



# Establishing “alter ego” liability

## *An update on piercing the corporate veil*

BY ARA JABAGCHOURIAN

In far too many circumstances, victims are handed a situation where the tortfeasor has little or insufficient assets, either through insurance or otherwise, to compensate for the harm that they have caused. Many of these companies rely on the corporate fiction for protection. Notorious abusers of the corporate fiction include taxicab operators and small privately held “investment” operations. Where you are dealing with a closely held company (few shareholders), attorneys should delve into a serious investigation relating to liability under the equitable doctrine of alter ego in order to bridge the shortfall to obtain full justice for your client.

The law of alter ego allows a party to pierce the corporate veil and pursue the shareholders of the corporation based on the manner in which they have dealt with the corporation. (*Associated Vendors, Inc. v. Oakland Meat Co.* (1962) 210 Cal.App.2d 825) Factors that lend to alter ego liability include the commingling of corporate funds, failure to observe corporate formalities including maintaining minutes and failure to contribute sufficient capital. (*Id.*; *Mid-Century Ins. Co. v. Gardner* (1992) 9 Cal.App.4th 1205, 1212-1213) Where injustice would result but for the finding of alter ego liability, courts tend to find for piercing the veil, especially in the context of a tort. (*Mesler v. Bragg Management Co.* (1985) 39 Cal.3d 290, 300; *Cascade Energy & Metals Corp. v.*

*Banks* (10th Cir. 1990) 896 F.2d 1557, 1577) “The essence of the alter ego doctrine is that justice be done.” (*Mesler, supra*, 39 Cal.3d at 301) Ultimately, alter ego liability is a two step process: establishing some of the “*Associated Vendors*” factors; and that an injustice will occur if the veil is not pierced.

Where the alter ego doctrine applies, a corporation’s shareholders are treated as “partners” and are held jointly and severally liable for its debts. (*Minnesota Min. & Mfg. Co. v. Superior Court* (1988) 206 Cal.App.3d 1025, 1028 (ownership of even one share may be sufficient to impose alter ego liability)); (*Hiehle v. Torrance Millworks, Inc.* (1954) 126 Cal.App.2d 624, 630) An active shareholder who influences and governs the corporation can be held liable



as an alter ego. (*American Home, Ins. Co. v. Travelers Indem. Co.* (1981) 122 Cal.App.3d 951, 966.)

### **Associated Vendor factors**

There is no litmus test to determine when the corporate veil will be pierced; rather the result will depend on the circumstances of each particular case. (*Mesler v. Bragg Management Co.*, *supra*, 39 Cal.3d at 300) The seminal case, *Associated Vendors, Inc. v. Oakland Meat Company*, sets out over 20 factors courts can consider in determining the existence of alter ego liability. The factors considered in piercing the corporate veil include: commingling of funds or other assets, the use of funds for something other than corporate uses, failure to maintain adequate corporate records and/or confusion of the records of the separate entities, identification of the directors and officers of the two corporations, the use of the same office or business location, the employment of the same employees and/or attorney, failure to adequately capitalize a corporation, the use of a corporation as a mere shell, instrumentality or conduit for a single venture, the failure to maintain arm's length relationships among related entities, and the use of corporate entity to procure labor, services or merchandise for another entity. (*Associated Vendors, Inc.*, *supra*, 210 Cal.App.2d at 838-840.)

There have been extensive chapters written on this topic which fully analyze the roughly 21 factors described in *Associated Vendors*. I briefly touch on the most common factors that seem to spring up in cases involving the alter ego doctrine.

#### **• Undercapitalization**

Inadequate capitalization of a corporation, in view of its planned operations, is clearly an important factor in assessing whether to pierce the corporate veil. (*Minton v. Cavaney* (1961) 56 Cal.2d 576, 579-580; *Holley v. Crank* (9th Cir. 2004) 400 F.3d 667, 675) This analysis turns on whether or not there is sufficient capital to operate the business standing alone from any other entity. Where you have a situation where the target alter ego is

floating loans or infusing monies to cover basic operating expenses, you are on your way in piercing the corporate veil.

Several courts have held that inadequate capitalization is in and of itself sufficient to find piercing of the corporate veil. (See *Automotriz del Golfo de California S.A. De C.V. v. Resnick* (1957) 47 Cal.2d 792, 799; *Laborers Clean-Up Contract Admin. Trust Fund v. Uriarte Clean-Up*

---

*“Inadequate capitalization of a corporation, in view of its planned operations, is clearly an important factor in assessing whether to pierce the corporate veil.”*

---

*Serv., Inc.* (9th Cir. 1984) 736 F.2d 516, 524; *Nilsson, Robbins, et al. v. Louisiana Hydroelec.* (9th Cir. 1988) 854 F.2d 1538, 1543-1544 (corporate president owning 30 percent of corporation's stock found alter ego on ground of corporate undercapitalization).) Where organizers of a corporation failed to invest any money at all or where the principals reduce an operating corporation to a mere shell by stripping it of its assets, piercing the corporate veil is generally upheld. (*Jack Farenbaugh & Son v. Belmont Const., Inc.* (1987) 194 Cal.App.3d 1023, 1033-1034.)

Evidence that is critical to establish this factor include financial statements, independent audit reports, investment documents from shareholders, discussions with the chief financial officer or the independent accounting firm. Facts such as capital flowing from your primary defendant to the alter ego defendant, a shareholder not investing any money into the company, or coverage of invoices made by the alter ego on behalf of the primary defendant lend to establishing undercapitalization. Obtaining invoices and check ledgers are also supportive of establishing the undercapitalization prong. Knowledge of what the shareholders placed at risk in the company is also

necessary, both from the onset of the company, as well as any capital infusions throughout the corporation's existence. An expert in the particular industry you are dealing with may also need to be obtained to opine into the proper capitalization needed for the primary defendant.

#### **• Commingled assets and operations**

Establishing common assets or conduct between the two companies will strengthen any liability under the doctrine of alter ego. Where you can demonstrate that the same facility is used, same bank accounts, or that business operations are one and the same, you are likely to bolster a claim of alter ego. Also, both companies need to maintain arm's-length transactions in order to avoid alter ego liability. A lack of receipts, or in-kind exchanges are strong facts supporting a lack of arm's-length transactions. The use of common employees and attorneys also lends to alter ego liability.

A typical game that is played when operations are commingled and the transactions between themselves appear not to be at arm's length, the corporate defendants claim that the exchange was in-kind. In other words, the corporations claim that they were essentially trading value (services, products, money) for another form of value. These claims typically fall apart when the valuation of such barter exchanges is requested. Depositions of officers of either corporation (or both) are helpful in establishing that no such valuation was ever made. The typical inquiry centers on what, if any, comparison of the exchanged services or products was made to the market price of such services and products. It is even less likely that such due diligence was ever recorded in writing.

#### **• Corporate formalities**

In closely-held companies, it is very likely that not only are the boards of directors identical or very similar, but also, the officers are similar and the companies fail to uphold corporate formalities. Board of director meeting minutes need to be requested. The less the two compa-



nies are treated as separate entities from all standpoints, the less likely they will be treated as a unit. You are likely to see that if board meetings are held, they are held at the same time but will only be treated as the board meeting for one company with the other company functioning as a line item. The failure to abide by the corporate formalities may not be enough, in itself, to obtain a finding of alter ego at trial, but should be sufficient to hurdle summary judgment.

The key to this analysis is to establish as many of the factors as possible. The more factors you can demonstrate, the stronger your equity claim will be.

### Resulting injustices if the corporate veil is not pierced

In addition to establishing the *Associated Vendors* factors, the plaintiff must also demonstrate that an injustice will result if the veil is not pierced. To establish this prong, plaintiff must show that an inequitable result would occur if the alter ego “were allowed to escape liability for [their] actions.” (*Nilsson, Robbin, et al.*, *supra*, 854 F.2d at 1544.) Inadequate capitalization is sufficient to satisfy the requirement of inequity if the corporate fiction is allowed to remain. As the California Supreme Court has held:

If a corporation is organized and carries business without substantial capital in such a way that the corporation is likely to have no sufficient assets available to meet its debts, it is inequitable that shareholders should set up such flimsy organization to escape personal liability. The attempt to do corporate business without pro-

---

*“In addition to establishing the Associated Vendors factors, the plaintiff must also demonstrate that an injustice will result if the veil is not pierced.”*

---

viding any sufficient basis of financial responsibility to creditors is an abuse of the separate entity and will be ineffectual to exempt shareholders from corporate debts. It is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unincumbered capital reasonably adequate for prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege.

(*Automotriz del Golfo de Calif. S.A. de C.V.*, *supra*, 47 Cal.2d 792, 797)

An inequity or injustice is also more likely to be found by a court if the corporate veil is not pierced in the context of a tort rather than a contract. (*Cascade Energy & Metals Corp. v. Banks* (10th Cir. 1990) 896 F.2d 1557, 1577.) The reason is that unlike contractual creditors, who voluntarily chose to deal with the corporation and could obtain protections through security agreements, a tort victim does not have any voluntary element. (*Ibid.*)

The injustice prong ultimately lies in the fact that the victim will not be fully compensated because the corporate de-

fendants failed to treat themselves as separate entities. The more egregious the companies’ violation of the *Associated Vendors* factors, the softer courts press the “injustice” prong.

### Concluding remarks

This article serves merely to provide a brief outline of the alter ego doctrine in California. Although pursuing such a claim partially transforms your personal injury case into a business litigation matter, personal injury attorneys should not shy away from pursuing such claims. Also, other vicarious liability agency theories such as agency or joint enterprise should not be ignored, you will see that there is heavy overlap in these theories. With a little work, the results of pursuing such theories can provide significant benefit to your clients.

*Ara Jabaghourian is a senior associate at Cotchett, Pitre & McCarthy, where he practices civil litigation in numerous areas. He has served as a judicial extern for Presiding Justice James Ardaiz of the California Court of Appeal, Fifth Appellate District and Justice Marvin Baxter of the California Supreme Court. He has also served as a staff attorney for the Federal Trade Commission’s Bureau of Competition in Washington, D.C.*



Jabaghourian

*He has tried numerous trials to verdict in the areas of personal injury, medical malpractice, contract disputes, corporate dissolutions, and fraudulent investment schemes.*

