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Property and polity issues

By Brent Gwillim and J. Meinen

This article pertains to the approach that the Illinois Courts have taken with regard to property disputes between a national church and a local church which is part of the national organization. The role courts play in resolving church property disputes is severely limited by the First Amendment guarantee that the right to free exercise of religion will not be abridged. Courts have no authority to resolve church property disputes that turn on matters of church doctrine, practice, polity, or administration. Therefore, where hierarchical religious organizations have established internal policies and tribunals for adjudicating such disputes, civil courts are required to defer to these tribunals. Where church doctrine is not in controversy, however, courts do not have to defer to internal tribunals, and the courts may

resolve the disputes by apply neutral principals of law.

The Illinois approach to church litigation is dependent upon several different factors. First, the subject of the church dispute determines whether there is a justiciable question for the courts. Secondly, the organizational structure of the church determines the scope of the civil court's role. Finally, courts generally apply one of two types of scrutiny; i.e., strict deference or neutral principles to determine the outcome of the dispute. Illinois courts have a varied approach to settling church disputes, but must not disturb the free exercise of religion.

Initially, the subject of the church dispute affects the court's role in adjudicating the dispute. The State has an obvious and legitimate interest in the peaceful resolution of property disputes, and in providing a civil forum where the ownership of church property can be determined conclusively. *Presbyterian Church v. Hull Church*, 393 U.S. 440, 445, 89 S.Ct. 601, 604, 21 L.Ed.2d 658 (1969). This interest is tempered by the First Amendment to the United States Constitution, which denies to civil courts the authority to resolve questions of church doctrine or polity. *Jones v. Wolf*, 443 U.S. 595, 602, 99 S.Ct. 3020, 3024, 61 L.Ed.2d 775 (1979). The First Amendment does not dictate a particular method for handling church disputes, however. "[A] State may adopt any one of various approaches for settling church property disputes so long as it involves no consideration of doctrinal matters, whether

the ritual and liturgy of worship or the tenets of faith." *Maryland & Virginia Eldership of the Churches of God v. The Church of God at Sharpsburg, Inc.*, 396 U.S. 367, 368, 90 S.Ct. 499, 500, 24 L.Ed.2d 582 (1970). When a doctrinal or polity issue arises in the determination of a property dispute, the courts must defer to the resolution reached by the church's highest ecclesiastical authority. *Jones*, 443 U.S. at 602, 99 S.Ct. at 3025. Where a doctrinal controversy is not involved, the court may determine who owns or controls church property in much the same manner that it would decide a secular property dispute. *Jones*, 443 U.S. at 602, 605, 99 S.Ct. at 3024, 3026. Where doctrinal controversy exists based on the Court precedent, these matters cannot be adjudicated in a civil court because they delve into ecclesiastical beliefs of the church. Allowing a civil court to settle this aspect of the dispute violates the First Amendment of the Constitution. The property question may still be justiciable if it can be severed from the larger religious dispute.

Next, whether there is a severable, neutral property issue that a civil court can adjudicate depends on the organization of the church and structure of the congregation seeking to separate from the general church. "A major factor in resolving questions of ownership and control of church property resulting from disputes between local and national church organizations is the structure of the parent church body and its relationship to the local church." *Lowe v. First Presbyterian*

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Church of Forest Park, 56 Ill.2d 404, 409, 308 N.E.2d 801, 804 (Ill.1974). Courts generally recognize two different church structures: hierarchical and congregational. Therefore, when a doctrinal or polity issue arises within a property dispute and the church is organized hierarchically, a civil court's decision must defer to the general church. See *Serbian Eastern Orthodox Diocese v. Milivojevic*, 426 U.S. 696, 96 S.Ct. 2372, 49 L.Ed.2d 151 (1976). Where the dispute combining religion and property arises in a congregational church and the local church is strictly independent of other church structures, the court ought to defer to the decision of local congregational governance. *Maryland & Virginia*, 396 U.S. at 368-69, 90 S.Ct. at 500-01. Illinois has already judged the Presbyterian Church to be a hierarchical church and granted deference to the general hierarchy. *Lowe*, 56 Ill.2d at 412. Specifically, the court noted the ascending bodies of governance from the congregation to the Presbytery and from the Synod to the General Assembly, the control exerted at each level, and the significance of the structure to each member. *Id.* The court articulated this standard:

Where a local church is but a subordinate member of a superior general church organization, and has directly or impliedly consented to its form of government, that church is ordinarily bound by the decisions of the ecclesiastical judicatories. In these circumstances, the civil courts cannot, in the process of involving property disputes between the local and the general church, independently determine questions properly within the sphere of ecclesiastical bodies.

Id. at 415. The organization of the church affects not only whether the court may hear the dispute, but also the analysis the court will use.

Finally, Illinois courts generally apply two different analyses for determining property disputes between general and local churches. One of these, the neutral principles approach, allows the court to apply objective legal principles to its examination of church documents, constitutions, charters and laws, deeds and other evidence. *Jones*, 443 U.S. at 602,605, 99 S.Ct. at 3024, 3026. In this analysis the court determines who owns or controls church property in much the same manner that

it would decide a secular dispute. The other approach taken by Illinois courts is strict deference. Strict deference follows the organizational analysis as set out above. Courts may determine the matter is too entangled within church hierarchy and rule that the hierarchical decision should stand as a matter of law. See *Watson v. Jones*, 80 U.S. 679, 13 Wall. 679 (1871). This case represents absolute deference to internal church determinations. The modern standard developed as a balance between strict deference and neutral principles. Illinois seems to favor a neutral principles approach. "Following the analysis used in *Jones*, Illinois courts have adopted the 'neutral principles of law' approach, in which a court may examine church charters, constitutions and bylaws, deeds, state statutes and other evidence to resolve the matter in the same way as it would a secular, or nonreligious, dispute." *Marsaw v. Richards*, 368 Ill.App.3d 418, 427, 857 N.E.2d 794, 800-01 (1st Dist. 2006). Illinois applies this neutral principles approach in two types of church property disputes: ownership disputes and control disputes.

In church ownership disputes, a court may decide whether property belongs to the local church or general church by reference to 'objective well-established concepts of trust and property law.' In control disputes, where the local congregation is itself divided into conflicting factions, the courts may determine which faction control the property, without infringement upon first amendment rights, by consulting the 'well-established principles of statutory and common law traditionally applied to determine who has legal control over any particular corporation or voluntary association and how freely or extensively that control can be exercised.'

Aglikin v. Kovacheff, 163 Ill.App.3d 426, 433, 516 N.E.2d 704, 708 (1st Dist. 1987). Courts prefer the neutral principles approach over the strict deference approach because the analysis is less likely to infringe on religious beliefs. *Id.* at 431. In a hierarchical situation, the court will likely analyze the relevant church documents and conclude that the general church holds title to the property. Several different portions of the *Book of Order* and spe-

cific sections of the Constitution of the Presbyterian Church (U.S.A.) unconditionally grant the property of the church to the general church during these type of disputes:

All property held by or for a particular church, presbytery, synod, the General Assembly or the Presbyterian Church (U.S.A.), whether legal title is lodged in a corporation, a trustee or trustees, or an unincorporated association, and whether the property is used in programs of a particular church or of a more inclusive governing body or retained for the production of income, is held in trust nevertheless for the use and benefit of the Presbyterian Church (U.S.A.)

Book of Order, G-8.0201 (2005/2007). This trust agreement specifically asserts that all property, no matter how title is held, remains in trust for the benefit of the entire church. Further, the Presbytery is charged with taking possession of a church's property when the church is in schism. *Id.* at G-8.0600. When a schism arises, the *Book of Order* dictates it is the Presbytery that declares which faction is the true church. *Id.* at G-8.0601. Importantly, the presbytery's determination does not depend upon which faction received the majority vote of the congregation. *Id.* The Presbytery is further authorized to take control of church property when the property is being used contrary to the Constitution of the Presbyterian Church (U.S.A.). *Id.* at G-8.0301. It is clear that from a neutral principles standpoint the Presbytery may take control of local church property. The Presbytery must be cautious in moving forward and taking control of local church property, however. Illinois caselaw holds that where a Presbyterian Church merely replaced a local session and did not dissolve the church pursuant to the *Book of Order*, the Presbytery was not the rightful holder of the property. *York v. First Presbyterian Church of Anna*, 130 Ill.App.3d 611, 618, 474 N.E.2d 716, 722 (5th Dist. 1984). In the hierarchical structure as in the structure of the Presbytery Church (U.S.A.), the Presbytery should follow the express policies of the *Book of Order* to ensure the Illinois courts respect the hierarchical decision and to buttress the neutral principles analysis.

Conclusion

Although, the role courts may play in resolving church property disputes is severely limited by the first amendment, Illinois courts will either adhere to the general church's hierarchy and not adjudicate the matter or will apply neutral principles of law to settle property dis-

putes between local and general churches. Courts have no authority to resolve church property disputes that turn on matters of church doctrine, practice, polity, or administration. Where a property question is distinguishable courts may resolve the dispute by applying neutral principles of law.

Seventh Circuit overturns arbitration decision based on failure to specifically adhere to state substantive law

By Howard Z. Gopman

In *Edstrom Industries, Inc. v. Companion Life Insurance Company*, 2008 WL 351450 (decided February 11, 2008), the Seventh Circuit Court of Appeals took the unusual step of overturning an arbitrator's decision on the basis that the arbitrator failed to apply specific substantive law. Those of us who practice in the arbitration field know how difficult it is to overturn an arbitration award.

The case arose in Wisconsin when the plaintiff Edstrom, a manufacturing company, chose to have a self-insured insurance plan with what is called a "stop loss" insurance policy. In other words, it was to pay claims out of its pocket up to \$65,000, and Companion would pay an amount above this.

However, the plaintiff was to have told the insurance company of any participant who could reasonably be expected to incur medical expenses in excess of \$32,500 in 2004. The company made no such representation, and it is not clear from the opinion as to whether this was done purposely or by accident or omission. Nevertheless, an employee had a child who incurred grave medical problems, and Companion used its representation clause to raise the child's deductible from \$65,000 to \$450,000.

Thus, Edstrom invoked arbitration and lost and then sought to have the arbitrator's decision overturned in federal

district court and then appealed to the Seventh Circuit.

The arbitration clause in the contract between the parties included an "express stipulation that the arbitrator shall strictly abide by the terms of this [policy] and shall strictly apply rules of law applicable thereto..." The Seventh Circuit says that this means strict adherence to Wisconsin law.

The importance of the use of Wisconsin law was that the plaintiff argued that this meant the application of a statute that says a "misrepresentation cannot affect an insurer's obligations unless the insured "knew or should have known that the representation was false." Wis. Stat. 631.11(1)(b).

The arbitrator did not mention the statute in his decision. Furthermore, the magistrate judge said it did not apply because the "stop loss" policy was a contract of reinsurance.

The Seventh Circuit held that this was not a contract of reinsurance and that therefore the Wisconsin Statute would apply. Thus, because of the drafting of this particular arbitration clause, which said that the arbitrator is to apply Wisconsin law "strictly," the case was sent back, and the arbitration award was vacated to be returned to the arbitrator for the arbitrator to determine whether Edstrom knew or should have known that its representation to Companion was false.

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A primer on pleading securities fraud under PLSRA: the Seventh Circuit's decision in *Tellabs*

By Professor Charles W. Murdock, Loyola University School of Law

In *Makor Issues & Rights, LTD v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006), the Seventh Circuit, in an eminently reasonable opinion, examined (1) the requirement of pleading with particularity under PLSRA, (2) the requisite specificity for the “bespeaks caution” safe harbor for forward-looking statements, (3) the pleading requirements for a strong inference of scienter, and (4) the establishment of control person liability. The breath and clarity of the opinion provide a clinic on the effect of PLSRA from the perspective of the requirements to plead securities fraud.

The case essentially involved a series of positive and specific statements by Notebaert, the CEO of Tellabs, and Birck, the chairman of the board, with respect to two of Tellabs key products, the Titan 5500 and the Titan 6500. They reported the continuing growth of the 5500 and that the 6500 was ready to ship. In point of fact, according to the complaint, demand for the 5500 was precipitously declining and the 6500 was not yet being produced.

With respect to particularity, the Seventh Circuit declined to require plaintiffs to identify the names of their confidential sources, stating that it would be too much to require plaintiffs to provide “name, rank, and serial number” for each confidential source. *Id.* at 596. Rather the standard was that plaintiffs must describe their sources with sufficient particularity “to support the probability that a person in the position occupied by the source would possess the information alleged.” This standard protects the privacy of the sources, while giving the court sufficient information to assess the soundness of the allegations. Otherwise, sources might be deterred from exposing malfeasance and might be subject to retaliation. The confidential sources in this case included former managers and high-level executives, who were thus in a position to provide reliable information about whether management’s statements were false and material and whether man-

agement knew this to be the case.

The court then addressed whether the allegations in the complaint were sufficiently particularized and held that statements such as “we feel very, very good about the robust growth we’re experiencing” and “demand for our core optical products ... remains strong” were too vague, did not specifically identify the 5500, and were “unlikely to induce an investor to purchase Tellabs stock.” *Id.* at 597. However, in response to a question from an analyst about whether Tellabs was experiencing any weakness in the 5500 sales, the CEO responded “we’re still seeing that product continue to maintain its growth rate; it’s still experiencing strong acceptance.” According to the court this statement went well beyond puffery; it was a direct response to an analyst’s inquiry about a possible decline in the 5500 sales, and it would be reasonable for an analyst or investor to believe the CEO; it would clearly be misleading to describe an alleged decline as equivalent to continued growth.

Moreover, in the frequently asked questions section of the 2000 annual report, the CEO and the Chairman responded to the question “are you worried that the [5500] has peaked” by stating flatly “No... Although we introduced the product nearly 10 years ago, it’s still going strong.”

With respect to the 6500, statements such as the “product is exceeding our expectations” are meaningless and, according to the court, are discounted by the market as pure hype. However, statements such as that the 6500 system is available now [December 11, 2000], and that it was shipped through the first quarter, were particular, specific, and, according to the complaint, completely false. According to the court, the foregoing allegations of misleading statements met the particularity standard.

The court then addressed whether Tellabs’s financial results for the fourth quarter of 2000 were also misleading. The court found that an allegation that Tellabs “flooded its downstream cus-

tomers with unordered Titan 5500s,” a practice known as channel stuffing, and that Tellabs had to lease extra storage space in January and February 2001 to accommodate the large number of returns, met the particularity hurdle.

The next issue was whether Tellabs’s overstated revenue projections, which included disclaimers, met the PLSRA “bespeaks caution” safe harbor for forward-looking statements. Each projection was accompanied by the following statement:

Actual results may differ from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, risks associated with introducing new products, entering new markets, availability of resources, competitive response, and a downturn in the telecommunications industry. The Company undertakes no obligation to revise or update these forward-looking statements to reflect events or circumstances after today or to reflect the occurrence of unanticipated events. *Id.* at 599.

According to the Seventh Circuit, the appropriate standard to apply in determining whether cautionary statements are meaningful is whether the disclaimer mentions “those sources of variance that (at the time of the projection) were the principal or important risks,” a test it enunciated in *Asher v. Baxter International*, 377 F.3d 727, 734 (7th Cir. 2004). While the foregoing disclaimer did encompass Tellabs’s troubles, the court observed that it also “encompass[ed] a whole world of other possible contingencies.” *Id.* The court concluded that the “breath of these warnings makes it impossible for us to conclude that they meaningful described ‘the principal or important risks’ facing Tellabs at the time it made the projections. Indeed, this level of generality exemplifies the useless caveat emptor boilerplate we criticized

in *Asher*.”

Plaintiffs, having overcome the hurdles of particularity and bespeaks caution, additionally had to meet what was, according to the court, an even more arduous hurdle, namely, adequately alleging scienter. PLSRA requires that the complaints must allege with respect to each act or omission “facts giving rise to a strong inference that the defendant acted with the required state of mind.” 15 U.S.C. §78 u-4(b)(2). The Seventh Circuit rejected the position of the Ninth Circuit that PLSRA raised the substantive state of mind requirement for securities fraud allegations on the basis that, if Congress had wanted to impose a more stringent scienter standard than that which prevailed at the time of the legislation, it would have done so explicitly, just as it expressly changed the pleading requirements to require particularity. *Id.* at 600. The court adopted the following scienter standard that was in effect prior to PLSRA, namely, “an extreme departure from the standards of ordinary care, [] which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”

While PLSRA did not impose a more stringent substantive scienter standard, it did raise the bar for pleading by requiring the plaintiff to plead sufficient facts to create “a strong inference” of scienter. In determining what is necessary to plead a strong inference, the Seventh Circuit rejected both the position of the Second and Third Circuits, which have held that PLSRA adopted the Second Circuit’s pre-PLSRA standard of “pleading either motive and opportunity or strong circumstantial evidence of recklessness or conscious behavior,” and the position taken by the Ninth and Eleventh Circuits that have opted for a more onerous pleading burden. Instead, it agreed with the other circuits that “the best approach is for courts to examine all of the allegations in the complaint and then to decide whether collectively they establish such an inference. Motive and opportunity may be useful indicators, but nowhere in the statute does it say that they are either necessary or sufficient.” *Id.* at 601.

The court then addressed the “degree of imagination” that courts can use in divining whether or not a com-

plaint creates a “strong inference.” The Sixth Circuit had indicated that a plaintiff is entitled “only to the most plausible of competing inferences,” but that the inference does not need to be “irrefutable.” *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004). Since the Sixth Circuit recognized that its approach might infringe upon a plaintiff’s Seventh Amendment right to a jury trial, the Seventh Circuit decided that it was wiser to adopt an approach that could not be viewed as an usurpation of the jury’s role. Accordingly, it required that the plaintiff must allege facts that, if true, “a reasonable person could infer that the defendant acted with the required intent”. *Id.* at 602.

The final issue relating to scienter was whether scienter allegations made against one defendant could be imputed to the other defendants, in other words, whether the “group pleading presumption,” which presumes that “group-based information,” such as that conveyed in prospectuses, registration statements, annual reports and press releases, is the collective work product of the officers as a group. Since PLSRA spoke of defendant in the singular, the Seventh Circuit determined that plaintiffs must create a strong inference of scienter with respect to each individual defendant.

Applying the foregoing principles to the facts at hand, the court first reviewed the allegations against the CEO, Notebaert. According to one confidential source for allegations in the complaint, a market analyst, internal reports revealed that the market for the 5500 was drying up by March 2001. Yet in April 2001, the CEO told financial analysts that demand continued to grow. According to the court, while it was conceivable that the CEO had not yet seen these reports, nevertheless plaintiffs had provided sufficient facts for a reasonable person to infer that the CEO knew that his statements were false. According to another confidential source, the CEO stayed on top of the company’s financial health through weekly conversations with his fellow executives. The Seventh Circuit concluded that “[g]iven the significance of the Titan 5500 and the number of reports suggesting that it was in trouble, we find it sufficiently probable that Notebaert had information indicating that his statements were false.” *Id.* at 603. In so doing, the court quoted with

approval the statement in *Florida State Board of Administrators v. Green Tree Financial Corp.*, 270 F.3d 645, 665 (8th Cir. 2001):

One of the classic fact patterns giving rise to a strong inference of scienter is that defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate.

The CEO also made a number of false statements regarding the 6500, suggesting that it was available and being shipped, whereas Tellabs did not ship a single Titan 6500 during the class period. According to a confidential source who was a sales director, the CEO saw weekly sales reports and production projections and knew that the 6500 was not ready to ship. Accordingly, plaintiffs established a strong inference of scienter in that the CEO lied when he informed investors that the 6500 was available and being shipped.

Plaintiffs also sufficiently alleged scienter with respect to the CEOs execution of the 10-K report containing the projections that the court previously found were not protected by the disclaimers. One source stated that the CEO worked directly with sales personnel to effect the channel stuffing. Moreover, since the revenue projections rested on the company statements that it was doing better than it actually was, the CEO’s scienter for those alleged misrepresentations also served as circumstantial evidence of his scienter for the misleading projections.

Plaintiffs were not as successful in their allegations against Birck, the chairman of Tellabs. While plaintiffs alleged generally that he had regular meetings with the CEO and that both he and his CEO had their hands on the pulse of the organization, the chairman’s last public comment was in February, prior to the time that the decline in interest for the Titan 5500 was obvious. Moreover, the chairman made no actionable statements with respect to the 6500. With respect to the projections in the 10-K reports that both the chairman and CEO signed, the chairman’s possibly unreasonable trust in the CEO does not rise to the level of recklessness required by the statute.

The court also determined that the

fact that the chairman sold 80,000 shares of Tellabs the first week of February 2001 do not create a strong inference of scienter. 80,000 shares was only 1 percent of the chairman's holdings and the complaint provided no information as to his previous pattern of sales. *Id.* at 604.

However, the good news for the chairman in the previous paragraph was short-lived since the court held that the chairman was liable as a control person under section 20 of the 1934 Act, 15 USC §78t (a). Under section 20, a person who controls a primary violator is also liable, unless such control person can prove that he acted in "good faith." Thus, since the chairman was one of a

group that controlled Tellabs, a primary violator, they will also be liable unless they can establish their good faith. The court acknowledged that this was something of a "backdoor" to liability since the court had previously determined that the Chairman's scienter had not been adequately alleged. *Id.* at 605. Nonetheless, the complaint's allegations with respect to control person liability were sufficient, and the Chairman will later have the opportunity to prove whether or not he acted in good faith.

Finally, plaintiffs' claim against the Chairman for insider trading under section 20A of the 1934 Act survived. In order for plaintiffs to succeed on this claim, they must establish that his sale

involved a violation of the Act. While the securities law fraud claims against the chairman were dismissed for lack of scienter, he still may be liable as a control person. According to the court, "whether §20 (a) control-person liability standing alone can serve as the 'separate underlying violation' required by §20A for insider trading is an open question of law and raises an important issue of statutory interpretation that should not be decided in a vacuum." *Id.*

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The threat is real – The fight for limited liability in Illinois

By Derek P. Usman, Usman Law Group, P.C., Chicago, Illinois

The statutory provisions providing limited liability to shareholders of Illinois business entities were undermined recently when the Illinois Supreme Court endorsed "direct participation" as a viable theory of tort liability under Illinois law. In *Forsythe v Clark USA, Inc.*, 2007 WL 495292 (Ill. Sup. Ct.), our state's Supreme Court considered whether a parent company could be held liable under a theory of direct participant liability for controlling its subsidiary's budget in a way that led to a workplace accident. Subsequently, the court recognized that the parent company's "participation" in the subsidiary's conduct could subject the parent to direct liability. Even though Illinois statutes permit separate incorporation for the purpose of limiting liability, the direct participation theory may now be used to eliminate the protection of limited liability for a parent (or affiliate).

Justice Garman's opinion in *Forsythe* concluded that evidence of budgetary mismanagement, accompanied by the parent's negligent direction or authorization of the manner in which the

subsidiary accomplishes that budget could lead to liability for the parent. Furthermore, the elements required under the direct participant theory are a parent's specific direction or authorization of the manner in which an activity is undertaken and the foreseeability of injuries—budgetary mismanagement alone is insufficient. The court then remanded the case back to the trial court. (In the same opinion, the court also held that upon a finding of liability under the direct participation theory, the parent-defendant would not be protected by the exclusive remedy provision of the Workers' Compensation Act available to the subsidiary because there is a direct action against the parent and not the subsidiary).

Under the court's analysis, once the parent company directs or authorizes the manner in which an activity is undertaken, the company owes a duty of care to the plaintiff. The court explicitly asserted that this duty of care arises from policy-based factors courts utilize to determine the existence of a duty. Then the court stated that the corporation had a duty to utilize rea-

sonable care in directing or authorizing the manner in which an activity is undertaken. Next, when the duty was breached, the breach was the proximate cause of the injury. Specifically, the court found that the corporation directed the implementation of the subsidiary's budget in such a manner that there was a disregard for the interests of the subsidiary and dangerous conditions were created.

The Illinois Supreme Court is following other jurisdictions around the nation that have endorsed theories that erode limited liability for shareholders of business entities. Aside from the emergence of the direct participant liability theory in the Illinois legal landscape, Illinois entities need to be wary of a myriad of alternative theories that courts are upholding to erode the limited liability of incorporated businesses. These theories have been upheld not just in a tort context but contract situations as well. One such theory is termed "single business enterprise" where business connections, common ownership and various other means are utilized to establish that two distinct

entities are operating in a coordinated manner. Seem familiar?

The primary purpose for the enactment of incorporation statutes is to insulate shareholders from unlimited liability for corporate activities. Upon reliance on these long-standing statutes and principles, holding corporations create subsidiaries as a common strategy to minimize risk for shareholders. These same shareholders are attempting the preservation of their investments by relying on laws that explicitly limit liability. Apparently, mandatory capitalization laws, insurance requirements, product safety requirements, etc. are deemed insufficient by courts that allow novel theories that undermine limited liability protection provided to shareholders of entities created under statutory authority.

The court in *Forsythe* has opened the door to utilize another theory, direct participation, to disregard corporate form and impose liability against a statutory entity. Still yet, let's not forget the ever-popular veil piercing lawsuit. Cases raising veil-piercing issues are the most frequently litigated in all of corporate law and limited liability in Illinois is undermined whenever a veil piercing lawsuit is initiated. As a starting point, Illinois courts may look at as many as eleven factors before piercing the veil. A renowned commentator on the erosion of limited liability has stated that the list of possible factors used in veil piercing cases is aimed at satisfying particular public policy goals. Similarly, the furtherance of public policy aims is also a significant consideration underlying the adoption of the direct participation theory by the court in *Forsythe*. However, a recurring problem is that later judges often capriciously modify (if remember at all) public policy aims.

Additionally, abuse must usually be demonstrated to pierce the corporate veil. However, abuse tends to become an elusive term when courts attempt to apply the word in litigation. In *Forsythe*, the opinion's analysis provides that a parent corporation's power to control the subsidiary, by itself, does not impose a duty. However, an abuse of the power, by exerting too much control, could lead to liability for the conduct of its subsidiaries as an alter ego. This alter ego theory is not based upon any clear abuse but upon control exercised by a parent (or individual shareholder).

The court's opinion also asserted that parent corporations are not held directly liable for their own wrongdoings but for their actions against third-parties through the agency of subsidiaries. Therefore, even in situations where corporations are deemed not to be alter egos of each other, liability is possible under an agency theory. The Illinois Supreme Court has authorized the use of the agency theory to impose liability on the parent for the subsidiary's acts. The court reasoned that the subsidiary has the power to bind the parent because the subsidiary acted as the parent's agent in a transaction(s). However, since shareholders or parents always have the potential to control, an agency theory is always a viable option to bypass limited liability protection. The end result is a movement away from the stringent abuse standard utilized in veil piercing cases, where an alter ego must

be established, to the more accessible agency theory where just the presence of control is seemingly sufficient to dispense with limited liability.

As is evident by court decisions, not only in Illinois, but also across the country, the threat to eliminate the protection of limited liability is real. Companies conducting business in Illinois need to adjust their operating procedures to avoid the pitfalls associated with emerging theories that undermine limited liability protection. In particular, liability based upon the direct participant theory looks towards holding parent companies, and not their subsidiaries, for redress. At the expense of eliminating the protection of limited liability, the attachment of liability is moving away from being based upon reprehensible, abusive conduct and towards, simply based upon, shareholder control.



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Lawyers' Assistance Program provides confidential assistance through education, referral to professionals, or peer support from one of our trained volunteers – another lawyer or judge who has experienced a similar problem and confronted it successfully. All requests for information and assistance are handled in complete confidence as guaranteed by Supreme Court Rule 1.6.

If you need help, do the honorable thing.
Call Lawyers' Assistance Program.



LAWYERS' ASSISTANCE PROGRAM, INC.

20 South Clark Street, Suite 1820 • Chicago, Illinois 60603
312.726.6607 office • 312.726.6614 fax

200 West Third Street, Suite 305 • Alton, Illinois 62002
618.462.4397 office • 618.462.4399 fax

toll free: 800.LAP.1233
email: gethelp@illinoislap.org
website: www.illinoislap.org

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