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Legal Business Services

The value of legal entity management

A multi-part study by Deloitte
Part two: the impact on litigation risk

While much has been published on the topic of legal entity management (LEM) —managing the books and records of a parent company's various legal entities in different geographic locations—by law firms and technology providers, almost all of it has focused on how to manage entities and subsidiaries effectively. There has been little research on the strategic elements of entity management or, more importantly, what is the value of effective legal entity management. This multi-part study by Deloitte Legal Business Services* aims to change that by researching the reasons that entity management is important: not what must be done, but the reasons behind this important function.

Part One was a study of the impact of effective entity management on M&A. Part two is a study of its impact on litigation risk. The sources for our research are prominent outside counsel, established in-house litigators, and subject matter experts from Deloitte.

For this study, we interviewed a total of 15 legal specialists. This group included 10 law firm partner litigators, including K&L Gates and Hogan Lovells. Combined, they have advised litigants on billions of potential losses through their careers. We also spoke with in-house counsel from Fox Corporation, Fender Musical Instruments Corporation, and Kyndryl Holdings, to understand the potential tactics to mitigate risk from the corporate legal department perspective. This report covers what we distilled from their comments on the value of sound entity management in the context of litigation risk.

Our hypothesis was simple: Companies that manage their entity management and books and records poorly tend to incur unnecessary litigation risk. Risk that adversaries could pierce the corporate veil. Risk that matters may end up in suboptimal jurisdictions. Risk that poor corporate governance might alert government regulators to issues, and the resultant investigations could lead to downstream litigation.

We found all those risks and more. Substandard legal entity management (LEM) can result in:

1. The corporation being viewed as a shell, creating personal liability for directors and officers, or making it difficult to separate parent companies from subsidiaries.
2. Judges or juries perceiving sloppiness to be misleading actions or deception.
3. The inability to rely on board minutes to document and corroborate that decisions are addressed at the board level.
4. Lack of proof for diversity of jurisdiction, resulting in cases remaining in state court.
5. Government investigations leading to downstream litigation.

Let's take a closer look at our hypothesis and each of our findings.

The professionals interviewed for this report include:

» ***Archis A. Parasharami****, Partner and Co-Leader of Class Actions Practice at Mayer Brown*

» ***Christopher A. Smith****, Partner – Litigation at Husch Blackwell*

» ***David J. Chizewer****, Principal and Chair of the Litigation Practice Group at Goldberg Kohn*

» ***Gregory J. Casas****, Shareholder – Litigation and Antitrust Practice Groups at Greenberg Traurig*

» ***Michael Hefter****, Partner – Litigation at Hogan Lovells LLP*

» ***Michael J. Mueller****, Partner – Litigation at Hunton Andrews Kurth LLP*

» ***Miles D. Scully****, Partner – Litigation at Gordon Rees Scully Mansukhani, LLP*

» ***Ryan M. Philp****, Partner – Litigation at Hogan Lovells LLP*

» ***Robert W. Sparkes, III****, Partner – Commercial Disputes and Class Action Litigation at K&L Gates LLP*

» ***Seth M. Cohen****, Partner – Litigation at Hogan Lovells LLP*

» ***Aarash Darroodi****, General Counsel and Executive Vice President at Fender Musical Instruments Corporation*

» ***Gregory M. McLaughlin****, Vice President and Associate General Counsel; Global Head of Litigation & Investigations at Kyndryl*

» ***Jeffrey A. Taylor****, General Counsel at Fox Corporation*

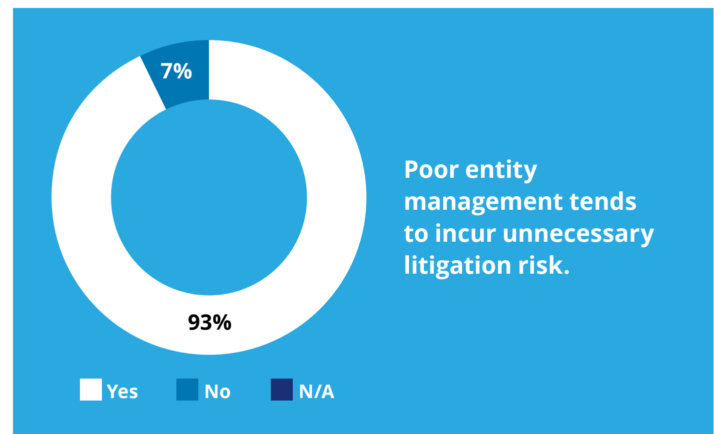
» ***Anthony Campanelli****, Partner at Deloitte Financial Advisory Services LLP*

» **Don Fancher**, *Co-Leader, Deloitte Legal Business Services and Principal, Deloitte Financial Advisory Services LLP*

Companies that manage their entity management and books and records poorly tend to incur unnecessary litigation risk.

Examining our hypothesis

To many companies, forming a subsidiary poses an opportunity to diversify their risk, house intellectual property (or even real properties) or strategically keep products and brands separate. Managing the corporate formalities and maintaining corporate separateness ensures that companies may experience the full protection of the limitations of corporate liability. Doing so poorly, however, can be counterproductive when it comes to litigation and lawsuits. When their corporate governance is not properly maintained, the existence of a subsidiary may have an adverse effect.



"Litigation is a civilized form of warfare. And in warfare, your goal is to find the weakness in the enemy's line and that's where you attack. Adversaries, especially plaintiffs' counsel, review the entire organization. If they identify a weak point, they will treat it as an entryway to dig further and further and further. It is ultra-important to make sure there are no points of weakness."

– Aarash Darroodi, General Counsel & Executive Vice President, Fender Musical Instruments Corporation

It was the belief across the board of our respondents that proper LEM was essential in mitigating potential risk and embracing the protections offered in the corporate forum.

Our interviewees almost unanimously (93%) encouraged the practice of sound corporate governance principles to limit potential liability at every stage of a subsidiary's life. "Because of the ambiguity that often is created by problems that come with poor LEM, it can make it very difficult to draw a ring fence where the problem might be," says Jeff Taylor, general counsel of Fox Corporation.

It's not just that sloppy LEM can cause headaches. It's also pervasive. "This is an issue that occurs in almost every case that's litigated," says Miles D. Scully, a litigation partner at Gordon Rees. "The extent to which a company keeps its corporate formalities in check can affect everything, starting with whether or not you have the right to sue (or the right to defend) in a court of law."

1. Poor LEM can cause the corporation to be viewed as a shell, creating personal liability for directors and officers.

One of the rights afforded to corporations operating in the United States is that their owners, directors, officers, and employees are generally protected from personal liability by what is often known as the "corporate veil." However, if legal entities are not properly structured and records are not properly kept, that veil can be "pierced," typically as part of an argument that the subsidiary acted simply as a shell and not a separate entity. This is commonly known as the "alter ego" doctrine.

"People think annual board meetings, corporate minutes, and state filings are just paperwork," says Gordon Rees' Scully. "But they are there for a reason- because they give corporations a very special privilege. And that is the privilege of avoiding personal liability."

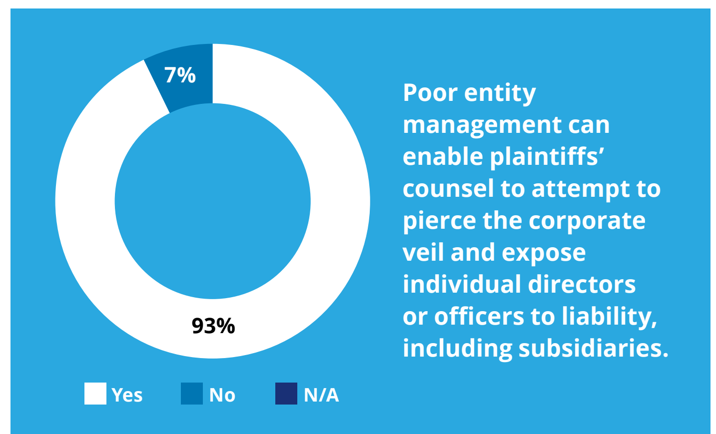
Remarkably, 93% of our respondents saw a potential risk from plaintiffs' counsel attempting to pierce the corporate veil, and many shared their direct experiences with this sort of strategy. "Plaintiffs' lawyers are always looking to see if you can get to somebody personally," explains David J. Chizewer, principal and chair of the Litigation Group at Goldberg Kohn.

"I've seen courts that have ignored the doctrine of having separate corporate forms and have asserted personal jurisdiction over a corporate entity that would otherwise not be subject to that court's jurisdiction," says Archis A. Parasharami, litigation partner at Mayer Brown.

Proper legal entity management, however, can mitigate risk from aggressive and creative plaintiffs' counsel. "It is easier to defend alter ego claims when you can produce governance documents that demonstrate the separate corporate existence," says Ryan Philp, partner at Hogan Lovells.

A lack of care for legal entity management also allows litigation to creep up from subsidiaries to parent companies if corporate separateness is not abundantly clear. Robert Sparkes, a litigation partner at K&L Gates, remembers a case in which he represented a large global bank where no proper records were kept for an acquired subsidiary. He was able to fight back, but "we had limited information and documentation. Had those documents been available, there would have been no risk and we could have saved significant time in court."

Court time is not the only downside. **"It's going to cost management time when plaintiffs' counsel makes these arguments. It's going to distract from the strategies and objectives of the organization. It absolutely can have a negative effect if you're not following the right processes and open yourself up to that risk,"** says Don Fancher, co-leader of Deloitte Legal Business Services and principal, Deloitte Financial Advisory Services LLP.



2. Sloppy LEM can cause judges or juries to perceive misleading actions or deception.

One of the key findings from Part One of our report was that poor LEM can jeopardize the credibility of the company and its management. Similarly, in this research, we found that disorganized LEM can cause judges or juries to perceive simple sloppiness as misleading actions or deception.

A word we heard repeatedly in our interviews was "atmospheric," meaning that when governance documents are not in order, it may cause a perception or atmospheric issue in litigation, resulting in, for example, an intentional spoliation of evidence claim.

Of our interviewees, 87% confirmed poor LEM can interfere with judge and jury perceptions, and 100% of the law firm lawyers we interviewed either experienced or detected such risk interfering with their litigation strategy.

K&L Gates' Sparkes has experienced this. "When the plaintiff receives an incomplete document production and says [at a deposition], 'Look at all that's missing. And your witness is supposed to be the most knowledgeable person you could find?' Plaintiffs' counsel can sometimes create a pretty good argument by filling in the blank spots left open by either the witness and/or the documents." It's better to leave no openings in a corporation's narrative that can be filled in for a jury by plaintiffs' counsel.

There was a resounding sentiment amongst the outside counsel about their inability to properly litigate cases when certain incorporation filings go missing. "It hurts advocacy when documents that may have helped you to form a defense or a claim don't exist," shares Hogan Lovells partner Seth Cohen.

Sometimes the result can be simply an uncomfortable moment at a deposition. Many of our interviewees, however, reported that atmospheric issues amplified risks to the point where they advise early settlements, sometimes on unfavorable terms.

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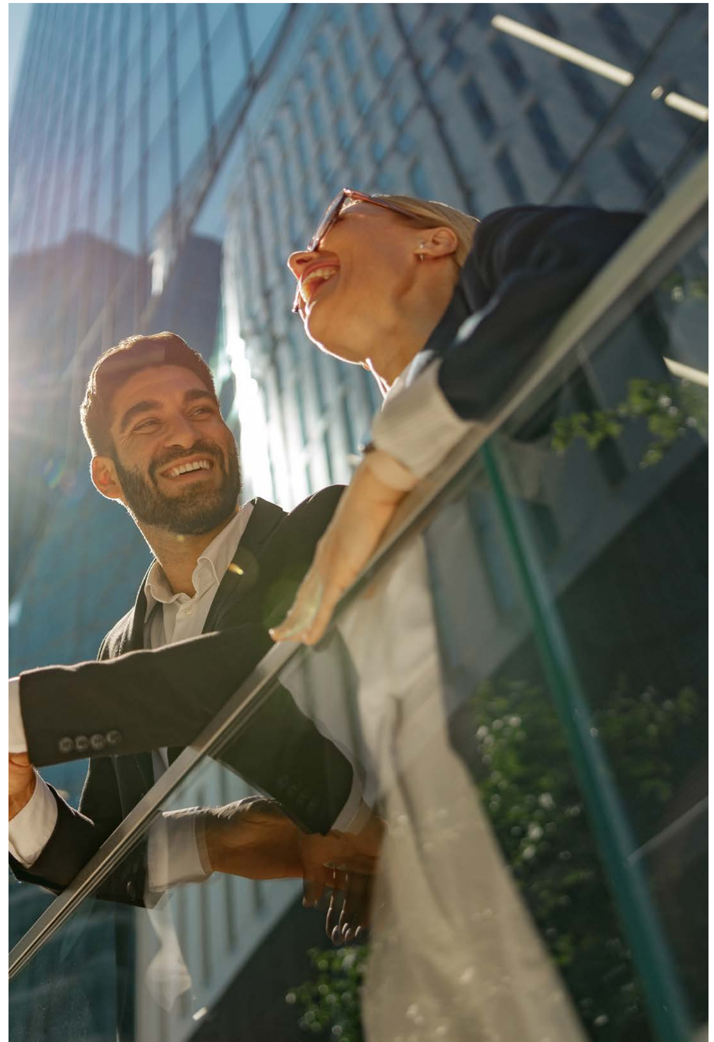
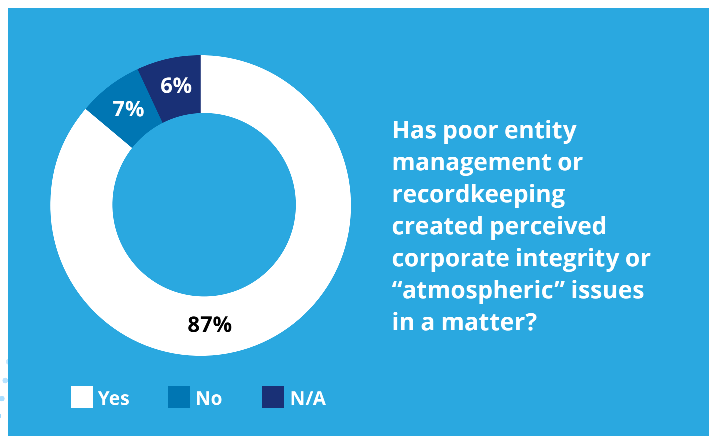
– Seth M. Cohen, Partner, Litigation, Hogan Lovells





3. Without suitable board minutes, it can be difficult to document that decisions are properly made at the board level.

It may seem surprising, but organizations without proper legal entity management practices sometimes also do not hold regular board meetings or record accurate meeting minutes, especially at the subsidiary level. The majority of our respondents, 60%, confirmed they have experienced or detected litigation risk under these circumstances.

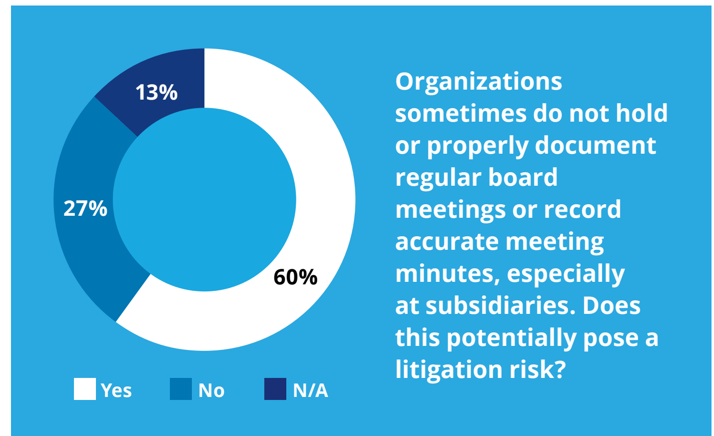
For every matter, Gordon Rees' Scully asks, "Did the board have the right to make the decision under the bylaws of the company? Did they exceed their purview or their mandate? Did they disclose everything that they were supposed to disclose under the laws?" during the risk assessment. The inability to prove that decisions that should have been made at the board level actually were can cause big trouble in court. And the absence of board minutes can call into question the board's testimony.

"If it's something the board has addressed as an issue, but they don't keep accurate notes, it can become hearsay. But when it's documented, it makes your argument so much more impactful," explains Deloitte's Fancher.

Husch Blackwell partner Christopher Smith has seen this happen. "**Plaintiffs' lawyers often try to make a case that the board was falling down on its fiduciary duties and obligation to guard against risks. To defend yourself, you need to have records and board minutes that demonstrate that your board is conducting itself as a board should.** And if you can't find those records because they're poorly kept, then you risk ending up with litigation."

In other instances, proper LEM can help win cases or mitigate damages. Documents that tell the story of where management is acting in ways the board disapproves can serve as a record of what the board knows or doesn't know and can exculpate board members from the liabilities associated with material information.

While some prefer limiting written documentation, providing enough detail can be critical, according to Anthony Campanelli, a partner in the New York Forensic practice of Deloitte Financial Advisory Services LLP. "A one-page summary that's very high level can cause scrutiny of those minutes. It needs to at least be clear on who voted in which way."



4. Poor LEM can cause cases to end up in suboptimal jurisdictions.

Loose, unmanaged, or dormant subsidiaries can allow plaintiffs' counsel to file lawsuits in jurisdictions that may not be optimal for defendants, for example by making it difficult to prove the diversity of jurisdiction required to move a case to federal court. Most of our interviewees have either personally experienced jurisdictional hurdles or agreed they posed a substantial litigation risk.

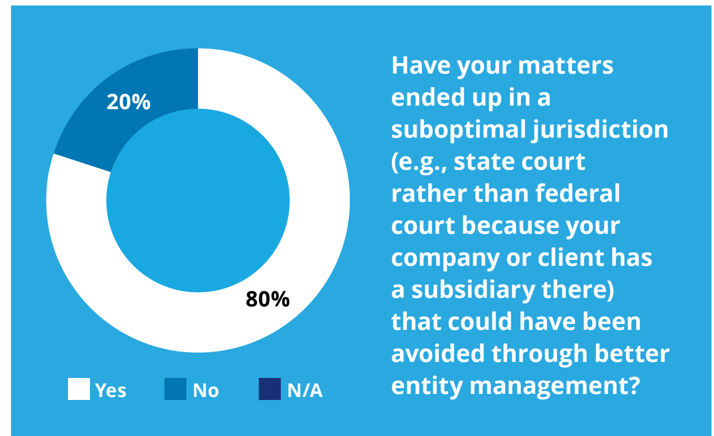
Taking proper care to close dormant subsidiaries is an essential step to avoiding the potential pitfalls associated with having to litigate in difficult jurisdictions. "Anybody who creates a subsidiary in a state must know they're creating a risk of being sued in that state," says Michael J. Mueller, partner at Hunton Andrews Kurth.

Many of our interviewees emphasized the consequences of a bad litigation venue. Smith of Husch Blackwell recalls a situation in which his client did not have its LLC members up to date and therefore could not prove diversity and would not have had the basis to remove the matter from that state court. "They simply hadn't updated those documents, causing a rush to both remove members, which has a limited time window, and also make sure the documents supported the new members."

Opportunities to correct mistakes like this are not always so readily available. And even when they are, updating documents while in the midst of a litigation matter can sully the litigants'–and their counsel's–credibility.

"If you are opening yourself up to litigation and the jurisdiction is unfavorable, then that can absolutely increase your risks. It can increase your cost, it can increase the damages and it can reduce the likelihood of success."

– Don Fancher, Deloitte

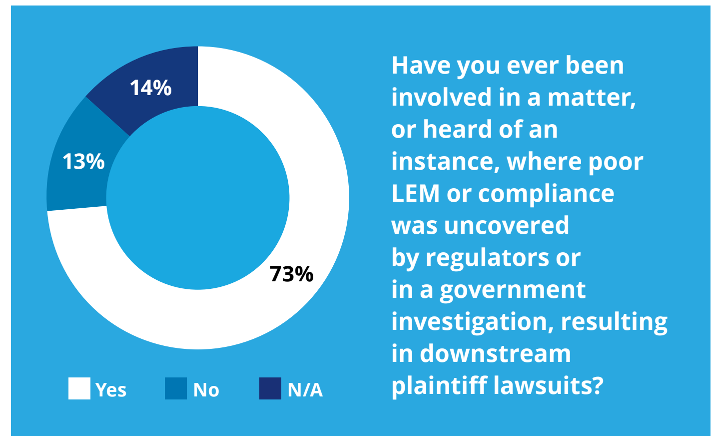


5. Government investigations based on poor LEM can lead to downstream litigation.

When government agencies uncover improper LEM, plaintiffs' firms often catch wind and file lawsuits. Notably, 73% of our interviewees confirmed having experience with or concerns about potential litigation risk from this source. "Government enforcement actions can be public record, significantly increasing the risk that they are monitored by plaintiffs' firms or others to whom you are or may be adversarial," says Greg McLaughlin, vice president and associate general counsel and global head of litigation and investigations at Kyndryl.

Civil plaintiffs will also sometimes pursue follow-up investigations that can cause tension between shareholders and their boards. Cases involving healthcare fraud or explosions at facilities, for instance, "can spur any number of different regulatory actions," warns Michael Hefter, partner at Hogan Lovells. "And then shareholders claim that if the board should have done a better job in oversight, the issue would never have happened and therefore the director should be liable."

Government agencies tie legal entity management and record keeping with internal controls, which can undermine the ability to fend off the regulator. Jeff Taylor of Fox Corporation believes that "if a company's internal controls are so sloppy that the SEC could come after it, it is safe to expect a civil action challenging the effectiveness of its internal controls, especially if it's a public company."

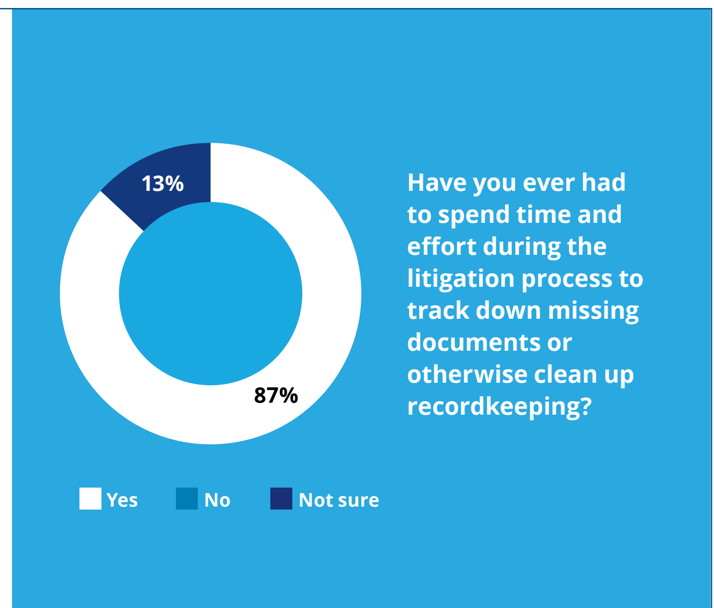


"Shareholders' attorneys often follow up government investigations with a demand to access corporate books and records under Delaware General Corporation Law Section 220 if they suspect that they can make the case that the board was falling down on its obligation to performance, fiduciary duties and guard against risks."

– Jeff Taylor, General Counsel, Fox Corporation

The Litigation Costs of Poor LEM

Sloppy LEM practices can not only increase litigation risk. They can increase litigation costs as well. Remarkably, 87% of our interviewees report having had to spend time and money to clean up or ameliorate errant subsidiary documents and filings. Potentially worse, the inability to locate governance documents can make it difficult for legal teams to defend themselves to the fullest and in some cases even can cause litigants to capitulate early. A few of our respondents have experienced situations of this nature, and one even reported a potential cost of billions of dollars in settlements and judgments. Others noted the cost of significant time and distraction the administrative tasks can cost senior leadership in the legal team and the management team even at the parent company level.



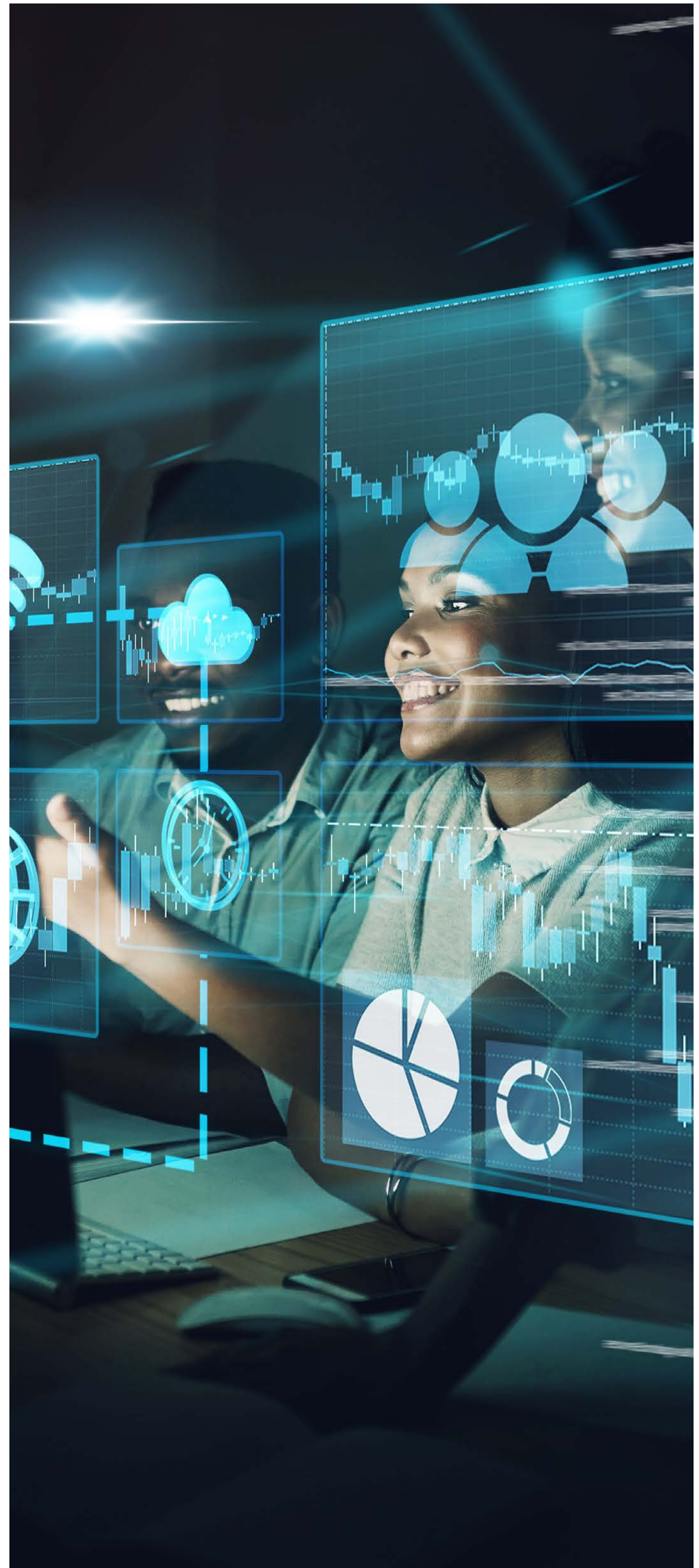
The more you know: the benefits of consistent legal entity management

When facing litigation, corporations need every advantage they can get.

While our research revealed strong disadvantages associated with poor LEM, the inverse was also true: World-class LEM eliminates distractions and allows the parties, their lawyers, judges, arbitrators, and juries to focus on the legal theories and facts pertinent to the matter. Sound subsidiary management confers these key benefits:

- **Greater confidence:** Triers of fact who can see that businesses have been carefully managed may have greater confidence in the company's executive witnesses and the documents that are shared as evidence.
- **Better jurisdictions:** The ability to prove the company has actual operations in multiple jurisdictions may enable it to move litigation to a jurisdiction it finds more reliable. It also may help it pass the diversity test required to move litigation to federal court.
- **Cost savings:** Most of our respondents believe they can overcome poor LEM most of the time, but doing so takes time and money. Solid LEM practices obviate the need for cleanup and can therefore reduce litigation costs.

How can corporate leadership leverage these benefits? By investing the time and resources upfront to have their legal, compliance, and tax teams review their entity structures and records, resolve any gaps, and manage their subsidiaries carefully. It's an investment that can reduce litigation risk and can increase the opportunity to settle less expensively or win at trial.



View from the practice

(Summary of Deloitte LEM Commentary)

In part two of our study on the value of entity management, our research uncovered a number of potential implications of substandard legal entity management on litigation risk. Our experience shows proper LEM practices and maintenance of corporate separateness allows companies and their subsidiaries to work hand-in-hand with counsel to mitigate risks and improve the likelihood of a positive outcome in litigation or arbitration proceedings. Poor LEM, on the other hand, can create more legal work for outside counsel, unfavorable litigation circumstances, additional time in court, and subsequently, additional legal fees or higher settlement amounts.

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