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Piercing the corporate veil to collect damages

PIERCING THE CORPORATE VEIL AND HOLDING PASSIVE CORPORATE BUSINESS OWNERS PERSONALLY LIABLE FOR TORTS CAUSED BY THE CORPORATE ENTITY

Every case for a plaintiff's attorney typically involves the same three high-level factors that must be present in order for the case to be successful:

1) Liability;
2) Damages; and
3) Collectability.

While every combination of these factors presents their own unique problems, an extremely perilous combination for a plaintiff's attorney is the case of clear liability, high and/or concrete damages, but problems with collectability. Fact patterns that fit these types of lawsuits are generally where the main tortfeasor is judgment proof, there is little to no insurance for the claim, and there are no viable theories of liability against third-party defendants with deep pockets.

Unless your client is willing to pay hourly to pursue the case, cases with collectability problems can be a financial nightmare for plaintiffs' attorneys in which substantial time and money is invested in a case that will never be recovered.

In certain situations, the doctrine of "piercing the corporate veil" can be the only solution solving the collectability issue and make the case economically feasible to pursue. This article provides a step-by-step analysis of how to successfully establish alter-ego liability against passive owners of a business that has injured a plaintiff.

Overview of the piercing the corporate veil doctrine

The court, and not the jury, decides whether to pierce the corporate veil and apply alter-ego liability to individual defendants. This is because alter-ego liability is an equitable doctrine.

The two main requirements for invoking the alter-ego doctrine are:

(1) There is such a unity of interest and ownership between the corporation and the individual(s) or organization controlling it that their separate personalities no longer exist ("Unity of Interest"), and

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(2) The failure to disregard the corporate entity would sanction a fraud or promote injustice ("Inequitable Result").

(*Communist Party of the United States v. 552 Valencia, Inc.* (1995) 35 Cal.App.4th 980, 993; *Mesler v. Bragg Management Co*. (1985) 39 Cal.3d 290, 300; *Automotriz del Golfo de California. S.A. v. Resnick* (1957) 47 Cal 2d 792, 796.)

Unity of interest factors

With respect to the "unity of interest" element, case law has identified a number of factors that break down into the following categories:

1) Financial issues (e.g., was the corporation adequately capitalized?);

2) Corporate formality questions (e.g., was stock issued, are minutes kept and officers and directors elected, are corporate records segregated?);

3) Ownership issues (e.g., what is the stock ownership picture?); and

4) Commingling issues (e.g., are corporate assets commingled, does the parent company merely use the corporate shell of the subsidiary to obtain goods and services for the parent company?)

(See *Associated Vendors, Inc. v. Oakland Meat Co*. (1962) 210 Cal.App.2d 825, 839-840; see also *Tomaselli v. Transamerica Insurance Co.* (1990) 25 Cal.App.4th 1269, fn. 13.)

The single most important "Unity of Interest" factor is inadequate capitalization. Inadequate capitalization is so powerful because if an entity is organized and carries on business without substantial capital in such a way that the entity is unable to have sufficient assets available to meet its liabilities, public policy holds that it is inequitable that the owners set up such a flimsy entity to escape personal liability. For this reason, the attempt to do corporate business without providing a sufficient basis of financial responsibility to creditors is an abuse of the separate entity and will be ineffectual to exempt the shareholders/members from corporate debts.

California law requires that shareholders/members should in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, then this is a ground for denying the separate entity privilege. (*Shafford v. Otto Sales Co., Inc*. (1957) 149 Cal.App.2d 428, 432-433.)

Inadequate capitalization has been cited in many cases as an important factor weighing toward alter ego: (*Automotriz del Golfo de California. S.A.,* 47 Cal.2d at 797; *Minton v. Caveney* (1961) 56 Cal.2d 576, 580; *Claremont Press Publishing Co., Inc. v. Barksdale* (1960) 187 Cal.App.2d 813, 816-817; *Pan Pacific Sash and Door Co. v. Greendale Park Inc*. (1958) 166 Cal.App.2d 652, 657-658; *Talbot v. Fresno-Pacific Corp*. (1960) 181 Cal.App.2d 425, 431-432; and *Wheeler v. Superior Mortgage Co*. (1961) 196 Cal.App.2d 822, 827.)

So powerful is the factor of inadequate capitalization that a number of decisions *hinged on it alone*. For example, in *Carlesimo v. Schwebel* (1948) 87 Cal.App.2d 482, 493, the court denied an allegation of alter ego, purely because the corporation in question was adequately capitalized. While in *Temple v. Bodega Bay Fisheries, Inc*. (1960) 180 Cal.App.2d 279, 283-284, the court found alter ego, purely because the corporation had no capital.

Lastly, for purposes of this test, the members must put up capital which belongs to the entity. Frequently, members will give money to their entities, in the form of loans. *Loans, however, are not capital; if the only money a corporation has is in the form of shareholder loans, it has no capital*. (*Claremont Press Publishing Co*. 187 Cal.App.2d at 816-817; *Pan Pacific Sash and Door Co.*, 166 Cal.App.2d at 657-658.)

Inequitable result

The second factor for determining whether alter-ego liability applies is when the failure to disregard the corporate entity would sanction a fraud or promote injustice. This is a factual analysis made on a case-by-case basis.

It is important to note that it does not require a showing of actual fraud on the part of the defendants. Instead, it is sufficient that the refusal to invoke personal liability on the part of the defendants will bring about inequitable results. (*Minifie v. Rowley* (1921) 187 Cal. 481, 488.)

Seeking to evade payment of a creditor is the most common reason for the second element to be fulfilled. If the first element is shown, and the purpose of the alter-ego arrangement was to avoid paying a creditor, then alter ego will likely be found. (*Riddle v. Leuschner* (1959) 51 Cal.2d 574, 581; *Stark v. Coker* (1942) 20 Cal.2d 839, 846-849; *Minifie*, 187 Cal. at 488; *Pan Pacific Sash and Door Co.*, 166 Cal.App.2d at 559-560; *Talbot*, 181 Cal.App.2d at 431-432; *Temple,* 180 Cal.App.2d at 283-284; *Thomson v. L.C. Roney & Co., Inc*. (1952) 112 Cal.App.2d 420, 427-428; *Shea v. Leonis* (1939) 14 Cal.2d 666, 669; *Claremont Press Publishing Co., Inc.* 187 Cal.App.2d at 816-817.)

Potential fact pattern involving piercing of the corporate veil

The following is a potential fact pattern that gives rise to the need to invoke alter-ego liability: Three partners (David, Daniel, and Dylan) decided to form a limited liability company for the purposes of purchasing and operating a preexisting medical laboratory ("LLC"). The main function of the LLC was to test specimens and report the results to doctors.

The LLC had various employees including drivers who went from various doctor's offices and picked up specimens and delivered them to the laboratory to be tested. One day, on the way to pick up a specimen, an employee driver for the LLC, Douglas, ran a red light while texting and caused an automobile accident injuring third-party Peter.

The LLC insured Douglas' vehicle but only with the state minimum of $15,000/$30,000 liability insurance. Douglas is 20 years old, making minimum wage, has no assets, and is judgment proof.

At the time of the accident, the LLC was not making a profit and owed money on a loan used to purchase the laboratory

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from its prior owner. LLC members David, Daniel, and Dylan have significant assets including real estate, investment properties, stocks, and cash in bank accounts.

Peter can easily obtain a judgment for his injuries against the LLC and Douglas. The real issue is whether Peter can pierce the LLC's corporate veil and hold LLC's members David, Daniel, and Dylan personally liable for the tort committed by LLC employee Douglas. The answer depends on an analysis of the "unity of interest" factors and whether the application of limited liability will result in an inequitable result to Peter.

Game plan for seeking to pierce the corporate veil

Generally, the issue of whether the corporate veil needs to be pierced does not come up until after the initial round of discovery responses are received and it is determined that there is little to no insurance to cover the claim. Once the issue of collectability arises, it is time to start building the case for alter ego liability against the individual defendants who own the corporate entity.

The following is the step-by-step game plan for establishing alter-ego liability against the individual owners of a corporate entity. The strategy is the same regardless of whether the entity is a limited partnership, limited liability company, or a corporation.

Amend the complaint to allege alter-ego liability against all owners of the corporate entity

The first step towards establishing alter-ego liability is to amend the complaint and name the individual owners of the entity as defendants (if they are not already named) and generally allege alter-ego liability. The following is an example of alter-ego allegations:

> Plaintiff is informed and believes, and based thereon alleges, that Defendant [Corporate Entity] is the alter ego of Defendants [individual owners], and DOES 1 through 25, inclusive, in that it has maintained such a unity of interest and ownership that the separate personalities of the corporate entity and the individual defendants no longer exist and that an inequitable result would follow if they were treated as separate individuals. Upon information and belief, Defendants [individual owners] and DOES 1 through 25 and [Corporate Entity] were engaged in the following activities rendering the alter ego doctrine applicable:
>
> Failure to adequately capitalize Defendant [Corporate Entity];
>
> Treatment of Defendant [Corporate Entity's] assets as their own;
>
> Commingling of funds and other assets and the unauthorized diversion of Defendant [Corporate Entity's] funds or assets for other than Defendant [Corporate Entity's] uses the detriment of creditors;
>
> Failure to maintain minutes or adequate records;
>
> Disregard of legal formalities;
>
> Representations that Defendants [individual owners] are personally liable for Defendant [Corporate Entity's] debts; and
>
> Use of Defendant [Corporate Entity] as a mere shell, instrumentality, or conduit for a single venture.

The reason for immediately amending the complaint is twofold: First, you want to ultimately hold the individual owners jointly and severally liable for the torts committed by the business entity. As such, the individual owners must be named as defendants in the complaint.

Second, you want to be able to obtain discovery about the assets (or lack thereof) of the corporate entity. Generally, plaintiffs are not permitted to seek financial discovery of a defendant unless a showing of malice, oppression, or fraud is made in accordance with Civil Code section 3295. An exception to this rule is where alter-ego liability is alleged in the complaint, which puts directly in issue, among other things, whether or not the corporate entity was adequately capitalized.

Written discovery to corporate entity and individual defendants

Once alter ego liability is alleged in the complaint, issue the following special interrogatories to the defendants requesting:

1) name(s) of all current and former owners of the corporate entity (if not known already);

2) name(s) of the certified public account for the entity; and

3) name(s) of the banking institution and specific bank account numbers for the corporate entity.

In addition, issue the following requests for production of documents to the defendants:

1) All entity formation documents including, articles of organization, articles of incorporation, bylaws, operating agreements and amendments, statements of information, shareholder ledgers, stock certificates, members units, minutes, etc.;

2) All state tax returns filed on behalf of the corporate entity and all K1's for the individual members;

3) All bank statements for the corporate entity;

4) All canceled checks for the corporate entity; and

5) All financial statements for the corporate entity.

The defendants will object to this discovery on the grounds of financial privacy and/or tax return privilege. Note that neither of these privileges are absolute and can be overcome by making a compelling showing that the information is directly relevant to the issue of whether the alter ego applies. In the meet and confer process, offer to enter into a protective order with respect to the financial information. Timely move to compel production of the documents in the event that the defendants refuse to produce the requested information.

Once you receive the responses to this discovery, analyze it to determine whether the corporate entity was properly formed, capital contributions were properly made by all the members in accordance with the terms of the agreements, the corporate formalities are being followed, there is commingling of corporate assets, and whether the tax returns reflect the proper ownership of the individual members and the gains and losses are being properly reported.

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In reviewing the corporate documents, make sure that the corporate entity was properly formed and that all members properly joined the entity.
If there are problems or irregularities in the formation of the corporate entity, then the default is a partnership/joint venture in which all partners are jointly and severally liable for the torts committed by employees of the partnership.

Third-party subpoenas and depositions

Depending on the completeness of the document production by the defendant corporate entity, you may want to issue subpoenas directly to the banking institutions and the certified public accountant for their records.

After you have had sufficient time to analyze and review the documents, you should take the deposition of the certified public accountant. A certified public accountant or tax preparer has no incentive to hide the truth and cover for the defendant entity and its owners. Note that there is no accountant privilege and/or work product privilege.

Be sure to inquire whether the tax preparer performed a compilation, review, or audit of the corporate entity. An audit is the highest form of assurance while a compilation is the lowest. You can use the fact that only a compilation was performed to impeach anything negative that the CPA testifies to about the financial condition of the corporate entity.

California Secretary of State website search

Perform a search on the California Secretary of State website on the corporate entity. There are two ways that a corporate entity's status will be suspended: 1) Failing to file a Statement of Information every two years; and/or 2) Failing to Pay State Income Tax.

If a corporate entity's status is suspended, then it cannot defend itself in a lawsuit. *(Reed v. Norman*, (1957) 48 Cal.2d 338, 343.) More importantly, if a tort is committed by a corporate entity during the time that its corporate status is suspended, there are strong arguments that limited liability does not apply or, at a minimum, provides a strong reason in support of piercing the corporate veil.

Note that if you want to introduce into evidence at trial documents filed with the Secretary of State, and the defendants will not stipulate to their authenticity, you can fill out a form with the Secretary of State and obtain certified copies of the documents. It may take up to a month for the request to be processed, so keep that in mind as the trial date approaches.

Perform a case name search for the corporate entity

Another thing to consider is performing a case name search on the Superior Court websites in the main counties where the corporate entity conducts business to determine if there are prior lawsuits/judgments against the corporate entity. This is relevant to the adequate capitalization factor. The argument is that the more that a corporate entity is sued, the more capitalization and/or insurance the corporate entity should have to protect future potential creditors.

Trial on the issue of piercing the corporate veil

Prior to trial, the defendants will most likely file a motion to bifurcate the issue of alter-ego liability until after there has been a determination of liability and damages. This motion will most likely be granted by the trial court. That being said, make the best arguments in opposition to this motion, for example that bifurcation will cause an unreasonable extension of the trial and duplicity of witnesses. As a plaintiff's attorney, you want the jury to know that the corporate entity was inadequately capitalized and that the individual defendants improperly commingled the funds and had unaccounted-for personal expenditures.

When it comes to the actual trial on the issue of alter ego, methodically present the evidence relating to both factors: 1) Unity of interest; and 2) Inequitable result.

We recommend starting with the formation documents and presenting a chronological overview of the financial condition of the entity from formation to the time of the wrongful act.

In a recent case where the court found alter-ego liability against five owners of a limited liability company, we first established that at the time of formation, all members did not sign the operating agreement while the specific terms of the operating agreement provided that the only way to become a member was by signing the operating agreement. We then argued that the default of a general partnership applied and that all members were jointly and severely liable.

In addition, we introduced evidence that only one alleged member made any capital contributions to the LLC and the other four members obtained loans from the first member ("Main Member") for their capital contributions. Thereafter, there were no further capital calls and, instead, the Main Member made additional loans to the corporate entity when needed. This was strong evidence of undercapitalization.

We also introduced testimony that Main Member had over a million dollars' worth of gold in his closet and the other members only agreed to join the LLC after being shown that Main Member had sufficient assets to fund the venture going forward. Again, strong evidence of undercapitalization.

Next, we introduced the monthly bank statements which showed the monthly opening balance, ending balance, deposits, and expenses. We were able to show that at all times the entity was severely undercapitalized and that loans were constantly being made by the Main Member.

We also went through the canceled checks and found several issued "cash" to the members of the LLC including, Main Member, that did not correspond with the financial records. This was strong evidence of commingling and mismanagement of funds.

In addition, we introduced evidence that there was only one decision maker, the Main Member.

We then had the CPA for the LLC testify that during the relevant time period, the corporate entity did not pay its minimum tax to the State of California,

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resulting in the suspension of the entity's status from California Franchise Tax Board. Again, we argued that there should be no limited liability protection during the time period that the entity was suspended.

The CPA also admitted that there were several discrepancies in the financial records including, among other things, in the ownership interest, loans, and expenditures. The CPA testified that he was only hired to perform a compilation and therefore he relied solely on the information provided by the members and did no independent corroboration.

Lastly, we made a very compelling argument that if alter-ego liability was not found, then the Main Member, who was the mastermind behind the entity and the only reason the entity existed in the first place, would escape personal liability, which would be an inequitable result to the plaintiff.

The trial court agreed and held that the five members were personally liable for the judgment. If the judgment was solely against the entity, it would have been worthless because at the time of trial the entity was long out of business and had no money or tangible assets.

This was a prime example of where the only way for the plaintiff to recover on the judgment was if the corporate veil was pierced and the individual members were found to be the alter ego of the LLC.

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