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The "Enterprise Liability" Theory of Organizational Liability Gains a New Foothold

Michael W. Peregrine, McDermott Will & Emery LLP

Corporate structure advisors to health care systems may wish to take note of the "enterprise liability" theory of organizational liability, as recently analyzed by the Pennsylvania Supreme Court in *Mortimer v. McCool*.[1]

While the reality of its application may be limited to particularized facts, it presents a risk to be considered in corporate structure design and maintenance.

Overview-Veil Piercing

The doctrines of "piercing the corporate veil"; "alter-ego treatment"; and (in the tax world) "attribution of assets" are generally well known to health care lawyers who are called upon to advise clients on the liability and related risks of particular corporate organizational structures and their associated governance, control, and funds flow arrangements.

Courts have long recognized limited liability as an essential attribute of the corporate form (i.e., the ability to limit risk to shareholder investment) and thus generally view the corporation as fundamentally separate from its shareholders. Yet as *McCool* notes, courts will seek to balance the public and commercial benefits of limited liability with the social cost of limited liability (i.e., to protect those who could not anticipate the need to protect against the risk of an unforeseeable encounter with a corporation unable to satisfy a judgment in excess of its value, leaving such persons remedy-less).

For that reason, courts in most states have been willing to "pierce the corporate veil" (to treat the shareholders and the corporation as identical) in circumstances where justice and public policy demand such treatment. Those circumstances often include "undercapitalization, failure to adhere to corporate formalities, substantial intermingling of corporate and personal affairs, and use of the corporate form to perpetrate a fraud."[2] In essence, veil-piercing remedies are grounded in a recognition that the "sanctity of the corporate structure" has already been violated by the presence of such circumstances.[3]

Distinction with Enterprise Liability

Enterprise liability represents a nuanced, potentially confusing, but most certainly (to the health care corporate lawyer) concerning basis for disregarding the corporate form in a given circumstance. The *McCool* case is not the first instance in which it has been addressed; as the Pennsylvania Supreme Court notes, enterprise liability has been recognized in one form or another by decisions in at least ten different states.[4] Indeed, the underlying concept is sometimes alternatively referred to as either the "single entity," "affiliate" "identity," or "horizontal" doctrine of liability.

As described in the *McCool* case, the core of the doctrine rests in the concept that "just as a corporation's owner or owners may be held liable for judgments against the corporation when equity requires, so may affiliated or 'sister' corporations—corporations with common ownership, engaged in a unitary commercial endeavor—be held liable for each other's debts or judgments."[5]

As a Pennsylvania commentator has noted, this is to be contrasted "with the traditional 'vertical' form, where a corporation's owner may be held liable for judgments against it when equity requires."[6] Citing *McCool*, the commentator describes Enterprise Liability as allowing for analogous form of veil piercing for "affiliated or sister corporations—corporations with common ownership, engaged in a unitary commercial endeavor."[7] And that should attract the attention of the health care lawyer.

Basic Facts

The *McCool* decision arose from facts mostly opposite from those traditionally present in complex corporate litigation. The plaintiff had been seriously injured in a car accident involving an alcohol-impaired driver who had just been served by the defendant restaurant/bar. The actual management and ownership structure of the restaurant/bar was highly complex, involving, among other elements, separate but somewhat interconnecting owners for each of the restaurant; the building in which the restaurant was located; and the owners of the restaurant's liquor license (provided by management agreement to the owners of the restaurant).

The foundational litigation was a dram shop action, which resulted in a substantial judgment against the owner of the liquor license and other defendants. Pennsylvania law made the owner of the liquor license jointly and severally liable for the plaintiff's entire judgment. However, the only asset of the owner of the liquor license was the license itself, which was materially insufficient to satisfy the judgment. As a result, the plaintiff sought to collect the balance of the judgment against the property owner, on the basis of enterprise liability arising from what was alleged as a unitary commercial endeavor given the various interlocking relationships between the sister companies.

After examining how courts in other states, as well as Pennsylvania, have previously analyzed the enterprise liability doctrine, the Pennsylvania Supreme Court declined to apply a prescribed test for its application. Rather, it recognized a more flexible approach, requiring that "the affiliates that the enterprise comprises have common owners and/or an administrative nexus above the sister corporations. Without that nexus, piercing the veil to reach a sister corporation cannot be just."[8]

This suggests that enterprise liability (in Pennsylvania at least) requires a triangular mechanism by which the liability "must run up from the debtor corporation to the common owner, and from there down to the targeted sister corporation(s) . . . requir[ing] a mechanism by which liability passes through the common owner to the sibling corporation."[9] Here, the plaintiff was unable to establish at least substantially common ownership among the parties. Thus, ironically, while the Pennsylvania Supreme Court acknowledged that the doctrine of enterprise liability could be available under certain circumstances, it could not apply under the facts of this case.[10]

Analysis and Relevance

The value of the *McCool* decision to health care lawyers rests in its confirmation that the doctrine of enterprise liability exists, has been applied in numerous states in various related ways, and that its most direct application is found in "sister" or "affiliate" relationships with common ownership.

Perhaps a plausible risk of enterprise liability may arise in the context of the diversified health care organization with multiple affiliates under common ownership, pursuing a broad portfolio of activities. Facts arising from such structures that could pose potential enterprise liability risk could possibly include:

- Reliance on management-styled boards of subsidiaries due to difficulty in recruiting independent directors to serve on such boards;
- Material financial support flowing to subsidiaries through some triangular mechanism;
- The unsupervised application of overlapping boards as control mechanisms;
- Inattentiveness to corporate formalities at the subsidiary level arising from cost-saving measures or similar practices;
- Reduced attention and oversight to the administration of subsidiary governance; and
- Concerns that disparities in the delivery of health care services were prompted by the allocation of assets or services within the corporate structure.

Conclusion

The sky is not falling here. As the *McCool* court concedes, the law continues to support the ability of “scrupulous business owners” to use the corporate model to diversify their operations across multiple subsidiaries in order to reduce their exposure to risk and regulation.[11] The doctrine of enterprise liability is only expected to apply in truly egregious circumstances—just like with traditional alter ego and veil piercing doctrines, and to deter direct abuses of corporate forms, using the corporation as a shell to protect funds from judgment, or treating corporate coffers as personal playthings—even if the vehicle for abuse is a sister corporation. But the court stopped short of articulating a standard beyond invoking enterprise liability when equity so demands a responsible party to be named.[12]

Ultimately, the Pennsylvania Supreme Court’s confirmation of the doctrine of enterprise liability is notable for those providing advice on corporate structure and liability risks arising from diversified parent/subsidiary organizations. No doubt the decision may prompt both private plaintiffs and regulators to pursue claims against such organizations based in whole or in part on enterprise liability arguments. Yet the decision may also prompt corporate management to take steps relating to organizational form and function necessary to reduce the related risk.

About the Author

Michael W. Peregrine is a partner in the law firm of McDermott, Will & Emery, where his practice focuses on corporate governance. He is a Fellow of the American Health Law Association. Mr. Peregrine gratefully acknowledges the valued contributions of his colleague, Gregory Fosheim, in the preparation of this article.

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[1] *Mortimer v. McCool,* 255 A.3d 261 (Pa. 2021).

[2] *Id.* at 266 (quoting *Lumax Industries, Inc. v. Aultman,* 669 A.2d 893, 895 (Pa. 1995)).

[3] *Lumax,* 669 A.2d at 895.

[4] *Mortimer*, 225 A.3d at 280-83.

[5] *Id.* at 266.

[6] Edward T. Kang and Ryan T. Kirk, *Enterprise Liability and When to Seek Piercing the Corporate Veil*, Law.com (Sept. 9, 2021), https://www.law.com/thelegalintelligencer/2021/09/09/enterprise-liability-and-when-to-seek-piercing-the-corporate-veil/.

[7] *Mortimer, 255 A.3d* at *266.*

[8] *Id.* at 285.

[9] *Id.*

[10] *Id.* at 266.

[11] *See id.* at 283 ("There is no evidence that scrupulous business owners have been punished anywhere for availing themselves of the option to distribute related businesses across multiple corporate entities to secure liability protection and legal advantage.")

[12] *See id. at 287* (discussing veil piercing jurisprudence as requiring an analysis of when to pierce and against whom).