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News & Types: Corporate, Finance & Acquisitions Update

Be Careful Who You Contract with and Who You Don't Contract with – Non-Party Not Bound

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Practices: Corporate, Finance & Acquisitions, Litigation

Northbound Group, Inc. generated and sold life insurance leads under the brand name "Leadbot." It was fairly successful in the late 1990s but was on the verge of failure around 2008－2009. It found a rescuer in Norvax, Inc. whose business was similar in that Norvax generated and sold health insurance leads. Norvax agreed to acquire the assets of Northbound and, for this purpose, formed an acquisition vehicle called Leadbot LLC. The result was an asset purchase agreement executed in February 2009 by and between Northbound and Leadbot LLC. Norvax was not a party to the asset purchase agreement. Northbound was to be paid through an "earn-out" calculated as a percentage of the monthly net revenue of Leadbot LLC.

Northbound claimed a breach of the agreement and sued Norvax and Leadbot. The district court dismissed some of Northbound's claims and granted summary judgment on the remainder. Northbound appealed, primarily on the summary judgement against it and in favor of Norvax. (*Northbound Group, Inc. v. Norvax, Inc.*, 7th Circuit Court of Appeals, No. 14-1651, July 28, 2015)

Judge Hamilton, who wrote the opinion for the 7th Circuit Court of Appeals, pointed out the obvious. Norvax was not a party to the contract. So how could it be liable on the contract?

Northbound had several points in response. First, it argued that Norvax was in privity with Leadbot which, in turn, was in privity with Northbound. The court called this a "novel" proposition, signaling the result. The argument was based on language in an earlier 7th Circuit opinion that only a party in privity or an intended third-party beneficiary to a contract can bring a claim. Judge Hamilton declined to extend this to a non-party, even one with a close relationship with the party to the contract.

Northbound then argued for "direct participant" liability, which is an Illinois judicial doctrine that a parent may be liable for the wrongful conduct of its subsidiary when "the alleged wrong can seemingly be traced to the parent through the conduit of its own personnel and management." But, to the court, there was an obvious problem. Illinois has applied the "direct participant" doctrine only to torts and violations of statute, and not to breaches of contract. In this case also, Northbound was arguing for an extension of the law which the court declined to grant.

Finally, Northbound argued the "alter ego" doctrine. As explained by the court,

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"Generally, before the separate corporate identity of one corporation will be disregarded and treated as the alter ego of another, it must be shown that it is so controlled and its affairs so conducted that it is a mere instrumentality of another, and it must further appear that observance of the fiction of separate existence would under the circumstances, sanction a fraud or promote injustice."

In this regard, Northbound could cite some evidence. For example, Leadbot was a brand under the Norvax umbrella. The purchase price for Northbound's assets were ultimately paid by Norvax. Norvax paid for the salaries of Leadbot employees.

The court even acknowledged that this evidence could show that Leadbot was a "mere instrumentality" of Norvax. So, the first element of the "alter ego" doctrine, that one is a "mere instrumentality" of the other, could be met. But what about the second? Where is the "fraud" and "injustice" that would be promoted?

Here the court fell back again on the distinction between tort and contract. A victim of a tort does not choose the wrongdoer. If the wrongdoer turns out to be an entity that is the "mere instrumentality" of another entity, then it may be an injustice to allow the other entity to escape liability.

But a contract situation is much different. Explained the court (quoting from a 1988 7th Circuit decision written by Judge Easterbrook):

> " . . . . [C]ontract creditors have entered into a voluntary arrangement with the corporation, which gave them an opportunity to negotiate terms reflecting any enhanced risk to which doing business with an entity enjoying limited liability exposed them. If they wanted guarantees from investors, they could have negotiated for them. Tort creditors had no chance to obtain compensation ex ante for exposure to increased risk, so to cut off all liability might encourage excessively risky behavior."

Northbound Group illustrates principals that are found in 7th Circuit opinions (and, no doubt, in other opinions). Parties to a contract have freedom of contract to negotiate their rights, obligations, liabilities, remedies and even who their contract is with. Of course, freedom of contract is a good thing. But, like other freedoms, it also comes with cautions. Once a contract is negotiated, a party will likely be unsuccessful in persuading a court to rewrite the contract or to add provisions that may not have been considered, are erroneous or, in hindsight, seem unfair. As *Northbound Group* also illustrates, courts will not add parties to a contract. There are many illustrations in our Updates. For a recent example, see: "Dissatisfied Buyer Loses $2.7 MILLION On "Economic Loss" Doctrine."

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