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REPORT FROM COUNSEL

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PARENT CORPORATIONS MAY BE HELD LIABLE ON THE LEASES OF THEIR SUBSIDIARY CORPORATIONS

By Matt A. Jarrell, Esquire

The New Jersey Superior Court recently held that a company that creates a subsidiary solely for the purpose of renting space may itself be held liable under the lease if it causes the landlord to believe that the company, rather than the subsidiary, is actually the tenant. The ruling has considerable implications for those companies that attempt to insulate themselves from the contractual liabilities of their subsidiaries, not just in New Jersey but in other states, including Pennsylvania, in which courts may find the New Jersey Court's reasoning persuasive.

Blimpie International, Inc., a well-known restaurant franchisor, created a wholly owned and admittedly judgment proof subsidiary, I.B.C. Services, Inc., for the single purpose of holding the lease on premises occupied by a Blimpie franchisee. I.B.C. Services entered into the lease with the shopping mall landlord and then subleased the premises to the franchisee, in this case an individual in Edison, New Jersey. When the tenant failed to pay rent, the landlord sued--not just I.B.C. Services, the tenant on the lease, but its corporate parent as well.

The Court held in favor of the landlord based on an exception to the general rule that one corporation's ownership of stock in another does not give rise to the stockholder's liability for the torts or contractual breaches of the other. That exception provides for liability where the stockholding corporation uses the subsidiary as its mere agent or instrumentality to create a shield behind which injustice is sought to be done. Invocation of the exception, the Court noted, required proof that the parent "so dominated the subsidiary that it had no separate existence but was merely a conduit for the parent." Beyond that domination, it must also be found that the parent has "abused the privilege of incorporation by using the subsidiary to perpetrate a fraud or injustice . . ." The great hallmarks of such abuse, the Court noted, "are the engagement of the subsidiary in no independent business of its own but exclusively the performance of a service for the parent and, even more importantly, the undercapitalization of the subsidiary rendering it judgment proof."

To illustrate its holding, the Court invoked the analogy of a puppeteer and the marionette. Blimpie International admitted that it created I.B.C. Services for the sole purpose of holding the lease on the premises of a Blimpie's restaurant. I.B.C. Services had no assets other than the lease itself and had no income except for the rental payments made by the franchisee, which were actually made directly to the landlord. In addition, the Court found no reason to dispute the lower court determination that Blimpie International exercised complete dominion and control over I.B.C. Services. The puppeteer's strings were plainly visible.

The Court also concluded that Blimpie International used I.B.C. Services to commit a fraud or injustice. The plaintiff's partners who dealt with I.B.C. Services testified that they believed they were dealing with Blimpie International and never discovered the fact of the separate entities until after their eviction of the franchisee. At pre-leasing of the premises, the franchisee and a second man connected to Blimpie International appeared at the premises wearing Blimpie uniforms and indicated a desire to open a Blimpie's restaurant. Moreover, the lease identified the tenant as "I.B.C. Services, Inc., having an address at c/o International Blimpie Corporation . . ." Finally, correspondence from the entity the landlord believed to be the tenant to the landlord was on stationary headed only with the Blimpie logo and none of the correspondence ever suggested the existence of an independent company standing between the franchisor and the franchisee.

Blimpie International's defense that it could not be held liable on I.B.C. Services' lease because it observed corporate formalities was summarily dismissed. The Court stated that "the separate corporate shell created by Blimpie International to avoid liability may have been mechanistically impeccable, but in every functional and operational sense, it had no separate identity. It was moreover not intended to shield the parent from its responsibility for its subsidiary's obligations but to shield the parent from its own obligations." The Court thus concluded that I.B.C. Services was created as a judgment proof corporation for the sole purpose of insulating Blimpie International from any liability on the lease in the event of the franchisee's default. Accordingly, the corporate veil was properly pierced and Blimpie International was held liable on I.B.C. Services' default on its lease.

Parent companies hoping to avoid Blimpie International's fate should be careful to avoid the kind of misperceptions that likely persuaded the court in that case to agree with the landlord. That court stated that though I.B.C. Services never claimed to be Blimpie International, it "affirmatively, intentionally, and calculatedly led [the landlord] to believe it was [Blimpie]." The end result might have been different had Blimpie International taken affirmative action to make clear that it was not the tenant under the lease and caused I.B.C. Services to act under its own, rather than Blimpie International's, logo and letterhead. Absent those easily rectified misperceptions, it is possible that the Court would have had considerably more difficulty finding intent on the part of Blimpie International to perpetrate a fraud or other injustice, a critical component to the Court's decision to pierce the corporate veil.

On the other hand, even without those misperceptions, the fact remains that I.B.C. was a judgment proof corporation created for the sole purpose of shielding the parent from liability under the lease. Blimpie International's then Executive Vice President testified that Blimpie International had created "hundreds and hundreds" of corporations for this purpose. Had it operated under no misperceptions regarding the identity or capitalization of its tenant, the landlord might have elected not to do business with the shell corporation at all without the added security of a secondary obligation assumed by Blimpie International; precisely what Blimpie International was trying to avoid in the first place. Companies similarly inclined to try to avoid the lease obligations of their subsidiaries may find that no one wants to do business with them.

About the Author

Mr. Jarrell is an associate attorney with the firm and is a member of the firm's Litigation Group. His practice currently focuses on a variety of commercial and corporate litigation matters. Prior to joining the firm, Mr. Jarrell worked for two years as an associate in the Corporate and Commercial litigation practice group of an established regional law firm. Mr. Jarrell is a 1997 graduate of West Virginia University and a 2000 graduate of Washington and Lee University School of Law.

CREDIT REPORTING AGENCY HELD ACCOUNTABLE FOR ERRORS

Judy discovered that her credit report from a large credit reporting agency erroneously included about a dozen accounts for a different person, also named Judith. The report identified Judy as using that person's name as an alias. Unfortunately, the "other" Judith, who did exist, had a checkered debt-paying history that was erroneously presented as Judy's in the credit report.

Judy's own spadework revealed that the credit reporting agency had merged her information with that of the second Judith because they had similar first names, were

born in the same year, were from the same part of the country, and, most importantly, their Social Security numbers differed by only one digit. This initial computer mistake was bad enough, but what ultimately led to a very large damages verdict for Judy was the inadequate response of the reporting agency once Judy had brought the errors to its attention.

The agency deleted some of the accounts that did not belong in Judy's report, but it kept most of them after supposedly verifying them with creditors. This "verification" was very superficial and did not convey to the creditors the information Judy had provided. In effect, the agency simply asked each creditor, "Is this what you reported?" Fully three years after Judy notified the reporting agency of the erroneous information in her report, some of it remained, and the undeserved stain on her credit was as obvious as ever. To add insult to injury, some of the deleted information from the second Judith even reappeared on Judy's report.

The situation came to a head when the erroneous credit report caused Judy to be denied a mortgage. By supplying still more information to the agency, including a supportive letter from the "other" Judith, and contacting creditors herself, Judy eventually cleaned up her credit report and got out from under the shadow of a stranger's unpaid debts. By then, however, she was a wreck emotionally, and the damage to her credit reputation was only beginning to be restored. A jury verdict made the credit reporting agency pay for these injuries, but sent an even louder message in a large award of punitive damages.

The success achieved in Judy's lawsuit was largely due to her own diligence. The steps she took are practically a blueprint for what someone should do when credit reporting errors are made and then left uncorrected by an agency. It took years in her case, but Judy prevailed in the end by making telephone calls, keeping notes and documents, contacting creditors directly, and even enlisting the aid of the debtor whose poor credit history had appeared in Judy's credit report.

ADA AND SMALL BUSINESSES

The Americans with Disabilities Act (ADA) prohibits disability discrimination in employment for employers with 15 or more employees. The prohibition is far-reaching and covers hiring, firing, and everything in between, such as promotions, benefits, and harassment in the workplace. The smallest of businesses are not affected by the ADA because of the 15-employee threshold for coverage. The ADA does apply, however, to many of the roughly 25 million small businesses in the nation.

Who Is Protected?

The ADA protects three categories of individuals: those with a physical or mental impairment that substantially limits one or more major life activities (like sitting, standing, or sleeping); those with a record of such an impairment, such as a person who

had debilitating cancer but is now in remission; and those who are regarded by employers as having such an impairment, even though the individuals otherwise are not so impaired as to be "disabled" under the ADA. Regardless of the category, the ADA protects only persons who are qualified, that is, they meet job-related requirements and can perform essential functions for the job, with or without a reasonable accommodation.

Hiring

While an employer can ask an applicant a wide range of questions concerning job qualifications, the ADA does not allow medical examinations or questions about disability until the employer has made the applicant a conditional job offer. An exception is recognized for questions directed to an apparently disabled applicant about whether a reasonable accommodation will be required.

After a job offer is made, an employer can ask any disability-related questions and require medical examinations, so long as these requirements apply to everyone in the same job category. For example, if, during a medical examination required of all employees in a job involving the use of dangerous machinery, it is revealed that an applicant has frequent and unpredictable seizures, the employer can withdraw a job offer to that individual.

Medical Information

Once a person is on the job, the ADA allows required medical examinations or questions about a disability only where there is a reasonable belief, based on objective evidence, that a particular employee will not be able to perform essential job functions or will pose a direct threat because of a medical condition. As an example, if a normally reliable employee has told her employer that a new medication she takes makes her lethargic, and she begins to make many mistakes, the employer can ask her how long the medication can be expected to affect job performance.

Reasonable Accommodation

The ADA differs from most other employment discrimination laws in imposing an accommodation duty on employers. If a disabled person needs a reasonable accommodation in order to apply for, or perform, a job, the employer generally must provide it unless to do so would create an undue hardship. An undue hardship means significant difficulty or expense, based on an employer's resources and operations.

Most accommodations are not expensive or burdensome. A diabetic employee may need regular breaks to eat properly and monitor blood sugar and insulin levels, or a blind employee may need someone to read information posted on a bulletin board. If more than one accommodation will work, the employer may take the option that is less costly or easier to provide.

In addition to the undue hardship defense, an employer need not provide an accommodation which:

- * assists an individual off the job;
- * removes or alters the essential functions of a job;
- * lowers production or performance standards; or
- * excuses violations of rules on good conduct.

Helpful Handbook

The Equal Employment Opportunity Commission, which is charged with enforcement of the ADA, has issued a new handbook to help small businesses comply with the ADA. The handbook provides many examples of factual situations with which small businesses could be confronted. The ADA primer can be accessed online at www.eeoc.gov.

ONLINE BANKING

Banks that rely on the Internet and other low-cost ways to provide service, as opposed to "bricks and mortar" branch offices, can save on expenses and pass the savings along to customers in higher returns on deposits and lower interest rates on loans. Online banking also gives customers the convenience of being able to monitor their accounts and complete transactions around the clock, without waiting for mailed statements or being limited by office hours.

The flip side of online banking is that, if a problem arises, you cannot sit down face-to-face with someone from the bank to resolve it. There is also a premium on doing research to check out the legitimacy of an unfamiliar and remote institution before you entrust it with your money and private information. A good place to start is the "About Us" section of a bank's website, which should at least give basic contact information. If it does not, that in itself should raise suspicions. Other warning signs include names or websites that are only slightly different from those of well-known institutions and rates of return that are far out of line with what other banks are offering. It is a good idea to confirm that an institution is federally insured by contacting the Federal Deposit Insurance Corporation or searching its "Institution Directory" at www3.fdic.gov/idasp.

Like any bank customer, users of online banking institutions are well-advised to safeguard private identification information, keep good records, and monitor transactions and balances regularly. Online banking customers also have the protection of federal laws such as the Equal Credit Opportunity Act, the Truth in Lending Act, and the Truth in Savings Act. Those who decide to do their banking solely in front of a computer screen

especially should know about the Electronic Fund Transfer Act, which deals with consumer rights involving electronic banking transactions.

FIRM ANNOUNCEMENTS

The firm is pleased to announce that Charles R. Reis has become a shareholder of the firm as of January 1, 2003. Mr. Reis is a 1964 graduate of Waynesburg College and a 1970 graduate of Duquesne University School of Law. He is a member of the firm's Estates and Trust Group and concentrates his practice in the areas of estate planning, estate administration, professional corporations, business and business succession planning. Mr. Reis is a former vice-president of the Trust and Investment Department of Mellon Bank. He has conducted numerous training sessions and lectures on estate planning topics for the Pennsylvania Bar Institute, Duquesne University Planned Giving Department, The Equitable, Penn Mutual, The New England, Commonwealth of Pennsylvania State Employees Retirement System, Mass Mutual, Westinghouse Retirees, Lions International, First Commonwealth Trust Company, Hefren-Tillotson, Inc., The Academy for Life Long Learning at Carnegie-Mellon University and various other groups.

The firm is also pleased to announce that Susan J. Messer has become a director of the firm as of January 1, 2003. Ms. Messer joined the firm in 1999 as an associate attorney and she is a member of the firm's Corporate and Financial Services Groups. Her practice includes corporate law, mergers and acquisitions, finance, real estate and employee benefits. Ms. Messer earned her B.A. degree from Duquesne University in 1989 and she received her J.D. from the University of Pittsburgh Law School in 1992. She is a member of the American, Pennsylvania, and Allegheny County Bar Associations.