

JOHNSON v. SMITHKLINE BEECHAM: A TEXTBOOK APPLICATION OF CORPORATE CITIZENSHIP PRINCIPLES

by
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Every first-year law student learns that arguments about federal jurisdiction sometimes become thorny skirmishes that can mire the parties at the outset of litigation. In the recent decision of *Johnson v. SmithKline Beecham*, 2013 U.S. App. LEXIS 11501 (Mar. 5, 2013), the United States Court of Appeals for the Third Circuit reaffirmed that under a straightforward application of United States Supreme Court precedents, the citizenship of a non-corporate entity is determined by the citizenship of its members, and a corporation's citizenship is determined by its "nerve center," or the "center of overall direction, control, and coordination," and not an ad hoc weighing of factors. Additionally, the court underscored the essential—if occasionally frustrating—role of corporate form in such inquiries. Under these principles, the court held that the citizenship of a limited liability operating company in *Johnson* was determined by the citizenship of its sole member, a corporation, and that the latter entity, a mere holding company that had no operational activities, was a citizen of the state where it held its formal board meetings and not of the states where the subsidiary was incorporated or had its operational headquarters.

State vs. Federal Court

The facts of *Johnson* could be cut from the pages of a civil procedure textbook. In August 2011, plaintiffs filed an action in the Philadelphia Court of Common Pleas against seven drug companies based on birth defects allegedly caused by their mothers' use of thalidomide during pregnancy in the 1960s. Defendants removed the case to the United States District Court for the Eastern District of Pennsylvania, asserting federal court jurisdiction based on the parties' diversity of citizenship. Plaintiffs' riposte was a motion to remand the action to state court, alleging removal was improper because four of the defendants—GlaxoSmithKline Holdings ("Holdings"), GlaxoSmithKline LCC ("LLC"), SmithKline Beecham Corporation ("SmithKline") and Avantor Performance Materials ("Avantor")—were Pennsylvania citizens, as was one of the plaintiffs. The district court denied the motion but certified its order for interlocutory review by the circuit court, which granted review.

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Defendants' Legal Structure and Activities

Plaintiffs' arguments centered on their contention that LLC and Holdings were Pennsylvania citizens. LLC was a large U.S. operating entity whose ultimate parent was GlaxoSmithKline plc ("plc"), a British corporation. LLC came into being as the result of a two-step process whereby its predecessor, SmithKline, first re-domesticated itself from a Pennsylvania corporation to a Delaware corporation and then converted itself into a Delaware limited liability company; under Pennsylvania law, the first step also automatically effected SmithKline's dissolution. The purpose of the conversion was to use the tax treatment of a limited liability company to facilitate formation of a non-profit pharmaceutical joint venture that, for tax reasons, would not have been feasible had SmithKline been a participant. Operationally, however, the transition from SmithKline to LLC changed nothing. Thus LLC, like SmithKline, maintained its headquarters in Philadelphia, where it continued to employ 1,800 people and to conduct extensive operations developing, manufacturing, and selling pharmaceutical products.

Before the conversion, SmithKline's sole shareholder was Holdings, a Delaware corporation, and afterward Holdings continued as LLC's sole member. Although the default rule under Delaware law would have vested LLC's "management" in Holdings as LLC's sole member, as part of its creation LLC had, pursuant to Delaware law, explicitly provided that SmithKline's former directors serve as LLC's managers. Accordingly, Holdings was a quintessential pure holding company: its role was essentially confined to owning its interest in LLC, not managing it, hence Holdings' physical presence and activities anywhere were minimal. Holdings had only a small single-room headquarters in Wilmington, Delaware with a single administrative employee who worked there only about 20 hours per year. It had a three-person board of directors, one member of which was based in Delaware, that conducted regular board meetings—sometimes partly telephonically but otherwise in Delaware—to approve financial statements, pay dividends, make new investments, and approve restructurings. The directors also received tax, accounting, and other support services as needed from LLC employees in Philadelphia and London.

Diversity of Citizenship

The defendants made a straightforward argument to support their claim of complete diversity. As a non-corporate entity, a limited liability company has the citizenship of its members, *Johnson*, 2013 U.S. App. LEXIS 11501 at *24 (citing *Carden v. Arkoma*, 494 U.S. 185, 195-96 (1990)), hence LLC's citizenship was determined by that of Holdings. As a corporation, Holdings under 21 U.S.C. §1332(c) was a citizen of the states in which it was incorporated and had its principal place of business, which the Supreme Court held in *Hertz Corp. v. Friend*, 559 U.S. 77, 78 (2010), was "the place where the corporation's high level officers direct, control, and coordinate the corporation's activities," sometimes referred to as its "nerve center." Thus Holdings was a Delaware, not Pennsylvania, citizen under both criteria, as it was incorporated in Delaware and that was also its nerve center: at least one director worked there, the board meetings were convened at that location and, as a non-operational holding company, it was exclusively through board resolutions that the corporation could act.

In response, plaintiffs did not dispute that LLC’s citizenship was that of Holdings, *id. at* *24, but advanced two arguments under which Holdings was actually a Pennsylvania citizen. First, under their “novel delegation theory,” *Johnson*, 2013 U.S. App. LEXIS 11501 at *31, plaintiffs argued that the court should actually consider *LLC’s* activities to determine Holdings’ citizenship. LLC’s managers were managing “on behalf of” Holdings; therefore, according to plaintiffs, they were still part of Holdings, and their decisions should be considered Holdings’ corporate activities. In other words, because Holdings “effectively transplanted its brain” into LLC’s Philadelphia managers, it should be considered a citizen of Pennsylvania. *Id. at* 32. Second, even if the court considered only Holdings’ own activities, its Delaware headquarters were essentially a sham, as no substantive decision-making could have taken place in the handful of 15- to 20-minute board meetings that occurred there each year; rather, all real decisions were made elsewhere, primarily in Philadelphia, and merely ratified at the board meetings.

The Supremacy of Simplicity

Although the court characterized plaintiffs’ arguments as having some “logical appeal,” *id. at* *40, it held they in fact contained insurmountable flaws. First, plaintiffs’ transplantation analogy was inapt: there was nothing to “transplant” because Holdings had never shouldered management responsibilities for LLC in the first place, those having been reposed from the outset in the former SmithKline directors. *Id. at* * 33. More fundamentally, the Court held that plaintiffs’ circular analysis, under which a limited liability company’s citizenship would be determined by its own activities rather than that of its member, turned established precedent upside down and was inconsistent with the Supreme Court’s injunction that jurisdictional rules “remain as simple as possible.” *Id. at* *41 (citing *Hertz*, 559 U.S. at 80). “The Supreme Court has emphasized that, although a corporation has citizenship, unincorporated entities do not, regardless of their substantive similarities to corporations.” *Id.* (citing *Carden*, 494 U.S. at 195).

The court also rejected plaintiffs’ argument that Holdings’ own activities—or comparative lack thereof—in Delaware, showed that locus could not have been its actual “center of direction and control.” *Id. at* *45-46. Inherent in the nature of a pure holding company is that its “business is straightforward and takes little time,” yet it constitutes such a company’s “primary activity: managing its assets.” *Id. at* *46. Here there was sufficient testimony from Holdings’ directors that the district court did not clearly err in concluding that Holdings’ “board controls its investment activities through consensus-based resolutions” that were actually considered on their merits and then adopted at the Delaware meetings. *Id. at* *48. In this connection, the trial court could properly find that the Philadelphia- and London-based tax and accounting services to which plaintiffs pointed were merely directed at informing and facilitating the board’s decisions. *Id. at* *54-55.

Finally, the circuit court dispatched relatively quickly with plaintiffs’ arguments that Avantor and SmithKline Beecham were Pennsylvania citizens. Although Avantor had relocated its headquarters from New Jersey to Pennsylvania, the district court’s finding that the company’s leadership did not move until five days *after* defendants removed the action was not clearly erroneous. *Id. at* *60. As to SmithKline, it was a dissolved entity whose liabilities had been assumed by LLC; accordingly, SmithKline was merely a nominal party with no interest in the litigation, and its citizenship was irrelevant to the jurisdictional inquiry. *Id. at* *64.

Form and Substance

The primary lesson of *Johnson* is the importance of legal form and readily administrable rules in determining diversity jurisdiction in federal court. Despite the functional commonality between corporations and limited liability companies, the citizenship of these two types of entities is determined very differently. If an entity is structured as a corporation, it will be a citizen of both its state of incorporation and its corporate “nerve center.” If an entity is structured as a limited liability company, however, its citizenship will be that of its *members*, no matter how remote those locales may be from the entity’s own operations and even “nerve center.” And if the limited liability company has only one member, which is in turn a corporation that is purely a holding company, it is highly likely that, so long as actual decisions are made at the holding company’s board meetings, the locus of *those* meetings will establish the citizenship of the limited liability company subsidiary.

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