Holding Companies Beware: Illinois Adopts "Direct Participant Theory"

In a landmark decision, the Illinois Supreme Court recently acknowledged "direct participation" as a viable theory of tort liability under Illinois law. Under this theory, parent companies may be held liable for the activities of their subsidiaries without "piercing the corporate veil" (veil piercing is the traditional mechanism to impose a subsidiary's liabilities on its parent company).

In Forsythe v. Clark USA, Inc., 2007 WL 495292 (Ill. Sup. Ct.), the Illinois Supreme Court recognized that a parent company's involvement in the decision making of its subsidiary could be sufficient to find that the parent company "participated" in the subsidiary's underlying, tortious conduct - thereby subjecting the parent to direct liability as a co-tortfeasor. Specifically, when a parent company imposes cost-cutting measures on its subsidiary and injuries are proximately caused by a lack of sufficient funds for the subsidiary's safe operation, the parent company now can be held directly liable as a participant in the subsidiary's underlying, tortious conduct. Importantly, a parent company found liable for its subsidiary's torts
under a direct participation theory cannot avail itself of the protections afforded by the Workers' Compensation Act.

This month's DataPoint analyzes the new doctrine of direct participant liability adopted by the Illinois Supreme Court in Forsythe and discusses key issues of concern for holding companies whose subsidiaries conduct business in Illinois.

I. Factual Background of the Forsythe Opinion

The Forsythe case involved two employees who died in a workplace fire at an oil refinery operated by Clark Refining. Their widows received a workers' compensation settlement from Clark Refining, but also sued the refinery's parent corporation, Clark USA, Inc., under a "direct participant" theory. Clark USA had no operations, but was simply a holding company; Clark Refining was a wholly owned subsidiary of Clark USA.

The fire was caused when other employees attempted to replace a valve on a pipe without first ensuring that flammable materials within the pipe had been depressurized. Those employees were not maintenance mechanics and were not trained or qualified to perform the work they were attempting. The plaintiffs' allegations of liability centered on the parent
company's overall "cost-cutting" business strategy. Specifically, the plaintiffs alleged that the parent company breached its duty to use reasonable care when it imposed budgetary requirements on the subsidiary that:

1. Required the subsidiary to minimize operating expenses, including costs for training, maintenance, supervision and safety.
2. Required the subsidiary to limit capital investments to those that would generate immediate cash, thereby preventing the refinery from adequately maintaining its facilities in a safe condition.
3. Failed to adequately evaluate the safety and training procedures in place at the refinery.

The plaintiffs further argued that the parent company's budgetary cutbacks forced the subsidiary to have unqualified employees act as maintenance mechanics which, in turn, led to the fire that killed the decedents. According to the plaintiffs, the parent company's conduct constituted "direct participation" in the events that proximately caused the workers' deaths.

For its part, Clark USA responded that, as a mere holding company (connected only to Clark Refining as a shareholder), it owed no duty to either decedent. Clark USA submitted evidence that its subsidiary was solely responsible for operating the refinery, and that
Clark USA had absolutely no control over the refinery's day-to-day operations.

The plaintiffs countered with evidence that the parent company's directors created and approved the subsidiary's budget, and that the two companies' respective boards met simultaneously. Moreover, the belt-tightening budget was created and overseen by the parent company's president - who also happened to be the subsidiary's chief executive officer.

II. Direct Participant Theory

In rendering its decision, the Illinois Supreme Court noted at the outset that the "direct participant" theory of tort liability had not yet been addressed in Illinois, although it had been adopted in a number of other jurisdictions. After a thorough discussion of the doctrine's history (dating back to a 1929 law review article), the Court held that direct participant liability is a valid theory of recovery under Illinois tort law:

[W]e conclude that budgetary mismanagement, accompanied by the parent's negligent direction or authorization of the manner in which the subsidiary accomplishes that budget, can lead to a valid cause of action under the direct participant theory of liability. (2007 WL 495292, at *8).
The Court continued by explaining, "[w]here there is evidence sufficient to prove that a parent company mandated an overall business and budgetary strategy and carried that strategy out by its own specific direction or authorization...that parent company could face liability." (Id., emphasis original). The key elements to an application of the theory are: (a) the parent company's specific direction or authorization of the manner in which an activity is undertaken, and (b) foreseeability. Thus, if the parent company specifically directs the subsidiary to engage in an activity where injury is foreseeable, then the parent company could be held liable. Similarly, if a parent company mandates a global course of action and then authorizes the particular manner in which a subsidiary engages in specific activities, the parent company could be held liable for any foreseeable injuries. (Id.).

Based upon the facts presented by the plaintiffs in Forsythe, the Court concluded that the parent company's business strategy mandated increased productivity from the subsidiary, which was driven in part by budgetary cuts. In order to determine whether those budgetary cuts were negligently directed, or conducted in a manner to benefit the parent company at the expense of the subsidiary, the Court zeroed in on the role of the parent company's president (who also
served as the subsidiary's CEO). In order for the plaintiffs to establish liability, the Court explained that they would need to establish more than the fact that the president made policy decisions and supervised the subsidiary's activities. Instead, the plaintiffs would be required to prove that the negligent business decisions occurred while the president was acting in his capacity as an officer of the parent corporation, as opposed to an officer of the subsidiary. The Court concluded there was a genuine issue of material fact as to which "hat" the president was wearing at that time, so as to preclude the entry of summary judgment. Accordingly, the Court remanded the case back to the trial court for further proceedings.

III. No Workers' Compensation Protection

The Illinois Supreme Court also considered - and soundly rejected - the parent company's alternative argument that the exclusive remedy provisions of the Illinois Workers Compensation Act should render the company immune from suit. 1

According to the parent company, the plaintiffs' theory of liability should be treated no differently than a conventional veil piercing / alter-ego theory. In that situation, the parent company would effectively "step into the shoes of" the subsidiary - which means that
the parent company could avail itself of the same protections afforded under the Illinois Workers' Compensation Act and the Kotecki Cap. 2

The Illinois Supreme Court rejected this argument and expressly distinguished the theory of "direct participant" liability from the "veil piercing" doctrine:

We reject this argument. Direct participant liability, as we now recognize it, does not rest on piercing the corporate veil such that the liability of the subsidiary is the liability of the parent. On the contrary, this form of liability is asserted, as its name suggests, for a parent's direct participation, superseding the discretion and interest of the subsidiary, and creating conditions leading to the activity complained of. (2007 WL 495292 at *11, emphasis added).

Thus, "direct participation" is an entirely independent theory of tort liability. It is a direct action against the parent company and is not derivative of the parent company's relationship with the subsidiary. Accordingly, a parent company found liable for it subsidiary's conduct under a direct participant theory cannot avail itself of any of the workers' compensation protections that would be enjoyed by the subsidiary.

IV. Conclusion
The Illinois Supreme Court's *Forsythe* decision is a troubling development for holding companies whose subsidiaries conduct business in Illinois. There are some limitations to the opinion, however. First, it is important to note that the Court did not enter a finding of liability against the parent company. Instead, the Court merely acknowledged the legal theory and remanded the case back to the trial court, where the plaintiffs must now prove their case. Second, the Court made clear that "mere allegations of budgetary mismanagement, standing alone, will not give rise to direct participant liability." Rather, liability will only attach if the parent company also negligently directed the manner in which the subsidiary achieved the budgetary goals.

Nevertheless, the *Forsythe* decision will provide fertile ground for the plaintiffs' bar, and holding companies may soon find themselves embroiled in litigation that would ordinarily have been confined to their subsidiaries. Accordingly, holding companies that share common management with their subsidiaries, or are highly involved in their subsidiaries' decision making, should be mindful of the "direct participant" doctrine and take appropriate steps to insulate themselves from liability. This will involve, in part, a higher level of rigor in the structuring and documenting of decision-making activities of
affiliated companies. Directors and officers should make certain that corporate decisions, as well as the deliberations that preceded those decisions, are: (a) adequately documented, (b) occur solely at the subsidiary level (where appropriate), and (c) do not create a false impression that the parent company is mandating a course of conduct for its subsidiary.

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1 By statute, an employee who suffers a work-related injury is generally precluded from suing his or her employer for that injury. (See, 820 ILCS 305/5(a)). Instead, the employee's exclusive remedy is to assert a workers' compensation claim against the employer's insurance carrier. (Id.)

2 The "Kotecki Cap" is a legal doctrine that holds a third party sued by an injured employee can assert a contribution claim against the employer, but the employer's liability is limited to the amount it would be required to pay under the Workers' Compensation Act. See, *Kotecki v. Cyclops Welding Corp.*, 146 Ill. 2d 155 (1991).