary, conduct a cleanup — especially if the prospective buyer's due diligence shows that the parent regularly guarantees or assumes the subsidiary's obligations. Even a strategic activity as seemingly innocent as a corporate reorganization for, as an example, tax purposes, can sometimes create Connecticut Transfer Act obligations that are costly and onerous to comply with.

Further, whether a parent corporation may be obligated to comply with state property transfer statutes, when the property is owned or operated by the subsidiary, can be predicated on both corporate structure and support activities undertaken by the parent prior to the transfer. The best example is New Jersey's ISRA, which applies to the sale or transfer of certain facilities (defined as industrial establishments) or corporate transactions/combinations involving entities that own (directly or indirectly) or operate the facilities.

While ISRA is nonapplicable when, among other things, the transaction in question involves a transfer of ownership or operations in which the indirect owner's (such as a parent corporation) assets would not have been available for the remediation obligations of the subsidiary, to avoid ISRA triggers, a parent corporation must explain to the New Jersey Department of Environmental Protection whether:

- the parent has exerted fiscal control over the subsidiary's industrial establishment, including imposing any restriction on financing, borrowing, budgeting, dividends and cash management of the subsidiary;
- the officers, directors or employees of the parent constitute a majority of the directors of the subsidiary industrial establishment such as is sufficient to effectively direct the management and policies of the subsidiary; and
- the officers, directors or employees of the parent are involved in day-to-day operations of the subsidiary industrial establishment and, if so, whether the day-to-day operations of the subsidiary encompass the generation, manufacture, handling, storage or disposal of hazardous wastes.

Another emerging trend that should give pause to corporate officers on environmental matters is that environmental regulators are increasingly using the "responsible corporate officer" doctrine to creatively enforce environmental laws by imposing civil fines and penalties on executives who are responsible for environmental compliance, and who had the authority to prevent the violations and to correct the violations once they were brought to management's attention. The state supreme courts in both Indiana and Connecticut recently adopted virtually identical formulations of this doctrine.

The risk for well-meaning parent corporations is that as they provide support and nurturing for the subsidiaries outside the context of the transaction, they are making decisions that cannot be changed later in the context of a transaction — decisions that can hinder or sway the outcome of the deal.

Likewise, once enforcement proceedings for noncompliance or environmental cost- recovery (whether governmental or third-party) commence, it is too late to insulate a well-meaning parent from the liabilities of a subsidiary if, for example, the parent's signature on a permit or corporate guarantee amounts to a statement on a public document (accessible through the Freedom of Information Act) that the parent's assets are available to cover for the subsidiary's liability.

The collective lesson offered by *Bestfoods,* property transfer laws like the Connecticut Transfer Act and New Jersey ISRA, and the emerging litigation that imposes civil liability on responsible corporate officers, is this: To manage the potential exposure to the parent corporation arising from the businesses or operations of its subsidiaries, corporate counsel needs to ask, at the time the parent support activities are being contemplated or the corporate EHS policy is being fashioned, whether the corporate parent will have pervasive control of the operations and the management decisions of the subsidiary, including those related to hazardous materials or wastes.

If the answer is "yes," the business and organizational relationship between parent and subsidiary should be carefully structured to minimize, if not avoid, the potential environmental risk to the parent.

Unfortunately, managing environmental exposure in light of responsible corporate parent conduct is only half of the challenge. These days, the responsible corporate officers must strike a second balance between providing nurturing care and support for subsidiary operations while meeting corporate disclosure requirements. At a time when a crisis of confidence has rocked Wall Street and led to legal demands for improved corporate responsibility, this second balance is particularly delicate.

For example, parents that structured or facilitated subsidiaries' acquisitions or divestitures by setting up SPEs to hold contaminated assets or move the subsidiaries' known or contingent environmental liabilities "off the balance sheet" by the perfectly legitimate transfer or reallocation of such environmental exposures to third parties by means of insurance products must scrutinize, if not reassess, such activities in light of the enhanced reporting requirements under the Sarbanes-Oxley Act of 2002.

Also, while it may be some time before the SEC adopts rules under Sarbanes-Oxley, the following provisions are among those with environmental relevance: Section 401(a) requires disclosure of off-balance sheet transactions, Section 401(b) imposes requirements regarding pro forma figures, and Section 401(c) requires the SEC to study off-balance sheet transactions and SPEs.

Forward-thinking parent corporations seek to proactively implement best practices and gather data from subsidiaries so as to disclose fully to its shareholders the enterprise-wide environmental risk and liabilities that should guide prudent investment decisions (following the ASTM benchmarks: ASTM International Standard Guide for Disclosure of Environmental Liabilities E2173-01, and Standard Guide for Estimating Monetary Costs and Liabilities for Environmental Matters, E2137-01). These enterprises also need to consider whether their actions could be viewed as departures from the safe harbor created by CERCLA (and its state law analogues) that shield corporate parents from potential liability if they did not participate in the management of the subsidiary's environmental affairs.

Therefore, when performing such tasks as developing and implementing a corporate document retention and destruction policy and preparing the Management Discussion & Analysis (MD&A) for SEC reporting purposes or setting environmental reserves in financial reports, it will be critical for management to coordinate with the responsible environmental personnel to realistically assess and accurately report environmental liability and compliance costs.

From a corporate governance perspective, perhaps nothing could harm a company and its executives more severely than receiving the full weight of the U.S. Justice Department and the SEC amidst allegations of criminally improper environmental disclosures or environmental accounting. One major company in 2001 was accused in a continuing case of:

- arbitrarily inflating liability based on amount paid in an acquisition instead of determining the appropriate remediation liability for each acquired business, then assessing the sufficiency of its liabilities for identified environmental projects at year-end;
- failing to disclose in the MD&A or elsewhere its arbitrary and improper accrual of environmental reserves through purchase acquisition accounting;
- improperly charging operating expenses to the environmental reserve instead of expensing such costs out of current period income;
- recording environmental insurance coverage litigation settlements in income when the environmental liability was overstated and while settlements were still being negotiated.

While the most severe environmental or securities enforcement litigation or prosecution, along the lines described above, might ultimately befall only a few corporations and their executives with conduct amounting to blatant malfeasance, the more likely scenario for many businesses is that enterprise-wide environmental risk and exposure can develop even from well-intended and innovative corporate strategies.

Unfortunately, corporate counsel advising the enterprise on traditional corporate governance issues often are not provided with essential information concerning the (current or future) environmental ramifications, up and down the corporate chain, of parent corporation support activities as well as corporate-wide EHS and EMS policies.

This results from the fact that many corporations do not routinely include their corporate counsel in the development and implementation of the EMS or EHS audit programs. (This practice is changing as more and more companies begin to draw the connection between good corporate governance and corporate citizenship/environmental stewardship.)

Conversely, the environmental compliance officer and managers of a subsidiary, who might be more likely to spot environmental risk lurking within proposed corporate nurturing activities, may not be consulted by the parent's senior management team (including corporate counsel) with regard to traditional corporate governance issues. Often, this situation is made worse by the temporal and spatial separation between corporate governance activities and an understanding of the deal complications and potential environmental liabilities that flow from those prior corporate governance activities. Accordingly, we recommend that several risk management strategies be considered by corporate counsel (*see the sidebar*).

Corporations large and small need to consider the possibility that even some of the most well-intentioned or seemingly benign corporate practices can eventually lead to unintended consequences for the enterprise by complicating, delaying or undercutting the economic value of a deal or exposing the corporation to direct or derivative liability if the government or some third party seeks in environmental litigation to disregard the corporate form.

Thus, corporate counsel may need to remind senior management that decisions made in corporate governance that are intended to be used as a shield can become a sword used against the parent in the merger and acquisition or enforcement/cost- recovery litigation contexts.

Equally important, counsel should emphasize that, while environmental issues need not be the "tail that wags the dog" with respect to traditional corporate governance decision making (such as, overlapping boards of directors), such potential future environmental issues should be contemplated at the time the corporate decision is being made.

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