Parents’ subsidiary liabilities hit home

listedmag.com/2016/03/parents%e2%80%99-subsidiary-liabilities-hit-home/

In 2013, a group of indigenous Guatemalan plaintiffs commenced legal proceedings against Canadian mining giant Hudbay Minerals Inc. (TSX:HBM), alleging that security personnel hired by Hudbay’s wholly owned subsidiary in Guatemala perpetrated violent human rights abuses when carrying out security operations at the company’s Fenix mine. Hudbay argued that the lawsuit should be thrown out by the Canadian courts. After all, a fundamental principle of corporate law is that parent corporations have a separate personality from their subsidiaries and can’t be held liable for their subsidiaries’ activities halfway around the world.

Making their case: In 2013, Guatemalan plaintiffs successfully argued that Canadian courts should hear a suit involving a Hudbay Minerals subsidiary

The case made news when the Canadian court saw it differently, and refused to dismiss the case. It said it found the plaintiffs’ novel counter-arguments to Hudbay’s defence intriguing enough to proceed. The Guatemalans’ position was that Hudbay should be responsible in tort law for its subsidiary’s actions because the parent company directed key aspects of the subsidiary’s operations and security program, and the parent company’s corporate policies applied to the subsidiary. The plaintiffs also claimed that Hudbay’s employees had dealt directly with the disputed land claim issues on the ground in Guatemala and had made public statements to that effect.

Three years later, the suit is proceeding. Both it and a similar action launched in 2015 against Vancouver-based Nevsun Resources Ltd. (TSX:NSU) represent an emerging trend of tort liability against Canadian parent companies in the resource industry. In Nevsun’s case, the company is being sued for the actions of its subsidiary in Eritrea, of which it owns a majority interest, with the Eritrean government owning the minority interest. According to Human Rights Watch, human rights conditions in Eritrea are dismal; citizens are subject to indefinite military service and the government frequent- ly uses conscripts to provide forced labour for companies. The Eritrean plaintiffs in this case claim that Nevsun’s subsidiary hired subcontractors who were connected to the Eritrean government and known to force employees to work against their will. The plaintiffs argue that parent Nevsun should be liable because it knew or should have known of this risk of human rights abuses.

These actions against Canadian mining companies follow on the heels of international developments that appear to support the notion that parent companies can be held legally accountable for their foreign-held subsidiaries. In 2012, the UK Court of Appeal imposed liability on a UK parent company, Cape plc, for asbestos-related injuries suffered by former employees of Cape’s subsidiary, which had since shut down and had no assets. What was damning to Cape was that health and safety matters were addressed at the parent level. The parent’s advisers were directly involved in formulating a response to asbestos risk.

Many quarters in Canada are critically questioning traditional concepts of limited liability and separate corporate personality that have shielded one corporation’s actions from those of another, as well. Last year, for example, the Supreme Court of Canada ruled on the right of a group of Ecuadorean villagers to enforce their US$9.51-billion claim judgment against U.S. parent corporation Chevron in Canada not only against the parent company but also against its wholly owned Canadian subsidiary.

In the wake of these developments, Canadian companies should prepare for a new era of corporate governance in which courts are more willing to look beyond the separate legal entity to hold parent companies directly liable in negligence for the conduct of their subsidiaries. Here is a list of factors a court would look at in holding that a

Canadian parent owes a duty of care to third parties for subsidiary conduct:

- ownership and effective control of the subsidiary (for example, whether the subsidiary is wholly owned or not);
- the degree of control exercised by the parent company over the situation giving rise to potential liability;
- public representations by the parent company regarding its relationship with its subsidiary;
- assumptions of responsibility by the parent company regarding the situation giving rise to potential liability;
- employment by the parent company, rather than the subsidiary, of the individuals responsible for the subsidiary's activities;
- adoption of policies by the parent that apply to its subsidiary.

Not all parent companies risk being liable for the actions of their foreign subsidiaries. Parents that take a hands-off approach in managing their subsidiaries may indeed face a lower risk of liability, but this strategy is counterintuitive to the way mining companies actually run their global operations. Parent companies that are actively engaged in the operations and affairs of their subsidiaries may face a greater risk of legal liability, but only if they fall short of the standard that would reasonably be expected of them under the circumstances. If they are involved in their subsidiary's affairs but they live up to a high standard, the law will protect them.

SO WHAT NOW? Parent corporations and subsidiaries should take the time to reflect and strategically develop leading-edge governance structures, policies and practices to address this new risk.

A fine balance is required to achieve strategic and operational integration between a parent and its subsidiaries while allowing subsidiaries to retain a sufficient level of autonomy and independence. Subsidiaries should ensure that they independently evaluate and consider the impact of enterprise-wide corporate policies before they adopt these policies; they should have the latitude to make changes as appropriate to reflect their operational needs and to comply with the local jurisdiction's legal rules and local context.

Similarly, parent corporations should evaluate the need for and extent of a centralized system versus a decentralized system for compliance, regulatory filings and record-keeping. A centralized system allows a parent corporation to better monitor, evaluate and address trends and risks at the enterprise-wide level, but the subsidiary should have systems in place that allow it to make and record local filings.

We also know that most subsidiary boards comprise management directors who are senior officers of the parent or another subsidiary. But remember that, although interlocking or mirror boards for subsidiaries might provide some efficiencies when a parent is a holding company and a subsidiary is an operating entity, directors who serve on both boards must be alert to the potential for conflicts and for parent liability for subsidiary conduct due to lack of independence.

Under Canadian corporate law, directors of a subsidiary owe a fiduciary duty to act in the best interests of the subsidiary. This can be especially challenging, given the conflicting demands of the directors who often end up sitting on subsidiary boards. The subsidiary's best interests can sometimes diverge from those of the parent. For example, when the subsidiary's stakeholders include significant creditors, the interests of those creditors may need to be considered in decisions relating to inter-corporate transfer pricing arrangements or in the case of financial distress of either parent or subsidiary. Corporate records and minutes should reflect that the subsidiary board turned its mind to the possible effect of a corporate transaction or contract on the subsidiary, and that it was not subservient to the requests of the parent's board or the parent's advisers.

The location of the mine and management of the subsidiary must also be considered. Local regulators often want to ensure that the subsidiary is making decisions in the local jurisdiction and, for Canadian tax purposes, the residence of a corporation generally will be located where mind and management are exercised. Typically, this is where the board carries out its functions. However, if the facts suggest that a Canadian parent corporation is making the key decisions with respect to its foreign subsidiary's business, and the subsidiary board does not review and fully consider the parent's proposal, the subsidiary may be found to be resident in Canada for tax purposes. Best practices may include a requirement that directors of subsidiaries personally attend board meetings in the local jurisdiction and that full minutes be kept by the subsidiary board evidencing all the factors that were considered in reaching a particular decision.

Poonam Puri is a law professor at Osgoode Hall Law School, an affiliated scholar with Davies Ward Phillips & Vineberg LLP and a respected adviser on issues of corporate governance, corporate law and securities law. E-mail: ppuri@dwpv.com. Luis Sarabia is a senior partner in the Litigation practice at Davies Ward Phillips & Vineberg LLP. He has experience in general corporate/commercial litigation with significant expertise in securities and mining cases. E-mail: lsarabia@dwpv.com.