402 - Parents & Subs: Avoiding Pitfalls in Dealings Between Affiliates

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Faculty Biographies

Frank Allen

Frank Allen started his legal career on the corporate staff of Hughes Aircraft Company where he was involved in the audit of government contracts and management performance of various government weapons systems. He has practiced law for over 30 years with an emphasis on contract, corporate law and business organization.

Mr. Allen was the president of Sunbrook Development Company, builder of the Sunbrook golf course and surrounding residential development in St. George, Utah. Upon completion, Golf Digest rated Sunbrook as the best public golf course in Utah. At Sunbrook, Mr. Allen was responsible for project management, finance and served as general counsel. For the past five years, he has been employed by ProPay USA, Inc. as chief legal counsel. He has also served on the initial board of Sky West Airlines; as well as Director of Tristate Broadcasting Company; St. George Thrift and Loan, Hurst Stores, Inc.; and Anthony Motors. He was a founder of the United Way of Washington County (United Way Dixie) and has served as its president and a director.

Currently, he is the chairman of the Washington County Volunteer Center and serves on the board of the Cause For Hope Foundation. Mr. Allen is a member of the Utah and California Bar Associations.

Mr. Allen graduated with a B.A. from Brigham Young University and J.D. and M.A. from the University of California at Berkeley.+

Bernard Schulte

Bernard M. Schulte is the general counsel of Mitsubishi Fuso Truck of America, Inc. (MFTA) in Logan Township, New Jersey. His responsibilities include all legal functions within MFTA, including supervision of outside counsel, corporate compliance, transactional work and supervision of the customs department. In addition, Mr. Schulte is responsible for insurance coverage and risk management functions, as well as providing counsel to all MFTA business and administrative departments.

Prior to joining MFTA, Mr. Schulte was an associate in the Washington, D.C. office of Reboul, MacMurray, Hewitt, Maynard & Kristol, where he worked on litigation and transactional matters and provided counsel in substantive areas including consumer product safety, telecommunications and motor vehicle franchise law. Prior to that Mr. Schulte served as an assistant general counsel in the United States General Services Administration, where he litigated complex government contract matters.

He currently is a member of ACC, DRI and the ABA, sections of litigation and business Law.

Mr. Schulte received a B.A. from Bucknell University and his J.D. from The Ohio State University College of Law.

Alan Tse

Alan K. Tse is general counsel of LG Electronics MobileComm U.S.A., Inc. in San Diego, the nation's #2 mobile phone manufacturer with annual US sales of over $4 Billion. He is responsible for all legal matters for LG's mobile phone business in North America and sits on the company's six member senior management committee.

Prior to joining LG, Mr. Tse was the vice president and general counsel of Ligos Corporation, a venture capital backed video compression software company based in Silicon Valley. Prior to Ligos, Mr. Tse was the vice president of strategic development and general counsel of Centerpoint Broadband Technologies, Inc., a Silicon Valley telecommunication equipment company. Mr. Tse started his career as a business and technology attorney at Brobeck Phleger and Harrison LLP in their Silicon Valley office representing technology companies and venture capitalists.

Mr. Tse serves on ACC's San Diego Chapter's board of directors. He is the co-founder and serves on the board of directors of the Asian American Legal Foundation and also the San Diego Asian Film Festival. Mr. Tse is a frequent speaker at national legal conferences on the roles and responsibilities of the general counsel and was named one of the best lawyers under 40 by the National Asian Pacific American Bar Association.

Mr. Tse holds a B.A. from the University of California at Berkeley where he earned Phi Beta Kappa honors and graduated cum laude from Harvard Law School.

Session 402

Parents and Subs: Avoiding Pitfalls in Dealings Between Affiliates

Piercing the Corporate Veil

Reaching the Parent Through a Subsidiary

Topics

- Traditional Veil Piercing
  - Liability of the Parent for Actions of the Subsidiary
- Piercing the Subsidiary to Obtain Jurisdiction over the Parent
  - Obtaining In Personam Jurisdiction over the Parent
- "Direct Participation" Claims
  - Employees wearing two hats
- Regulatory Pitfalls
  - Lesser standards applicable to specific regulated practices

Traditional Piercing of the Corporate Veil

- It is well established that a parent's exercise of control as a stockholder, including election of directors, does not in itself justify imposition of liability for actions of a subsidiary.

See, *United States v. Best Foods*, 524 U.S. 51, 118 S. Ct. 1876 (1998)

Traditional Piercing of the Corporate Veil

Public policy Bases to Pierce:

- Prevention of fraud, illegality or injustice;
- Parent so dominates subsidiary that separate corporate existence is a mere sham.

Fraud Element

While the equitable concept of preventing fraud or injustice is one consideration in most jurisdictions, some states require it as a necessary element before the corporate veil can be pierced.

See, *Evans v. Multicon Const. Corp.*, 30 Mass. App. Ct. 728, 574 N.E. 2d 395 (1991)

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Alter Ego Test

- Level of capitalization
- Observance of corporate formalities
- Payment of dividends
- Maintenance of corporate records
- Insolvency/siphoning of funds
- Functioning of officers / directors

See, *Pearson v. Component Technology Corp.,*

247 F.3d 471 (3d Cir. 2001)

Burden of Proof

- Whether or not Fraud element is required;
- Whether Alter Ego or lesser standard;
- Party seeking to pierce has a heavy burden.
  - Factual Determination Required

Common Elements

- Piercing the corporate veil requires a substantial level of proof.
- Court's are generally reluctant to pierce the veil on liability issues. (Jurisdictional issues may have different standards, addressed below.)
- Summary Judgment motions often succeed because plaintiff's can not overcome the burden.
  - Even under summary judgment standards, alter ego test is difficult to meet.
- If the subsidiary operates in any real way as an independent entity, chances are good of defeating an alter ego claim before it gets to a jury.

Piercing the Subsidiary to Obtain Jurisdiction over the Parent

- Assume: Parent not subject to long-arm jurisdiction
  - No property in forum
  - No direct business in forum
  - Products manufactured by and sold through subsidiary
  - No regular contacts in state

Piercing the Subsidiary to Obtain Jurisdiction Over the Parent

- Prior to reaching issues of liability for acts of a subsidiary, plaintiffs can be forced to support *In Personam* jurisdiction over a foreign (out of forum) parent.
- Summary Judgment motions based on lack of *In Personam* jurisdiction can force plaintiff to fight the uphill battle of piercing the corporate veil.

Piercing the Subsidiary to Obtain Jurisdiction Over the Parent-Traditional Veil Piercing Analysis

To defeat a Summary Judgment Motion, a party seeking to pierce the veil must demonstrate:

- Preliminary requirement: Common Ownership
- Secondary factors to be considered:
  - Degree of financial dependency of subsidiary
  - Parent's level of control over selection of executive personnel
  - Observance of the corporate formalities
  - Degree of control over subsidiary's marketing and operational policies.

See, *Volkswagenwerk Aktiengesellschaft v. Beech Aircraft Corp.*, 751 F.2d 117(2d Cir. 1984)

- Jurisdictions may differ over specific requirements, and describe the parent/subsidiary relationship differently (e.g. agency, instrumentality, integrated enterprise).

Piercing the Subsidiary to Obtain Jurisdiction Over the Parent - Alter Ego Jurisdictions

- Other courts may apply an "alter ego" test to determine whether assertion of *In Personam* jurisdiction over a parent corporation is appropriate.

See, *Action Manufacturing Co. v. Simon Wrecking Co.*, 375 F.Supp.2d 411 (E.D.Pa. 2005)

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Piercing the Subsidiary to Obtain Jurisdiction Over the Parent - Burden of Proof Issues

- Whether or not an alter ego test is used, a similar burden of proof (to defeat summary judgment) applies.
- Absent an evidentiary hearing, the party seeking to assert jurisdiction may need only make a, *prima facie* showing of facts to support jurisdiction in order to defeat summary judgment.

See, *Third National Bank of Nashville v. Wedge Group Inc.*, 882 F.2d 1087(M.D. TN 1989);
See also, *Action Manufacturing,* supra.

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Burden of Proof Issues (cont'd)

Where jurisdiction has been challenged and discovery has been conducted on the issue, the burden at trial or a preliminary hearing, shifts to a preponderance of evidence standard.

See, *Volksvagenwerk*, at 120.

Advantages of Early Challenge

Whether *prima facie* or preponderance standard applies, determination of jurisdictional issue based on corporate relationship is best handled pre-trial.

- Court decides the issue as a matter of law
- Avoids jury confusion and dilution of liability questions presented to the jury
- May drive settlement (if deep pockets go away)

Downside of Jurisdictional Challenge

- Discovery can get extensive / intrusive
  - Depositions of corporate officers / directors
  - Document Production could be extensive
  - Potential for electronic discovery could be disruptive and / or expensive

"Direct Participation" Claims

Recent press reports about Illinois Supreme Court decision in *Forsythe v. Clark USA, Inc.,* 2007 WL 495292 (Ill. 2007), have raised the potential for "Direct Participation" claims against parent corporations based on actions of subsidiaries.

- The burden of proving "direct action" is still high, and the risk can be avoided.

See Forsythe, supra., at 8

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Direct Participation Liability

In *Forsythe*, the court recognized the possibility of direct participation liability where specific direction from the parent resulted in the subsidiary action which lead to the underlying claim.

- Requires specificity in directions given
- Must exercise control beyond normal ownership
- Instructions must disregard the subsidiary's interest.

Direct Participation Liability
The Problem of Wearing Two Hats

- Certain statutory/regulatory schemes may impose direct liability even where the veil might not otherwise be pierced.
- Potential direct liability under Comprehensive Environmental Response Compensation and Liability Act (CERCLA) is possible where parents actions lead to conclusion that it was an "operator" of subsidiary's facility.
  Best Foods, supra. at 1886
- However, where joint employees "wear two hats," it is inappropriate to assume that those employees are acting on behalf of the parent when operating the polluting facility. Instead, this is a factual question that must be proven to impose direct liability. *Id.* At 1888

Best Foods Lessons

- Joint employees are not a problem provided roles are clearly defined / documented.
- Wear the subsidiary hat when acting on behalf of the subsidiary.
- Observe the formalities, especially when the parent is exercising appropriate control over the subsidiary.
  - Exercise of stockholder's business judgment is protected, but interference with day-to-day operations may not be.

Lessons Learned (cont'd)

- Document what hat is being worn
  - Discovery may be inevitable
  - Consistency of operations may be key.
  - Documentation is best proof-most likely to defeat prim facie burden to support direct liability or to pierce the veil.

Regulatory Pitfalls

- FCPA – SEC filings
- Industry Specific Regulations
  - CERCLA – "Operator" Standard
- Labor Regulations

FCPA Pitfalls

Potential parent liability may circumvent the veil piercing issue.

- Subsidiary violation of FCPA
- Violation unknown to parent
- Parental representations to SEC mistake facts
- Parent culpable even if misstatement is not willful.

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CERCLA Pitfalls

Parent / Subsidiary relationship may not insulate employees wearing multiple hats.

- Factual question whether parent is "operator" of a facility
- Joint employees may be problematic
- Parent employees "loaned" to subsidiary much more difficult to defend on an "operation" standard.

Labor Relations Pitfalls

- In the context of labor relations issues, the NLRB has developed an independent basis to impose liability on a parent for the actions of a subsidiary.
- Instead of traditional veil piercing, the NLRB will apply an "Integrated Enterprise" test to determine whether a parent will be held accountable for a subsidiary's actions.

"Integrated Enterprise" Test

- Specific to Labor Issues
- Lesser standard than traditional veil piercing
- Focus on labor relations rather then corporate formalities:
  - Affiliation of corporations
  - Interrelation of operations
  - Centralized control of labor relations
  - Common ownership or financial control

See, e.g. *Radio & Television Broad. Techs. Local Union 1264 v. Broadcast Serv. Of Mobile*, 380 U.S. 255, 85 S. Ct. 876 (1965)

"Integrated Enterprise" cont'd

- Widespread application to various Labor Law contexts.
  - FLSA
  - ADA
  - ADEA

See, *Pearson Supra*., at 486

- Specifically adopted by regulation as applicable to FMLA matters.

See 29 CFR. 3825, 104(2)(2)

Conclusions: Assessing the Dangers of Parent/Subsidiary Pitfalls

- **Examine the Corporate Structure**
  - Are the formalities maintained?
  - Separate Financial reports
  - Appropriate Licensing
  - Board Meetings – Held and documented

- **Examine the Corporate Structure (cont'd)**
  - What level of independence is exercised by the subsidiary?
    - Interlocking Boards / Officers
    - Two-hat employees (independence when acting for the subsidiary)
    - Level of day-to-day control exercised by executive officers
    - Direct actions ordered by parent
    - Assess the cost/benefits of maintaining the Veil

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- **Examine the Corporate Structure (cont'd)**
  - Financial Independence of the subsidiary
    - Is the subsidiary self-sustaining?
    - Mutual bank accounts, swept accounts
    - Borrowing practices
    - Capitalization of the subsidiary

Conclusions: Assessing the Dangers of Parent/Subsidiary Pitfalls

- **Analyze Costs / Benefits of Maintaining the Veil**
  - Are there risks that require the parent to be insulated?
    - Jurisdiction / Liability issues
    - Is parent already subject to in personam jurisdiction?
      - Often jurisdiction-specific issue
      - Applicability of state Long-Arm statute

- **Analyze Costs / Benefits of Maintaining the Veil (cont'd)**
  - Why was the subsidiary setup to begin with?
    - Licensing
    - Insulation from Liability
    - Insulation of foreign nationals from U. S. system

- **Analyze Costs / Benefits of Maintaining the Veil (cont'd)**
  - Do the risks of piercing justify the defense costs?
    - Weight potential value of case against costs of fighting jurisdiction
    - Is disruption of fighting jurisdiction work saving the disruption of being joined?
    - Is a Summary Judgment motion cost effective?
      - Discovery costs
      - Likelihood of success
      - Potential Jury Risk

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Conclusions: Assessing the Dangers of Parent/Subsidiary Pitfalls

- **Regulatory Pitfalls**
  - **Corporate Compliance function must consider subsidiary behaviors.**
    - Including subsidiaries within compliance initiatives / training will not generally create risk of piercing training
    - Failure to include subsidiaries can result in direct liability for the parent.
    - Industry specific regulations (CERCLA) may impose different standards that change the parent-subsidiary separation requirements and/o9r limit the amount of insulation provides
    - Labor relations issues may arise when the subsidiary has a substantial work force. Move attention to separation is required to demonstrate the independence of a subsidiary, especially where there is a close management (HR) structure.

Discovery of the Foreign Parent Corporation in U.S. Litigation with the Domestic Subsidiary

Presented by Alan K. Tse, General Counsel
LG Electronics MobileComm, U.S.A., Inc.

Issues:

- When is a foreign parent corporation discoverable in U.S. litigation with a domestic subsidiary?
- What are the devices available to obtain discoverable information from a foreign parent corporation?

Issue #1: When is a foreign parent corporation discoverable in litigation with a domestic subsidiary?

- Generally, a foreign parent company is not immune from domestic litigation discovery requests, IF the subsidiary is an *agent* or *mere department* of the foreign parent.
- To show that the subsidiary is an *agent*, the party wishing to serve the parent corporation must show that the subsidiary "does all the business that the parent could do were it here by its own officials."
- To show that the subsidiary is a *mere department*, the activities of the parent corporation must show a disregard for the separate corporate existence of the subsidiary.

General Factors for being an "Agent":

- The court will generally consider the following factors to determine if the subsidiary does all the business that the parent could do were it here by its own officials:
  - (1) The services must be sufficiently important to the foreign entity that the corporation itself would perform them if no agent were available.
  - (2) The managing or general agent "must be some person invested by the corporation with general powers involving the exercise of judgment and discretion, …and under the direction and control of superior authority, both in regard to the extent of his duty and the manner of executing it."

General Factors for being a "Mere Department":

- The court will generally consider four factors to determine whether the parent shows a disregard for the subsidiary's separate corporate identity:
  (1) Common ownership, which is "the most essential factor;"
  (2) Financial dependency of the subsidiary on the parent;
  (3) The "degree to which the parent corporation interferes in the selection and assignment of the subsidiary's executive personnel and fails to observe corporate formalities;" and
  (4) The parent's degree of *control* over the subsidiary's marketing and operational policies.

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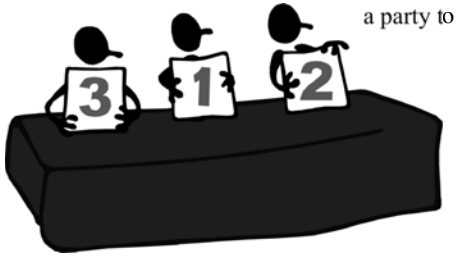
The 3 Main Scenarios for Discovery of the Foreign Parent Corporation:

#1: The Parent Foreign Corporation is directly named in the lawsuit or jointly with the domestic subsidiary

#2: The domestic subsidiary is named in the lawsuit with discovery requests of the foreign parent

#3: There are discovery requests made of the foreign parent when neither the subsidiary nor the foreign parent is a party to the litigation



#1: The Parent Foreign Corporation is directly named in the lawsuit jointly with the domestic subsidiary

- This is not so much a question of discovery as it is whether the foreign parent
- corporation should be a party to the lawsuit for the acts of the domestic subsidiary.
- Does the parent so dominate the subsidiary as to negate its separate identity?
- The courts have applied four tests to determine whether a parent corporation is liable for the acts of its subsidiary:
  - **the "agency" test**, which asks whether the parent exercise a significant degree of control over the subsidiary's decision making;
  - **the "alter ego" test**, which permits the court to pierce the corporate veil when necessary to prevent fraud, illegality or injustice;
  - **the "instrumentality" test**, which asks whether the parent exercised extensive control over the wrongful acts of the subsidiary; and
  - **the "integrated enterprise" test**, which considers interrelation of operations, centralized control of labor relations, common management and ownership or financial control.

#1: The Parent Foreign Corporation is directly named in the lawsuit jointly with the domestic subsidiary

- Case: *Material Supply Int'l, Inc. v. Sunmatch Indus. Co.*, 62 F. Supp. 2d 13, 19 (D.D.C. 1999).
- The court denied counterclaims defendants' motion to dismiss for lack of personal jurisdiction and failure to state a claim, holding that defendant was entitled to an opportunity to obtain information from counterclaim defendants about their relationship and, without that opportunity, the court could not ascertain whether defendant's failure to produce more persuasive evidence was due to lack of discovery or lack of evidence.
- Thus, limited discovery of the parent was allowed to establish personal jurisdiction and the alter-ego claims.
- "When the party which contests jurisdiction is an "alter ego" of an affiliated party over which the court has uncontested jurisdiction…the affiliated corporation's jurisdictional contacts may be imputed to the party."

#2: The domestic subsidiary is named in the lawsuit with discovery requests of the foreign parent

- Court must have personal jurisdiction and control over the documents.
  - If there is personal jurisdiction, the Hague Convention is no longer the mandatory method of discovery to the Hague signatories; the FRCP control.
- Was it within the "reasonable contemplation" of the foreign parent that it would need to provide documents if the subsidiary was party to a lawsuit?
- Is the request unduly burdensome? Blocking Statutes?
- Could the information be obtained from another source?

Volkswagenwerk Aktiengesellschaft v. Schlunk, 486 U.S. 694, 703 (1988)

- Schlunk's parents were killed in a car accident, who then filed a lawsuit in Illinois against Volkswagen of America, Inc. ("VWoA") and the foreign parent, Volkswagen Aktiengesellschaft ("VWAG"). Schlunk served the foreign parent through service on VWoA as VWAG's agent. VWAG argued that it could only be served in accordance with The Hague Service Convention.
- Issue: Is the Hague Service Convention the exclusive means of serving a foreign parent corporation?
- The Hague Service convention methods are not the exclusive means of serving a foreign parent corporation; they are supplemental to the Federal Rules of Civil Procedure, namely Rule 4(f).
- The court relied on the facts that VWoA is a wholly owned subsidiary of VWAG, which a majority of the members of the board of directors of VWoA are members of the board of VWAG, and that VWoA is by contract the exclusive importer and distributor of VWAG products sold in the United States. The court concluded that, because service was accomplished within the United States, the Hague Service Convention did not apply.
- The court found that VWoA and VWAG are so clearly related that VWoA is VWAG's agent for service of process as a matter of law, notwithstanding VWAG's failure or refusal to appoint VWoA formally as an agent. "Where service on a domestic agent is valid and complete under state law and the due process clause, our inquiry ends and the Convention has no further implications..."

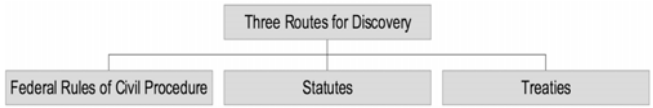
#3: There are discovery requests made of the foreign parent when neither the subsidiary nor the foreign parent is a party to litigation (non-party discovery)

- Who has *control* of the information sought?
- *Control* is defined as the legal right to obtain documents required on demand.
- Under FRCP 45(a)(1)(C), the test for production by subpoena asks whether the information sought is within the custody, possession, or control of the person on whom the subpoena is served.
- Determining control is more of a question of fact than law, governed by whether the party has actual managerial control over, or shares control with, its affiliate, regardless of the formalities of corporate structure.

Power Integrations, Inc. v. Fairchild Semiconductor Int'l, Inc., 233 F.R.D. 143 (2005)

- LGE-USA is a non-party, domestic subsidiary corporation of LGE-Korea.
- Power Integrations (Plaintiff) served a subpoena duces tecum and subpoena for deposition as to 43 integrated circuits allegedly manufactured to the named defendant, Fairchild, which Plaintiff thought were contained in products marketed by LGE-USA.
- LGE-USA won on its motions to quash the duces tecum and subpoena for deposition, and also won its protective order from discovery of LGE-Korea.
- The court based its decision on the fact that LGE-USA was strictly a marketing and sales company, meaning that it did not manufacture or have information on the circuits at issue, that LGE-USA was a non-party to the lawsuit, that there would be undue burden and hardship on LGE-USA to send its people to Korea in order to sift through documents for Plaintiff, and that LGE-USA and LGE-Korea operate as separate and distinct corporate entities. Plaintiff failed to utilize the Hague Service Convention to directly serve its request to the parent corporation without Plaintiff showing good cause for eschewing the formal process. Thus, the court concluded that this was not a situation or company that justified "piercing the corporate veil" for discovery of the parent corporation.

Issue #2: What are the devices available to obtain discoverable information from a foreign parent corporation?



- (1) The Federal Rules of Civil Procedure
  - Depositions, Interrogatories, Document Requests, Admissions, Sanctions
- (2) Statutes
  - 28 U.S.C. §§ 1781 – 1784
- (3) Treaties
  - The Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters
  - The Hague Service Convention
- Additionally, consider applicable decisional law and the Federal Rules of Evidence.

FRCP: Depositions

- Rule 28(b): Depositions may be taken in a foreign country:

  (1) pursuant to any applicable treaty or convention, or

  (2) pursuant to a letter of request (whether or not captioned a letter rogatory), or

  (3) on notice before a person authorized to administer oaths in the place where the examination is held, either by the law thereof or by the law of the United States, or

  (4) before a person commissioned by the court, and a person so commissioned shall have the power by virtue of the commission to administer any necessary oath and take testimony.

- HOWEVER, foreign depositions are often limited by the fact that many countries restrict or completely prohibit U.S.-type depositions in their territory.
- Foreign deposition rules change on a country to country basis.

FRCP: Interrogatories

- Rule 33
  - any party may serve upon any other party written interrogatories… to be answered by the party served or,
  - if the party served is a public or private corporation or a partnership or association or governmental agency, by any officer or agent, who shall furnish such information as is available to the party.
  - Foreign corporations are not immune from responding to interrogatories, but service and content of the interrogatory must conform with the appropriate method of service in the foreign country, taking into account the Hague Service Convention and the Hague Convention on the Taking of Evidence Abroad in Civil and Commercial Matters
  - Discussed more in depth on the production of documents under Treaties

FRCP: Document Production

- Rule 34: Request for production of documents
  - There is no restriction on documents being located in a foreign country, so long as the requested materials are within the party's *control*.
  - Only applies to parties, thus it cannot be used for obtaining documents from non-parties.
  - The request must list, either by individual item or by category, the items to be inspected, and describe each with reasonable particularity. The request shall specify a reasonable time, place, and manner of making the inspection and performing the related acts. The request may specify the form or forms in which electronically stored information is to be produced.

Statutes: 28 U.S.C.S. §§ 1781-1784

- **28 U.S.C.S. § 1781:** Letters of Request or Letters Rogatory
  - Allows the State Department to send letters rogatory, which are formal documents that request the foreign court to take evidence form a witness that falls within that foreign court's jurisdiction. The court would then send a summary of the deposition conducted.
  - Should only be used as a last resort device – time consuming and cumbersome
- **§ 1782:** Assistance to foreign and international tribunals and to litigants before such tribunals
  - (1) The object of the discovery request must be found or reside in the district,
  - (2) the purpose of the discovery must be "for use,"
  - (3) the use must be in a proceeding,
  - (4) the proceeding must be in a foreign or international tribunal, and the
  - (5) application must be made by the foreign or international tribunal or "interested person"
- **§ 1783:** (the Walsh Act):
  - Allows a U.S. court to issue a subpoena for U.S. nationals living in foreign countries.
  - The U.S. national can be forced to travel back to the U.S. to give a deposition or produce documents.
- **§ 1784:** Sanctions/Contempt
  - Foreign parties can be ordered to show cause before the U.S. court at a designated time why he should not be punished for contempt if the party fails to produce the requested documents, subject for deposition, interrogatory, etc.

Treaties: The Hague Conventions

- **The Hague Convention on Taking Evidence Abroad in Civil or Commercial Matters**, 23 U.S.T. 2555 (1970)
  - This Convention codifies procedures for taking depositions on notice and commission before foreign consuls and court appointed commissioners.
  - The Form Letter of Request is sent directly by a U.S. court to a foreign central authority.
  - The request should include (1) a list of any specific procedures desired by the requesting court (e.g. transcripts or participation in the proceedings by American counsel or local counsel representing the American firm, (2) be in duplicate, (3) be in the appropriate translation, but French or English is also acceptable in most countries. Finally (4) there should be a separate request for each witness.
  - Very time consuming and costly process. It can take up to 6 months or more.
- **In Force:** Anguilla, Argentina, Aruba, Australia, Barbados, Bulgaria, Cayman Islands, China, Cyprus, Czech Republic, Denmark, Djibouti, Estonia, Falkland Islands, Finland, France, French Guiana, French Polynesia, Germany, Gibraltar, Guadeloupe, Guernsey, Hong Kong SAR, Isle of Man, Israel, Italy, Jersey, Latvia, Luxembourg, Macao SAR, Martinique, Mexico, Monaco, Netherlands, Norway, Poland, Portugal, Saint Pierre & Miquelon, Singapore, Slovak Republic, Sovereign Base Areas of Akrotiri & Dhekelia, Spain, Sweden, Switzerland, U.K., U.S., Venezuela
- Pre-trial discovery is generally not allowed in most countries party to the Convention. Many countries made specific declarations objecting to the Article 23 provision on pre-trial discovery of documents.

Treaties: Document Production

- The Hague Convention allows parties to request documents from any foreign party or non-party.
- There is no set time limit for which the foreign party must respond under the formal process, but it is usually a 6 month window.
- The standards for discovery arguably do not differ from the FRCP to the Hague Discovery means.
- Blocking Statutes:
  - *Procedural* – block compliance with foreign discovery requests unless certain technical procedures are followed
  - *Discretionary* – allow government agencies to block compliance
  - *Industrial* – blocks discovery requests in certain industries
- Examples:
  - Swiss banking laws
  - U.K. Trading Interest Act
  - Antitrust and "claw-back" blocking statutes

Societe Internationale Pour Participations v. Rogers, 357 U.S. 197 (1958).

- Swiss holding company filed an action in the U.S. to recover seized property under the Trading with the Enemy Act. The U.S. District Court ordered production of a large number of documents, of which the Swiss company complied with most of the requests by lobbying the Swiss government for a release of the records. However, Swiss law prohibited the disclosure of the remaining documents, under criminal sanction. The lower court acknowledged that the Swiss company had made a good faith effort to comply, but dismissed the lawsuit for failure to produce under Rule 37.
- The U.S. Supreme Court reversed the lower courts, holding that it while (1) the Swiss company did have control over the documents and that (2) Rule 37 of the FRCP did govern, that (3) dismissal of the case was improper where the party had made good-faith efforts to comply, and was not in collusion with the Swiss government to block production.
- The fact that Swiss law prohibits, under criminal sanctions, the disclosure by a Swiss banking firm of its documents does not bar a conclusion that the plaintiff had "control" of these documents within the meaning of Rule 34, relating to discovery and production of documents within the "control" of a party.
- The reasons why a party does not comply with a production order of a Federal District Court, and his willfulness or good faith, do not affect the fact of noncompliance and are relevant only to the path which the District Court might follow in dealing with his failure to comply.

Discovery from Non-Parties

- FRCP: Rule 45
  - A person not a party to the action may be compelled to produce documents or statements under a subpoena duces tecum or subpoena ad testificandum.
- Statutes:
  - 28 U.S.C.S. § 1782. Assistance to foreign and international tribunals and to litigants before such tribunals does apply to non-parties, but there are several restrictions, such as the foreign court is not bound to honor these requests, only doing so on the presumption of comity.
  - "Tag jurisdiction" also applies.
- Treaties:
  - The Hague Conventions
  - The letters rogatory apply to both parties and non-parties
  - This is typically the exclusive method of discovery when the domestic subsidiary is found to be independent from the foreign parent.

Foreign Service of Process

- Rule 4 of the FRCP
- Rule 4(f) allows for service of process by treaty
- The Hague Convention does not determine the validity of service of process under a common law agency theory when the foreign corporation or its agent is located and served within the United States.
- The Hague Service method is not exclusive when serving a foreign corporation, but is merely an additional tool to the FRCP at the disposal of the party.

Foreign Service of Process

- **The Hague Service Convention**, 20 U.S.T. 361 (1969)
  - Established a Central Authority, a judicial authority conforming to the laws of the respective country, in each country for service of process to be judicially expedited.
  - To effect service of process under the Hague Service Convention, the attorney must fill out a USM-94 form, found at any U.S. Marshall's office, which is then sent to either the Central Authority (formal service), to a deliveree who has voluntarily agreed to accept it (informal service), or can be made by personal service if voluntarily agreed to do so.
  - Form must include (1) the identity and address of the applicant, (2) the name and address of the requesting authority, (3) reference to the statutory authority to serve the document, (4) designation of the method of service, (5) translation into the official country language, and (6) submitted in duplicate.
- **In Force**: Anguilla, Antigua & Barbuda, Argentina, Aruba, Bahamas, Barbados, Belarus, Belgium, Belize, Bermuda, Botswana, British Virgin Islands, Bulgaria, Canada, Cayman Islands, China, Cyprus, Czech Republic, Denmark, Djibouti, Egypt, Estonia, Falkland Islands, Fiji, Finland, France, French Polynesia, Germany, Gibraltar, Greece, Guernsey, Hong Kong SAR, Ireland, Isle of Man, Israel, Italy, Japan, Jersey, Kiribati, South Korea, Latvia, Lithuania, Luxembourg, Macau SAR, Malawi, Mexico, Montserrat, Netherlands, Nevis, Norway, Pakistan, Pitcairn, Poland, Portugal, Russian Federation, St. Christopher (Kitts), St. Helena & Dependencies, St. Lucia, St. Vincent & The Grenadines, Seychelles, Slovak Republic, Slovenia, Solomon Islands, Spain, Sri Lanka, Sweden, Switzerland, Turkey, Turks & Caicos Islands, Tuvalu, Ukraine, U.K., U.S., Venezuela
- Always look at the reservations and declarations each country made on accession to the treaty, as some countries have specific reservations against particular methods of service. The Convention method should be employed in all countries party to it.

Societe Nationale Industrielle Aerospatiale v. United States Dist. Court for S. Dist., 482 U.S. 522 (1987).

- After an airplane sold by two French corporations crashed in Iowa, three individuals filed separate suits against the two corporations in the U.S. Dist. Court in Iowa. The two corporations were served with (1) a request for the production of documents pursuant to Rule 34, (2) a set of interrogatories pursuant to Rule 33, and (3) requests for admissions pursuant to Rule 36.
- The corporations filed a motion for a protective order, arguing that (1) because they were French corporations and the materials sought through discovery could be found only in France, the exclusive procedures for such discovery were dictated by the Hague Convention, and under a French penal law (the "blocking statute"), the corporations could not respond to discovery requests that did not comply with the Convention.
- The Court held that the Hague Convention does not provide the exclusive discovery procedures the District Court must use when litigants seek evidence abroad; nor are such litigants required in all cases to resort first to the procedures of the Hague Convention before using the normal discovery methods of the Federal Rules of Civil Procedure; but the Hague convention is still a valid method of discovery if there is jurisdiction over him.
- With respect to the French blocking statute, although such a statute did not deprive the District Court of the power to order a party subject to its jurisdiction to produce evidence, even though the act of production might violate the statute, such a statute was relevant to the Dist. Court's comity analysis to the extent that its terms and its enforcement identified the nature of the sovereign interests in nondisclosure of specific kinds of material.

Takeaways

- Party vs. Non-Party determination
- Relationship of the foreign parent and subsidiary
- Does the domestic subsidiary have "control" over the information requested?
- What is the party's interest in obtaining the requested information?
- Blocking laws, reservations against production, criminal sanctions

Session 402

Parents and Subs: Avoiding Pitfalls in Dealings Between Affiliates

The Formation of a Subsidiary

A Canadian Case Study

Presented by Frank A. Allen, Chief Legal Counsel
ProPay USA, Inc.

ProPay USA, Inc.

ProPay Succeeds by Empowering its Customers with Innovative Payment Services that are Simple, Safe and Affordable.

- Agent of Wells Fargo Bank NA providing payment solutions, including merchant accounts to small businesses.
- Agent of MetaBank providing payment accounts and co-branded cards to companies to facilitate the payment of commissions.
- All services are delivered to customers online or by IVR.

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PROPAY
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Creative Memories
Close to my Heart
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ADVOCARE We Build Champions
NU SKIN
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Formation of a Subsidiary by ProPay

To form a subsidiary or not? That is the first question.

- What are your company's objectives giving rise to the consideration of creating a subsidiary? List:
  - Primary objectives.
  - Secondary objectives.
- Can these objectives be realized without forming a subsidiary?

1. Formation Issues

- If the answer is No, what form of entity should you choose?
  - Engaging outside counsel and consultants.
  - In what jurisdiction should this entity be formed?
  - The impact of tax, customs duty and liability issues on choice of entity and jurisdiction.
  - Capitalization
  - Who will be the officers, directors and shareholders of the entity?
  - Are there directors' Residency requirements?

Create a List of Potential Issues

1. **Formation Issues (See above)**
2. **Taxation Issues**
   - **Income Tax**
     - Under the Canadian Income Tax Act (the "ITA"), a corporate entity is subject to Canadian income tax if: (i) it is a resident of Canada or, (ii) it carries on business in Canada. A corporation will be considered to be a resident of Canada if it is incorporated in Canada or if its "central management and control" resides in Canada. Corporations that are not resident in Canada will be viewed as carrying on business in Canada, and subject to tax under the ITA, if they solicit orders or offer anything for sale in Canada through an agent or servant, irrespective of whether the contract or transaction is completed inside or outside Canada.

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- **Treaty Relief from Broad Scope of ITA**

  Non-resident corporations who are residents of countries with which Canada has a bilateral tax treaty (for example, all O.E.C.D. countries, including the U.S.), are relieved from the broad scope of the ITA's "carrying on business" rules and are generally only subject to Canadian income tax if they carry on business through a "permanent establishment" situated in Canada.

- **Limited Liability Company not an effective option**.

  In order for a U.S. corporation to be considered a "resident" under the U.S. Treaty, it must be liable for tax in the U.S. Based on this requirement, the Canada Revenue Agency (the "CRA") has indicated that "flow through" Limited Liability Companies or LLCs do not qualify for treaty relief since under the U.S. Internal Revenue Code, it is the members of the LLC who pay tax (and not the LLC itself). Given the foregoing, U.S. LLCs are not an effective alternative for (1) operating a company in Canada, or (2) owning a separate Canadian subsidiary that is operating a company in Canada.

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- **Canadian Tax Rates Payable by Canadian Corporations**

  For businesses which are subject to Canadian income tax (e.g., U.S. residents who carry on business in Canada through a permanent establishment situated in Canada), the rate of Canadian income tax payable by the corporation is a function of the applicable federal and provincial income tax rates that apply. Currently, for businesses with a permanent establishment situated in Ontario, the combined rate of tax is approximately 36.12%.

- **Withholding Taxes on Payments to Non-Resident**

  In addition to paying federal and provincial income taxes at the corporate level, the ITA imposes a 25% withholding tax on various payments made to non-residents including dividends, management fees, interest and royalty payments. The requisite amount of withholding taxes, however, are often reduced under Canada's various tax treaties – to the extent the recipient of the payment qualifies for treaty relief.

  - Dividends
  - Management Fees
  - Rents & Royalties
  - Interest Withholding

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- **Interest Deductibility (Thin Capitalization Rules)**

  A special thin capitalization provision in section 18(4) of the ITA restricts the amount of interest which is deductible by a Canadian corporation on debt owed to a non-resident lender who is either a 25% shareholder of the corporation or related to such a shareholder. The maximum debt-to-equity ratio for this purpose is set at 2:1 (i.e., for every dollar of equity, there may be a maximum debt of two dollars).

- **Branch Tax for Foreign Branches**

  In addition to paying corporate tax on the taxable income (i.e., profit) attributable to the Canadian branch, non-resident corporations with a separate Canadian branch, are required, under the ITA, to pay a yearly branch tax of 25%. Section 6(d) of Article X of the U.S. Treaty, however, reduces the branch tax to 5% and provides an exemption for the first $500,000 of Canadian income of the branch.

  The branch tax is essentially the equivalent of the 5% non-resident withholding tax which would apply under the U.S. Treaty for dividends. Unlike the withholding tax for dividends, however, the branch tax is applicable in the year in which the profit is earned and not when the profits are repatriated.

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- **Start-up Losses**

  Non-capital start-up losses may be carried back three years or carried forward for ten years and deducted from the taxable income of the Canadian subsidiary during those years. After eleven years, the losses can no longer be used for tax purposes. Capital losses may be carried forward indefinitely but can only be deducted from taxable capital gains.

- **Provincial Rules on Payments to Non-Residents**

  In addition to the federal rules governing payments to non-residents, consideration must also be given to the impact of any special rules in each province in which the subsidiary maintains a permanent establishment. For example, the province of Ontario denies a deduction of a proportion of any amount paid in respect of a management or administrative fee or charge when made to a related entity. This results in additional provincial tax to the payor of 5% of the amount paid.

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3. Transfer Pricing Considerations

All transfer pricing arrangements between a Canadian subsidiary and its U.S. parent corporation may be carefully reviewed by the CRA. In general, the amounts paid by the Canadian subsidiary should reflect the amounts that would be paid between parties dealing at arm's length who are at the same level of trade. In Information Circular 87-2R, *International Transfer Pricing* ("IC 87-2R"), the CRA provides a detailed overview of Canada's transfer pricing policies, indicating that the following traditional transaction methods will result in the most reliable "arm's length" price:

- Comparable Uncontrolled Price (CUP) Method
- Resale Price Method
- Cost Plus Method

To the extent these methods are not appropriate, the CRA would then apply the transactional profit methods being the "profit split method" and the "transactional net margin method".

NOTE: CRA FOLLOWS THE OECD NOT IRS APPROACH!

- CDN "CONTEMPORANEOUS DOCUMENTATION" REQUIREMENT– Possible Additional 10% Penalty

4. Sales Tax Issues

- **OVERVIEW**

The Canadian government and its provinces impose a variety of sales and use taxes on various goods, services and intangibles. At the federal level, there is the 7% Goods and Services Tax (GST); whereas, at the provincial level there are the following provincial retail sales taxes ("PST") at the following rates: 7% in British Columbia, 7% in Saskatchewan, 7% in Manitoba, 8% in Ontario, and 10% in Prince Edward Island.

The province of Alberta does not impose a sales tax; whereas, the provinces of Newfoundland, New Brunswick and Nova Scotia impose an additional 8% Harmonized Sales Tax (HST) which is payable under the federal GST legislation. In Quebec, there is the 7.5% Quebec Sales Tax ("QST") which, for all intents and purposes, operates in the same fashion as the GST. The various taxes, on a province by province basis, may be summarized as follows:

Province	GST/HST Rate	PST Rate	PST Payable on GST Included Price"
British Columbia	7%	7%	No
Alberta	7%	0%	N/A
Saskatchewan	7%	7%	No
Manitoba	7%	7%	No
Ontario	7%	8%	No
Quebec	7%	7.5%	Yes (effective rate 8.025%)
Nova Scotia	15%	0%	N/A
New Brunswick	15%	0%	N/A
Newfoundland	15%	0%	N/A
Prince Edward Island	7%	10%	Yes (effective rate 10.7%)

- **GST OVERVIEW**
  - **GST/HST Payable on all Supplies Made in Canada**

    The GST is a value-added tax which has been in effect since January 1, 1991. It is imposed under Part IX of Canada's *Excise Tax Act* (the "ETA"), and is administered by the CRA. The 7% GST is imposed on a comprehensive range of transactions involving goods, services and intangibles—called "supplies"—unless these supplies are "exempt" or "zero-rated" under Schedules V and VI of the ETA.

  - **GST Requirements to Register, Collect and Remit GST**

    Unlike other sales taxes, which only apply to the final consumer or user of the goods/services, the GST is levied on every transaction in the production and distribution chain, generally requiring all suppliers to register for the GST, and charge, collect and remit GST on their supplies.

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- **GST Payable on Imported Goods/Services**

  In addition to taxing all taxable supplies "made in Canada", the ETA under Division III also imposes GST on imported goods and services. The GST paid on importation will, however, be recovered through a tax credit mechanism provided the importer is a GST registrant.

- **PST OVERVIEW**

The biggest difference between PST and GST lies in the fact that the PST is only payable by the final consumer or user of the goods. Accordingly, purchases made for the purposes of resale are not subject to PST.

If a Canadian subsidiary is established by a U.S. company, the subsidiary could be required to register and collect PST in each province (except Alberta which has no PST) in which it carries on business.

5. Employer Source Deductions

Canadian employers are required to deduct and remit certain amounts from wages and salaries paid to employees and are also subject to certain payroll taxes.

- Personal Income Tax
- Employment Insurance Premiums
- Canadian Pension Plan Premiums
- Provincial Employer Health Tax

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6. Customs Duty Overview

With the importation of goods comes the obligation of determining the applicable country of origin for the goods, properly classifying the goods according to the Canadian *Customs Tariff* and valuing the goods according to detailed value for duty provisions under the *Customs Act*.

- **Tariff Classifications**
  - *Customs Tariff Schedule*
- **Origin Of Goods**
  - If goods qualify under NAFTA, Rules of Origin, no duty payable.
- **Value For Duty**
  - Six Valuation Methods
    - Transaction Value
    - Transaction Value of Identical Goods
    - Transaction Value of Similar Goods
    - Deductive Value
    - Computed Value
    - Residual Value

- **Transaction Value (Price Paid Or Payable)**
  - GATT "Sold for Export" Requirement
    - Goods must be "sold" (e.g., transfer of title to a separate purchaser)
    - Good "for export" to Canada (as condition of sale)
- **Transaction Value (Price Paid Or Payable)**
  - Unique "Purchaser in Canada" Requirement
    - Purchaser must be in Canada – Either a resident (i.e., Carrying on business and management and control in Canada), a permanent establishment, or a "non-resident importer" that imports and warehouses unsold inventory in Canada
    - Recent *FosterGrant* case (FCA)
      - "Carrying on business" requirement meant so long as Canadian subsidiary buys and sells on its own account for profit in Canada
      - Cannot be an agent, amanuensis, or branch of parent

7. Competition Acts

- **Federal Competition Act**
  - Misleading advertising
    - "Dual Track" enforcement process:
    - Criminal
      - "Knowingly or Recklessly"
      - Jail and/or fines
    - Civil
      - Balance of probabilities
      - Cease and desist, corrective advertising
  - Deceptive telemarketing
  - Distribution and pricing practices
  - Contest disclosure requirements
  - Multi-level marketing
- **Provincial Consumer Protection Laws**
  - Consumer Protection Laws
  - Content requirements for direct sales contract signed by consumer
  - Buyer's Right to Cancel statement
  - Impact of Consumer Protection Act, 2002 (Ontario)

8. Consumer Packaging and Labeling Act

- Applies to most "Prepackaged Consumer Products"
- Requires 3 declarations:
  - Product identity
  - Net quantity
  - Manufacturer/dealer name and address
- Bilingual requirement
  - Product identity and net quantity must be in both English and French
- Prohibits misleading labeling

9. Privacy Issues

- **Provincial Privacy Legislation in Canada**
  - Quebec: Loi sur la protection des Renseignements personnels dans le secteur privé
  - BC: *Personal Information Protection Act*
  - Alberta: *Personal Information Protection Act*
  - Ontario: Bill 21 *Personal Health Information Act,* 2003
- **Federal Privacy Legislation in Canada**
  - *Personal Information Protection and Electronic Document Act* (PIPEDA)
  - Staggered implementation:
    - -- Federally regulated business, 2001
    - -- Federal health sector, 2002
    - -- Provincially regulated private sector, 2004

- **Application of PIPEDA**
  - January 1, 2004 – applies to all private sector entities that collect, use or disclose personal information in the course of commercial activities, unless the province enacts legislation that is "substantially similar" to this Act
  - So PIPEDA applies to all organizations that collect personal information about customers who are people.

Personal Information Protection and Electronic Documents Act (PIPEDA)

- ***Creates right to privacy concerning "personal information"***
  - Basic principle: personal information should not be **collected, used or disclosed** without the prior knowledge and consent of the individual.
  - PIPEDA does not define the terms "collection, use and disclosure".

- **Definitions**
  - Personal Information – means information about an identifiable individual, but does not include the name, title or business address or telephone number of any employee of an organization.
  - Work Product Information – means information prepared or collected as part of responsibilities or activities related to employment or business and is not personal information.
  - Professional or Business Directory Information – may be collected or used if related directly to the purpose for which the information appears in the directory. PIPEDA Case Summary 141.
  - Commercial Activity – means any particular transaction, act or conduct or any regular course of conduct that is of a commercial character, including the selling, bartering or leasing of donor, membership or other fundraising lists.
- **PIPEDA does not apply to**:
  - Government
  - Information collected for domestic purposes
  - Journalistic, artistic or literary purposes
  - Publicly available information (to be specified in regulations)

- **Appropriate Consent**
  - Implied
  - Express
  - Opt-in vs. Opt-out
- **Withdrawal of Consent**
  - Consent may be withdrawn at any time, subject to legal or contractual restrictions and reasonable notice.
- **Oversight Under PIPEDA**
  - Complaints filed with federal Privacy Commissioner
    - Commissioner may investigate on own initiative
  - Investigation results in report of findings and recommendations
  - Report of Commissioner enforceable by Courts:
    - Order organization to correct its practices
    - Require organization to give notice of actions
    - Award damages, including for humiliation suffered by complainant

10. Provincial Registration

- **Name Registration**
  - Corporate name must be approved in various provinces before extra-provincial registration permitted
  - "Business name", which is different from corporate name, must also be registered
- **Extra-Provincial Registration**
  - Branch operation and incorporated entity required to register before conducting business in the specific jurisdiction
  - Registration requirements depend on whether activities constitute "carrying on business"
  - "Carrying on business" test varies across Canada
    - Local telephone directory listing
    - Advertising with local address
    - Resident agent, representative, warehouse, office or place of business
    - Owns real estate
    - Licensed or registered to do business locally under other legislation
    - Solicits business locally
    - "Otherwise carries on business"

11. Doing Business in Quebec

- Charter of French Language. French is the official language of Quebec.
- Consumer Protection Act
- Regie
- Privacy Legislation
- If you intend to do business in Quebec, you should retain counsel in Montreal to assist in ascertaining applicable Quebec legislation.
- References:
  - **http://www.gouv.qc.ca/wps/portal/pgs?lang=en**
  - **http://www.pch.gc.ca/index_e.cfm**

12. Employment Law Issues

- There is no "at will" employment in Canada.
- Termination issues

13. Intellectual Property Issues

- Federal registration of trademarks
- Federal registration of patents

14. Other Legislation Applicable to Your Business Activity

- For example, ProPay must comply with the List of Names, Regulations Establishing a List of Entities, subsection 83.05(1) of the Criminal Code of Canada.

Caveat

"…good strategies [including the formation of a foreign subsidiary] start with massive amounts of quantitative analysis—hard, difficult analysis that is blended with wisdom, insight and risk taking." "…truly great companies lay out strategies that are believable and executable." "Again, good strategies are long on detail and short on vision."

—Louis V. Gerstner Jr., Who Says Elephants Can't Dance? pp. 223 and 225

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