THE ALTER-EGO DOCTRINE EXCEPTION IN CALIFORNIA CORPORATE LAW

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The alter ego doctrine is used to establish the direct liability of a shareholder or owner when the shareholder or owner improperly uses the corporate entity to commit acts which harm the corporation itself, or third persons involved with the corporation.

Despite the common thinking that shareholders are immune from the debts and obligations of a corporation, sometimes, in extraordinary circumstances, those shareholders can be made to answer for the corporate debts. It is a long held rule of law in California that the courts must recognize the limited liability afforded by the corporate entity. However, in certain circumstances where equity dictates, the courts may, upon a substantial showing of facts, find an exception to the rule. That exception is called the alter-ego doctrine.

The first case which deviated from the ordinary rule of separate corporate existence was decided in 1921 by the California Supreme Court in Minifie v. Rowley, 87 Cal. 481, 202 P. 673. There, the Court set forth the elements required to be present in order for the shareholders to be made liable for corporate obligations. The Minifie holding formed the basis for the alter-ego doctrine which has been evolving into a substantial body of law ever since.

BASICS OF THE EXCEPTION TO THE RULE

Under the alter-ego doctrine, when the corporate form is used to perpetuate a fraud, circumvent a statute, or accomplish some other wrongful or inequitable purpose, the courts may disregard the corporate entity and hold its individual shareholders liable for the actions of the corporation. “The separate personality of the corporation is a statutory privilege, and it must be used for a legitimate business purpose and must not be perverted. When it is abused it will be disregarded and the corporation looked at as a collection or association of individuals.” (In re: International Cab Company, No. Dist Court, Bank 98-30535 WDM). The alter-ego doctrine is intended to prevent individuals or other corporations from misusing the corporate laws by the device of a sham corporate entity formed for the purpose of committing fraud or other misdeeds.
In California, there is no litmus test for applying the alter-ego doctrine remedy, however, the courts have consistently stated that there are two general requirements for application of the alter ego doctrine:

1. There must be such a **unity of interest** and ownership between the corporation and its equitable owner(s) that the separate personalities of the corporation and its shareholders do not truly exist.

2. There must be an **inequitable result** if the acts in question are treated as those of the corporation alone., or stated differently, the failure to disregard the corporate entity would sanction a fraud or promote injustice. Robbins v. Blecher (1997) 52 Cal. App. 4th 886.


The test is easy to state, but courts have found it difficult to apply. Las Palmas Associates v Las Palmas Center Associates (1991, 2nd Dist) 235 Cal App 3d 1220, While the test is consistently stated, most cases have avoided formulas and tests and relied instead on the discretion of the trial court.

**SHOWING UNITY OF INTEREST**

In Associated Vendors, Inc., vs. Oakland Meat Company, (1962) 210 Cal App. 2d, 825, the court heard the case of a corporation sued for failure to pay lease amounts due on real property. The Plaintiff in that case sued both the corporation and the equitable owners of the corporation based on the theory of alter-ego. The trial court found that the defendant was liable for the debt, but held that it was not the alter-ego of its owners. The Plaintiff appealed and argued that the trial court was required to disregard the corporate entity because the two elements of unity of ownership and inequity were conclusively present.

On appeal, the Court stated “it is a fundamental rule that the conditions under which the corporate entity may be disregarded, or the corporation be regarded as the alter-ego of the stockholders, necessarily vary according to the circumstances in each case.” In further finding that the purpose of the alter-ego exception is “not to protect every unsatisfied creditor, but rather to afford him protection, where some conduct amounting to bad faith, wrongdoing, or inequitable purpose makes it unfair for the shareholders of a corporation to hide behind the corporate veil,” the Appellate Court determined that a trial court may disregard the corporate identity if the two-prong test originally set forth in Minifie, supra, is met, but that it was not required to do so as a matter of law.

The Appellate Court engaged in an exhaustive review of previous cases concerning the first prong of the alter-ego exception, and set forth a catalogue of factors which were pertinent to previous trial courts on the issue. Those factors tending to show a “unity of interest” are as follows:

1. Commingling of funds and assets.
2. Failure to segregate funds.
3. Diversion of funds or assets.
4. Treatment by shareholder of corporate assets as own.
5. Failure to maintain minutes.
6. Identical equitable ownership in two entities.
7. Officers and Directors of one entity same as controlled corporation.
8. Use of the same office or business location.
9. Employment of same employees.
10. Total absence of corporate assets.
12. Use of Corporation as mere shell.
13. Instrumentality or conduit for single venture of another corporation.
14. Concealment or misrepresentation of the responsible ownership, management and financial interests.
15. Concealment or misrepresentation of personal business activities.
17. Failure to maintain arms length relationships among related equities.
18. The use of the corporate identity to procure labor, services or merchandise for another entity.
19. The Diversion of assets from a corporation by or to a stockholder or other person or entity to the detriment of creditors.
20. The manipulation of corporate assets and liabilities in entities so as to concentrate the assets in one and the liabilities in another.
21. The contracting with another with the intent to avoid performance by use of the corporation entity as a shield against personal liability.
22. The use of the corporation as subterfuge for illegal transactions.
23. The formation and use of a corporation to transfer to it the existing liability.

In considering the factors on this list, appellate courts have held no one factor is conclusive. It is within the trial court's discretion to consider the presence or absence of any of these factors or other relevant circumstances. Arnold v Browne (1972) 27 Cal App 3d 386, 103 Cal Rptr 775.

**DEMONSTRABLE INEQUITABLE RESULT**

A Plaintiff may not prevail on the theory of alter-ego unless he/she/it proves to the Court that an inequitable result will occur if the Court recognizes the corporate form over the substance and nature of the injury. The doctrine does not depend upon the presence of actual fraud, but is designed to prevent what would be fraud or an injustice. Accordingly, bad faith, in one form or another, is an underlying consideration. Talbot v. Fresno-Pacific Corp., 181 Cal. App. 2d 425, 431. Without a showing of wrongdoing, violation of statute or evidence of injustice, the alter-ego exception cannot be employed by the Court as a remedy. Sonora Diamond Corp., v. Superior Court (2000) 83 Cal. App. 4th 523.
The essence of the alter-ego doctrine is that justice be done. *Mesler v Bragg Management Co.* (1985) 39 Cal 3d 290, 216 Cal Rptr 443. Although courts have considered many factors in justifying its application, their basic motivation is to assure a just and equitable result. *NEC Electronics, Inc. v Hurt* (1989, 6th Dist) 208 Cal App 3d 772, 256 Cal Rptr 441.

**CASES INTERPRETING THE ASSOCIATED VENDORS CRITERIA**

In 1985, the California Supreme Court heard the case of *Mesler v. Bragg Management Company*, 39 Cal. 3d 290; 216 Cal. Rptr. 443, 702 P.2d 601. There, the Court stated that “The essence of the alter-ego doctrine is that justice be done…..” Thus, the corporate form will be disregarded only in narrowly defined circumstances and only when the ends of justice so require.” Citing the *Associated Vendors* case, the *Mesler* Court determined that the bad faith or inequitable conduct justifying the invocation of the doctrine must be that of the party against whom it is invoked. That party must have played a part in a course of conduct which constitutes and abuse of the corporate privilege or must be seeking an inequitable advantage from the “fiction” of a separate corporate existence. The same principles apply where the entity sought to be held liable is another corporation rather than an individual.

In *Downey Savings & Loan Assn. v. Ohio Casualty Ins. Co.*, (1987) 189 Cal. App.3d 1072, the Court pierced the corporate veil as against *Downey Savings* because the facts reflected that it was a parent company owning 100% of an offending subsidiary, it shared office space and policy manuals with the subsidiary, *Downey Savings* and the subsidiary employed common personnel, and it had a consolidated financial statement with its subsidiary.

In 1991, the issue of alter-ego liability came up in the context of a motion for summary judgment in the case of *United Community Church v. Garcin*, 231 Cal. App.3d 327. There the Appellate Court overturned a trial court decision granting summary judgment and concluding that there was no triable issue of fact concerning the doctrine of alter-ego. The Appellate Court’s decision to overturn the trial court was based on the factors enunciated in the *Associated Vendors* case. The Appellate Court found that where the Plaintiff was able to show the presence of six of the factors identified in *Associated Vendors*, that was sufficient evidence to have raised a triable issue of material fact on the question of alter-ego and thus required reversal of the trial court judgment.

In *Tomaselli v. TransAmerica Ins. Co.*, (1994) 25 Cal.App. 4th 1269, the Court specifically declined to follow *Downey Savings* because there was no showing of critical facts evidencing commingling of assets, disregard for corporate formalities, or inadequate capitalization. Further, the *Tomaselli* Court stated that there was no demonstration of that critical element necessary to the finding of alter-ego liability: that an inequitable result would have followed if the corporate separateness had been respected.

In *Brooklyn Navy Yard v. Superior Court*, (1997) 60 Cal. App.4th 248, the Court heard a novel and untested question of law concerning the issue of alter-ego status. In that case, a Defendant corporation had Plaintiff’s corporate lawyer disqualified by the trial court on the basis of a conflict of interest because Plaintiff’s lawyer represented Defendants’ wholly owned subsidiary in an unrelated matter. The Plaintiff appealed the disqualification judgment and argued that there was no conflict of
interest because an attorney’s duty of loyalty to a corporate client does not bar the attorney from representing an interest adverse to the client’s parent.

The **Brooklyn Navy Yard** Appellate Court found that the disqualification was improper because the trial court used the wrong legal standard and it had failed to determine if the Defendant parent corporation and its subsidiary were the alter ego of each other. In making its decision, and due to a complete dearth of case law on point in the matter, the Brooklyn Navy Yard Court relied on the formal ethics opinion issued by The California State Bar Standing Committee on Professional Responsibility and Conduct, Opinion No. 1989-113, which reasoned that “Only in those limited circumstances where one corporation is the alter ego of the other should parent and subsidiary corporations be treated as the same entity for conflicts purposes.”

**BANKRUPTCY CLAIM AND GENERALIZED AND PARTICULARIZED INJURY**

California law distinguishes two types of alter ego claims: generalized and particularized. Generalized claims are those which derive from harm to the corporation and could be asserted by any creditor of the corporation. In other words, the corporation itself has been injured in such a way that each of its creditors is injured vicariously through the injury to the corporation. All the creditors of the corporation are affected and no particular injury exists.

Particularized alter ego claims are distinguished by direct harm to a creditor and do not derive from general harm to the corporation.

In the Bankruptcy scenario, with respect to a generalized claim, only the Debtor or Trustee has standing to assert the alter-ego claim where injury to the corporation is alleged. *In re Davey Roofing, Inc.*, 167 B.R. 604, 608 (Bankr. C.D. Cal. 1994).

A particularized creditor claim is not property of the bankruptcy estate and may only be brought by the specific party injured. The Trustee cannot assert the claim because he/she can only assert claims which benefit the entire estate. *CBS, Inc. v. Folks* (In re Folks) 211 B.R. 378, 385 (9th Cir. BAP 1997). In many circumstances, the Court will refuse to enforce the automatic stay in a particularized claim case. *Variable-Parameter Fixture Development v. Morpheus Lights, Inc.* 945 F. Supp. 603 (S.D.N.Y. 1996).

**CONCLUSION**

1. The Alter-ego doctrine is an exception to the rule.
2. The Alter-ego doctrine is an equitable remedy to prevent injustice.
3. The Court is never required to employ the Alter-ego doctrine.
4. The doctrine may only be employed on a case by case basis depending on the facts.
5. Alter-ego liability is a question of fact, not law.

6. Because the exception arises as an equitable remedy and not a cause of action, there is no right to a jury trial. *Dow Jones Co. v Avenel* (1984, 1st Dist) 151 Cal App 3d 144.

The information provided herein is not intended as legal advice and should not be acted upon. If you have additional questions about this subject matter or would like to consult with an attorney about this or related subject matters, please call Jennifer J. Hagan or James R. Hagan at The Hagan Law Firm (650) 322-8498.

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