

Reprinted with permission from the 09-25-2013 issue of The Legal Intelligencer. (c) 2013 ALM Media Properties.

Further duplication without permission is prohibited.



## Third Circuit Applies Corporate Law to Free Exercise Clause

Jeffrey G. Weil and Dylan M. Alper

2013-09-25 12:00:00 AM

The U.S. Court of Appeals for the Third Circuit recently decided a case involving a challenge, on religious grounds, to the Affordable Care Act. In *Conestoga Wood Specialties v. Secretary of the U.S. Department of Health and Human Services*, No. 13-1144, the Third Circuit rejected a religious-based constitutional challenge to the act's provision requiring companies to offer health insurance that covers contraceptives for women.

The plaintiff is a corporation owned and controlled by Mennonites, who are opposed on religious grounds to contraceptives like the morning-after pill. The Third Circuit rejected the plaintiff's challenge to the act, holding that secular corporations do not engage in the exercise of religion, although their individual owners may. Interestingly, although the case is a First Amendment case, the dispositive question in the case involves the interpretation of corporate law: Are corporations legally separate from their shareholders, directors and officers?

In 2010, Congress passed the Affordable Care Act. One of its most controversial components requires non-exempt employers, with 50 or more employees, to provide coverage for all U.S. Food and Drug Administration-approved contraception for women. Such contraceptives include the so-called morning-after pill. Companies that refuse to comply with the mandate are subject to both civil liability and harsh monetary penalties. The mandate is, on its face, designed to provide uniform insurance protection to all employees of non-exempt companies.

In *Conestoga Wood Specialties*, a corporate employer — but not its employees — challenged the mandate, alleging that it infringed on the corporation's First Amendment and statutory rights to the "free exercise of religion." The plaintiff, Conestoga Wood Specialties Corp., is a for-profit, family-owned

Pennsylvania corporation with 950 employees. Conestoga's owners, the Hahns, are staunch observers of the Mennonite religion.

Mennonites profess a belief in life at conception and opposition to the morning-after pill. Conestoga and the Hahns filed suit in the U.S. District Court for the Eastern District of Pennsylvania seeking to preliminarily enjoin enforcement of the mandate against Conestoga. The Hahns claimed that the mandate violates the Religious Freedom Restoration Act (RFRA) and the free exercise clause of the First Amendment of the Constitution by requiring them to underwrite decisions and procedures that are contrary to their religion.

The district court denied the Hahns' motion for a preliminary injunction. The Third Circuit affirmed by a 2-1 vote. The court held that for-profit, secular corporations are unable to engage in religious exercise.

The Third Circuit's opinion grounds a constitutional ruling on basic concepts of corporate law. In affirming that Conestoga did not have a likelihood of success on the merits, the Third Circuit found that: (1) under fundamental corporate law, Conestoga is legally separate from its owners, and (2) a secular, for-profit corporation, like Conestoga, does not exercise religion. In so finding, the court rejected the plaintiff's argument, based on the U.S. Supreme Court's decision in *Citizens United v. Federal Election Commission*, 558 U.S. 310 (2010), that if a corporation has First Amendment free speech rights, it surely has free exercise rights as well.

The court's analysis started with this question: Under the First Amendment's free exercise clause, can a secular corporation exercise religion? The court surveyed Supreme Court decisions applying constitutional protections to corporations. It concluded that, although some constitutional rights can be asserted by corporations — such as the right to free speech (*Citizens United*) — other rights, such as the privilege against compulsory self-incrimination, are "purely personal."

The court also noted that nonprofit religious organizations, such as churches, have free exercise rights under the First Amendment. Secular, for-profit corporations are different, however. As the Third Circuit observed, "We simply cannot understand how a for-profit, secular corporation — apart from its owners — can exercise religion."

In addition to arguing that the corporation had its own free exercise rights, Conestoga argued that, as a family-owned, privately held corporation, the individual constitutional rights of its owners "passed through" to the corporation itself. The same argument had previously persuaded the Ninth Circuit, which in 2012 ruled that a closed corporation owned by devoutly religious owners is "merely the instrument through and by which [its owners] express their religious beliefs ... [and] presents no rights of its own different from or greater than its owners' rights." Differing with the Ninth Circuit, the Third Circuit flatly rejected the "passed through" theory. It viewed that theory as resting on "erroneous assumptions regarding the very nature of the corporate form."

It is hornbook law, as articulated by the courts for decades, that "incorporation's basic purpose is to create a distinct legal entity, with legal rights, obligations, powers, and privileges different from those of the

natural individuals who created it," the opinion said. This basic concept is recognized across the judicial gamut — from Delaware, the proverbial laboratory of corporate law, to the nation's high court. Indeed, corporate owners rely on the separation between shareholder and company when making all types of business decisions; for the limitation of liability accompanying the corporate structure protects corporate entrepreneurs from the risk of personal liability. "A corporation and its stockholders are generally to be treated as separate entities. Only under exceptional circumstances ... can the difference be disregarded," according to *Burnet v. Clark*, 287 U.S. 410 (1932). With this protection, however, the corporation loses certain privileges belonging to individuals.

Family-owned corporations are no exception to this general rule. Pennsylvania law, under which Conestoga was incorporated, provides that a corporation is legally distinct and separate from its owners (shareholders) and managers (officers and directors) — even if the stock is held entirely by one person. "Even when a corporation is owned by one person or family, the corporate form shields the individual members of the corporation from personal liability," the opinion said. Absent this legal divide, owners of corporations could use the corporate structure when convenient — to avoid personal liability — and then act as if the structure is meaningless when self-interest so dictates. The Third Circuit itself has admonished that "care should be taken on all occasions to avoid making the entire theory of the corporate entity useless."

Pennsylvania law further recognizes that it takes exceptional circumstances to pierce the corporate veil and set aside the legal separateness of the corporation and its owners. Pennsylvania courts consider a variety of factors in determining when one can pierce the corporate veil, including failure to adhere to corporate formalities, undercapitalization and intermingling of corporate and personal affairs. However, utilization of this "alter ego" theory to hold owners responsible for domination of a business entity and/or flagrant disregard of the corporate form is the exception rather than the rule. To preserve decades of well-settled law on corporate separateness, there is a strong presumption against piercing the veil. Granting only haphazard deference to this principle would risk allowing business owners to ignore the corporate structure one day and claim its benefits the next.

Further support for the Third Circuit's holding comes from the fact that the mandate's burden falls on the corporation, not on its shareholders. The company, not the individual shareholders, has the obligation to comply with the act; and it, not the shareholders, faces sanctions for failure to do so. Accordingly, the effect of the act is felt most palpably at the corporate level — not at the shareholder level.

But not all agree. The Third Circuit panel itself featured a vigorous dissent by Judge Kent A. Jordan, who reasoned that the choice to incorporate should not come at the expense of the owners' free exercise rights. Jordan's dissent questions the significance of a corporation's for-profit character in the context of the First Amendment — a factor that the majority found important. In so doing, the dissent attempts to undermine the logic of the majority opinion: "The majority detects no irony in its adoption of the district court's comment that 'religious belief takes shape within the minds and hearts of individuals, and its protection is one of the more uniquely human rights provided by the Constitution,' while it is simultaneously denying religious liberty to Conestoga, an entity that is nothing more than the common vision of five individuals from one family who are of one heart and mind about their religious belief."

The dissent follows much of the reasoning found in the Tenth Circuit's recent decision in *Hobby Lobby Stores v. Sebelius*, No. 12-6294. Differing from the Third Circuit, the Tenth Circuit ruled that the mandate did impair the company's right to free exercise of religion. In arriving at that result, the Tenth Circuit expressly extended the reasoning of *Citizens United* to find that for-profit companies have First Amendment rights under the free exercise clause — as well as rights to political speech.

The U.S. solicitor general must now decide whether to appeal *Hobby Lobby Stores* to the Supreme Court. At the same time, Conestoga's legal representative, Alliance Defending Freedom, issued a press release August 14, making clear its intention to appeal the Third Circuit's ruling to the Supreme Court, proclaiming: "Every American, including family business owners, should be free to live and do business according to their faith. The cost of religious freedom for the Hahn family, which owns Conestoga Wood Specialties, is the same as the cost to many other job creators across the country who face this mandate: the potential for massive fines that would cripple their businesses and threaten jobs. For this reason, we will be asking the U.S. Supreme Court to review this case."

That rhetorical flourish seems to overlook the technical niceties of corporate law as well as the duties of all citizens, including corporations, to comply with duly passed laws. Moreover, that view, like the majority and dissenting opinions in *Conestoga Wood Specialties*, takes little or no notice of the people whose interests the act is designed to protect: the 950 employees of Conestoga who want and need insurance. Should their interests be compromised because of the personal religious beliefs of the people who own the corporation for which they work?

Although cloaked in constitutional garb, the case really turns on an important issue of corporate law. Will the distinction between corporation and shareholder be preserved uniformly in cases involving both public companies and closely held family companies? Will the distinction be preserved despite heartfelt religious beliefs of individual owners who view the business as an extension of themselves? The Third Circuit has said "yes" to those questions. The next word may come from the Supreme Court.

**Jeffrey G. Weil** is chair of the commercial litigation department at Cozen O'Connor and is experienced in class action litigation, including securities, products liability and antitrust. He can be reached at [jweil@cozen.com](mailto:jweil@cozen.com).

**Dylan M. Alper** also practices in the commercial litigation group at the firm in Philadelphia. He graduated from Washington University and Villanova University School of Law.