Adiós Alter Ego

Corporate Veil Piercing in the Product Liability Suit

By Christopher T. Sheean and Edward J. Keating

Properly establishing and maintaining a multilevel corporate structure will hinder plaintiff attempts to pierce the corporate veil.

Product manufacturers in today's market face many obstacles to remain profitable, viable entities. Competition from abroad, regulation from state and federal agencies, and attacks from the plaintiffs' bar have severely damaged manufacturers' and resellers' ability to remain in business. One way that companies have responded to these ongoing threats is through consolidation and acquisition, resulting in the formation of corporate families. Adopting a tiered, corporate structure has allowed product sellers and manufacturers to economize many corporate functions such as shipping, human resources, legal, accounting, and marketing. A multilevel corporate system has many benefits, but it also comes with risk. If not properly established and maintained, adopting a corporate family approach may create unintended exposure for the shareholders and parent companies of product manufacturers and sellers.

Dating back to English common law, courts have recognized that a legally formed corporation constitutes a separate entity from its founders or owners. Courts have done this to encourage business investment. However, abuses by corporate owners who fail to operate the corporation in good faith by undercapitalizing it, or by draining its resources for their own gain, have eroded public faith in the corporate structure, and courts have responded by allowing creditors to pursue actions directly against the officers or shareholders in extreme cases. Courts have developed a series of factors to recognize when that legal separation should be maintained, and when it should be pierced.

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The Doctrine of Piercing the Corporate Veil

A corporation is a legal entity that exists separate and distinct from its shareholders, officers, and directors, who are not generally liable for the corporation's obligations, debts, or liabilities. *In re Wolf*, 595 B.R. 735, 765 (Bankr. N.D. Ill. 2018); *Curci Investments, LLC v. Baldwin*, 14 Cal. App. 5th 214, 220 (Cal. Ct. App. 2017); *Helton v. U.S. Restoration & Remodeling, Inc.*, 2016-Ohio-1232, ¶ 88, 61 N.E.3d 808, 828, *appeal not allowed,* 2016-Ohio-5585, ¶ 88; *State v. Chase*, 407 P.3d 1178, 1182 (Wash. Ct. App. 2017), *review denied*, 190 Wash. 2d 1024, 418 P.3d 802 (2018); *Stevenson v. Delaware Dep't of Nat. Res. & Envtl. Control*, 2016 WL 4473145, at *4 (Del. Super. Ct. Aug. 19, 2016). In fact, it is perfectly legal to incorporate for the express purpose of limiting the liability of the corporation's owners. Stephen B. Presser, *Limited Liability and the Doctrine of Piercing the Veil*, Piercing the Corp. Veil §1:1 (July 2018 update). However, under both state and federal common law, abuse of the corporate form allows courts to employ the equitable tool known as veil piercing, which refers to a court's disregard of an entity's corporate structure. *Thomas v. Khrawesh*, 272 F. Supp. 3d 995, 1000 (E.D. Mich. 2017); *Portfolio Fin. Servicing Co. ex rel. Jacom Computer Servs. v. Sharemax.com, Inc.*, 334 F. Supp. 2d 620, 626 (D. N.J. 2004); *Cohen v. Meyers*, 175 Conn. App. 519, 540 (Conn. App. Ct. 2017).

Piercing the corporate veil occurs regularly and is one of the most litigated issues in corporate law. Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell L. Rev. 1036 (1991). This doctrine, in certain circumstances, imposes personal liability on otherwise protected corporate officers, directors, and shareholders for a company's wrongful acts. *Wandering Trails, LLC v. Big Bite Excavation, Inc.*, 156 Idaho 586, 594, 329 P.3d 368, 376 (Idaho 2014). The underlying rationale holds that if the parent, shareholder, officer, or director disregards the corporate structure, then courts will also disregard it as far as necessary to protect individual and corporate creditors.

Although the precise parameters of the doctrine vary by jurisdiction, piercing the veil usually requires the proponent to show that (1) there is such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, and (2) an inequitable result will follow if the acts are treated as those of only the corporation. *Yoder v. Honeywell Inc.*, 104 F.3d 1215, 1221 (10th Cir. 1997). The first element is sometimes referred to as the "alter ego" situation and may be established by showing domination over and control of the corporation, which usually occurs in the context of a parent–subsidiary relationship or a closely held corporation. Here, the court must essentially determine that the subsidiary is being used as a mere instrumentality of the parent corporation or individual charged. The second element is often satisfied when the corporate form is misused, when a corporation is undercapitalized so that it cannot meet debts that are reasonably expected to arise in the normal course of business, or when a plaintiff is misled by the corporate structure of an enterprise.

Whether these elements are satisfied is a question of fact that depends on the circumstances of each case. In *Yoder*, the court applied Colorado law in a product liability action based on an allegedly defective computer keyboard, and held:

> whether a subsidiary is an instrumentality of the parent is based on evaluating these elements: (1) The parent corporation owns all or majority of the capital stock of the subsidiary. (2) The parent and subsidiary corporations have common directors or officers. (3) The parent corporation finances the subsidiary. (4) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation. (5) The subsidiary has grossly inadequate capital. (6) The parent corporation pays the salaries or expenses or losses of the subsidiary. (7) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation. (8) In the papers of the parent corporation, and in the statements of its officers, "the subsidiary" is referred to as such or as a department or division. (9) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent corporation. (10) The formal legal requirements of the subsidiary as a separate and independent corporation are not observed.

104 F.3d at 1221.

In *Simeone ex rel. Estate of Albert Francis Simeone, Jr. v. Bombardier-Rotax GmbH*, 360 F. Supp. 2d 665, 675–676 (E.D. Pa. 2005), a product liability action based on an allegedly defective aircraft engine, the court held the following factors were a "non-exclusive guide" to determine whether a subsidiary will be considered the alter ego of its parent:

> (1) ownership of all or most of the stock of the subsidiary; (2) common officers and directors; (3) a common marketing image; (4) common use of a trademark or logo; (5) common use of employees; (6) an integrated sales system; (7) interchange of managerial and supervisory personnel; (8) performance of business functions by the subsidiary which the principal corporation would normally conduct through its own agents or departments; (9) marketing by the subsidiary on behalf of the principal corporation, or as the principal's exclusive distributor; and (10) receipt by the officers of the subsidiary corporation of instruction from the principal corporation.

In *Patterson v. Home Depot, USA, Inc.,* 684 F. Supp. 2d 1170, 1178 (D. Ariz. 2010), the court, applying Arizona law in a product liability action where a ladder allegedly malfunctioned and collapsed, analyzed the following factors in determining whether a parent and subsidiary demonstrate a "unity of control" necessary to pierce the corporate veil: stock ownership by the parent; common officers or directors; financing of the subsidiary by the parent; payment of salaries and other expenses of the subsidiary by the parent; failure of the subsidiary to maintain formalities of separate corporate existence; similarity of logo; and the plaintiff's lack of knowledge of the subsidiary's separate corporate existence.

In *Seasword v. Hilti, Inc.*, 449 Mich. 542, 548 n.10 (Mich. 1995), the Michigan Supreme Court rejected the plaintiff's argument that the parent corporation could be liable in a product liability action alleging the negligent design of a power drill, absent a showing that the

> subsidiary is a "mere instrumentality" of its parent [by proof that] the parent and subsidiary shared principal offices, or had interlocking boards of directors or frequent interchanges of employees, that the subsidiary is the parent's exclusive distrib-

uting arm, or the parent's revenues are entirely derived from sales by the subsidiary.

Similarly, in *McConkey v. McGhan Med. Corp.*, 144 F. Supp. 2d 958, 962–63 (E.D. Tenn. 2000), the court applied Tennessee law in a product liability action based on allegedly defective silicone breast implants, and it held that former parent company 3M was not liable under a veil-piercing claim where the sole evidence supporting the claim was a $5.5 million loan made to finance the establishment of McGhan four years before the subject products were sold.

Courts throughout the country apply these factors, but often the countervailing consideration is whether the alleged failure to maintain separate entities resulted in an unfair advantage or otherwise inequitably deprived the plaintiff of an adequate recourse.

Plaintiffs' Strategies

The issue of piercing the corporate veil arises most often when a plaintiff seeks to hold shareholders liable for the obligations of an insolvent corporation, but the doctrine may also be used to pursue a claim against the parent company of a product manufacturer or reseller for other reasons. Plaintiffs frequently bring disingenuous piercing-the-veil claims in an effort to harass or intimidate the defendants' decision makers during litigation, thereby gaining leverage in settlement negotiations.

To substantiate their claims, plaintiffs will seek extensive discovery of the defendants' corporate structure or hierarchy. Plaintiffs may also attempt to depose high-level executives in the corporation as well as lower-level employees. Forcing the defendant company to prepare and present a C-suite executive is an added aggravation and expense for the defendant. The goal of these depositions is to paint a picture that portrays the corporate structure as improperly benefiting an owner, director, officer, or parent company, and harming the public by shielding documents, hiding assets, and preventing the plaintiff's counsel from obtaining a full and fair understanding of the defendant parent corporation's conduct and assets. Accordingly, it is imperative that the parent and subsidiary take the necessary steps to avoid the potential for a veil-piercing claim, and for defense counsel to respond to discovery and prepare corporate witnesses to explain fully and completely the separation between parent and subsidiary to avoid any adverse finding.

The Punitive Damages Threat

The single greatest threat the parent of a product manufacturer or reseller faces when dealing with a veil-piercing claim is the potential for punitive damages. Most jurisdictions structure compensatory damages as economic, *i.e.*, those damages intended to compensate a plaintiff for his or her actual expenses, and noneconomic, such as pain and suffering, loss of enjoyment, etc. Assuming the subsidiary product manufacturer or reseller is properly capitalized, including a parent or affiliate company would not add to the amount of money available to satisfy a judgment, rendering a claim for liability against the parent company largely superfluous. However, punitive damages are intended to punish the defendant or defendants. *Ex parte Vulcan Materials Co.*, 992 So. 2d 1252, 1260 (Ala. 2008) (holding the purpose of punitive damages is to punish the wrongdoer). *See also Alain Ellis Living Tr. v. Harvey D. Ellis Living Tr.*, 308 Kan. 1040, 1051, 427 P.3d 9, 18 (Kan. 2018) (holding punitive damages are awarded to punish the wrongdoer); *Trinity Evangelical Lutheran Church & Sch.-Freistadt v. Tower Ins. Co.*, 2003 WI 46, ¶ 50 (holding "the purpose of punitive damages is to punish the wrongdoer, and to deter the wrongdoer and others from similar conduct…"); *Owens-Corning Fiberglas Corp. v. Malone*, 972 S.W.2d 35, 40 (Tex. 1998) (holding, "the purpose of punitive damages is to punish a party for its outrageous, malicious, or otherwise morally culpable conduct") (internal quotations omitted); *Whetstone v. Binner*, 2014-Ohio-3018, ¶ 16, *aff'd*, 2016-Ohio-1006, ¶ 16, 146 Ohio St. 3d 395 (holding the purpose of punitive damages is to punish and deter certain conduct).

The plaintiff is generally permitted to introduce evidence of corporate net worth to educate the jury on the amount necessary to punish the defendants. In a case where a corporate parent is a co-defendant with the product manufacturer or reseller, the plaintiff's counsel will typically seek discovery on the net worth of the subsidiary as well as the parent corporation. *Medivision of E. Broward Cty., Inc. v. Dep't of Health & Rehab. Servs.*, 488 So. 2d 886, 888 (Fla. Dist. Ct. App. 1986) (holding the financial documents of the subsidiary's parent corporation were subject to discovery where the subsidiary and its parent corporation acted "as one"); *Cap Gemini Am., Inc. v. Judd*, 597 N.E.2d 1272, 1286 (Ind. Ct. App. 1992) (holding the financial documents regarding the wealth of a parent corporation are admissible if the subsidiary was merely an instrumentality of the parent corporation). *Grosek v. Panther Transp., Inc.*, 251 F.R.D. 162, 166 (M.D. Pa. 2008) (holding the subsidiary had a duty to produce discovery regarding the financial condition of its parent corporation because the two entities had a "business relationship").

Where the subsidiary/product manufacturer is one of several subsidiaries of a parent company's corporate family, the parent company's net worth is often substantially greater than that of the subsidiary. Unfortunately, as a result, a jury will likely take the larger net worth figure as an indication that a greater amount of punitive damages is needed to punish the defendants thereby increasing the defendants' exposure. Accordingly, the parent company in a products liability lawsuit has a strong motivation to avoid even the threat of facing punitive damages.

Defense Strategies

The best defense to attempts to pierce the corporate veil is to avoid the appearance of an alter ego between the subsidiary and parent companies. As noted above in the section discussing the factors that courts consider in analyzing a claim of piercing the veil, the parent and subsidiary must maintain the corporate formalities. For instance, the parent and subsidiary should have separate boards and hold separate board meetings, and the parent should hold stock in the subsidiary. The companies must maintain separate financial records and accounts, and conduct their affairs at arms' length. If the parent company provides accounting, legal, human resources, or other services, an agreement memorializing the arrangement should be executed, with documentation of the consideration paid annually for such services. How the subsidiary and its products are marketed to the public is also important. The public should be aware that the subsidiary is different from the parent.

If faced with a claim against the parent based on an alter ego theory, defense counsel should pursue a motion to dismiss for failure to state a claim. A plaintiff alleging a piercing the veil claim is required to come forth with factual allegations for both elements of the veil-piercing claim to avoid dismissal. *Murray Eng'g P.C. v. Remke*, 2018 WL 3773991, at *9 (S.D.N.Y. Aug. 9, 2018). Often, plaintiffs attempting to pierce the corporate veil cannot allege sufficient facts to support their claim. In particular, plaintiffs frequently struggle to plead facts showing that their injuries were caused by an improper corporate structure.

In the event the plaintiff survives the motion to dismiss stage, defendants should move for summary judgment. Many times, even if sufficiently pled, the plaintiff cannot provide evidence supporting allegations that the corporate form was misused or that such misuse caused any harm. In anticipation of moving for summary judgment, defendants should carefully prepare fact witnesses for depositions. The goal in depositions of corporate employees is to avoid providing vague or inaccurate information that the plaintiff can spin into a genuine issue of fact preventing judgment as a matter of law on their veil-piercing claim.

Conclusion

Courts recognize the value of maintaining a corporate shield to protect investors and officers from the corporation's liabilities. However, where the corporation fails to maintain and demonstrate a distinction between the assets of the company and those of its shareholders adequately, or when it has engaged in what amounts to fraudulent activity to strip the assets or capital of the company to hide it from creditors in favor of its officers or shareholders, courts will invoke the equitable doctrine of piercing the corporate shield. It is incumbent on counsel for the corporation to provide sound advice to ensure that the company and its shareholders, parents, and affiliates maintain separate and distinct accounts, and that they properly document all transfers. Failing to do so may increase the overall exposure of the company, its affiliates, and its shareholders. FTD