Alter Ego Piercing, The Mists of Metaphor

Empirical studies have some surprising results on the frequency of ego piercing in litigated cases and which factors predominate when it does occur.

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Most civil practitioners and civil trial judges, somewhere along the line, have confronted alter ego-piercing issues. It first gained traction in the U.S. in judge Benjamin Cardozo's dicta in an early New York case involving a personal injury plaintiff suing a parent as the real culprit which should bear liability for a subsidiary railway defendant's conduct. Berkey v. Third Avenue Railway Co., 244 N.Y. 84, 155 N.E 48 (1926). Although many may think that this is a claim, in California it is more in the nature of an equitable procedural remedy tangentially hitched to a substantive cause of action. Hennessey's Tavern, Inc. v. American Air Filter Co., 204 Cal. App. 3d 1351, 1358-59 (1988). Most importantly, it is an equitable issue to be resolved by the trial court, see Dow jones Co. V. Agenual, 151 cal. App. 3d 144, 147-48 (1984), with strategic issues faced on a daily basis on whether to bifurcate the issue, to let the trial court listen to evidence on the issue during the trial for a later decision, or to request a jury advisory verdict subject to subsequent judicial review. No matter what, the trial judge in the case is the ultimate trier of fact on an alter-ego-piercing issue.

However, what may be surprising is that there are empirical studies that show how frequently alter ego piercing occurs, that provide insight into the contexts where it occurs (although the findings are not uniform), and that have some elucidation of which factors are persuasive in driving alter ego determinations. The results are mixed: some expected and some Surprising. But, first, some introductory principles on the alter ego doctrine are provided.

Alter Ego Piercing: Some Specific Principles

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There are two prongs that must be satisfied in order to justify alert ego piercing such that a shareholder is liable for corporations liabilities or a limited liability company (LLC) member is liable for an LLC's liabilities: (1) disregard of legal formalities and a failure to maintain arm's length relationships among r3lated entities; (2) failure to maintain minutes or adequate corporate records; (3) confusion of recordkeeping amount the separate entities; (4) failure to segregate funds among the separate entities; (5) commingling of funds and other assets; (6) the total absence of corporate assets and undercapitalization; (7) the failure to issue stock; (8) sole ownership of corporate stock by one individual or family members; (9) overlapping officers and directors; (1) the use of the same office or business location; (11) employment of the same employees and/or attorneys; (12) the unauthorized diversion of corporate funds or assets to other than corporate uses; (13) the use of a corporation as a mere shell, instrumentality, or conduit; (14) the diversion of assets from a corporation by or to a shareholder; (15) the concealment and misrepresentation of the identity of responsible ownership, management, financial interests; (16) the use of the corporate entity to procure labor, services, or merchandise for another person or entity; (17) intentionally contracting with another to avoid performance by the use of a corporate entity as a shield against personal liability; (18) use of a corporation as a subterfuge of illegal transactions; and (19) formation and use of a corporation to transfer to it the existing liability of another person or entity.

The "injustice" prong is most frequently established in cases where there was perpetration of a fraud, circumvention of a status, or commission of "other misdeeds" such as using corporations to make usurious loans. *Sonoma Diamond Corp. v. Superior Court* 83 Cal. App. 4th 523, 538 (2000); *Wheeler v. Superior Mortgage Co.*, 196 Cal. App. 2d 822, 830 (1961).

Studies on the Frequency of Alter Ego Piercing; It Happens More Than You Think

Many cases express the view that the alter ego doctrine should be used sparingly and with caution, sometimes stating it is an extreme remedy. Sonoma Diamond Crop., 83 Cal. App. 4th at 539; Las Palmas Assoc., 235 cal. app. 3d at 1249. Despite these

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pronouncements about the doctrine's limited utility, it is surprising what some surveys show about the frequency with which piercing occurs both in the United States, in general, and California specifically. It happens a lot.

In a 1991 study of 1,600 reported Westlaw decisions through 1985, Professor Thompson concluded that alter ego was the "most litigated issue in corporate law." He found that U.S. courts pierced the corporate veil 40.18% of the time (with very slight differences between federal and state courts), and that California courts pierced 45% of the time. see Robert B. Thompson, Piercing the Corporate Veil: An Empirical study, 76 Cornell L. Rev. 1036, 1048-49, 1051 (1991). A subsequent random sampling of Westlaw cases from 1985-1995 showed that U.S. courts pierced the corporate veil in 35.53% of cases, with federal courts doing it 7% more than state courts, but with no reporting of California's piercing percentage breakdown. Lee C. Hodge & Andrew B. Sachs, Piercing the mist: Bringing the Thompson Study Into the 19902, 43 Wake Forest L. Rev. 341, 347, 349, 350 (2008). Then, an updated analysis of Westlaw cases from 1996-2005 demonstrated that U.S. courts pierced the corporate veil in 27.12% of cases (30.33% state versus 23.68% federal), with California clocking in at 33.33%. Richard McPherson & Nader Raja, Corporate Justice: An Empirical Study of Piercing Rates and Factors Courts Consider When Piercing the Corporate Veil, 45 Wake Forest L. Rev. 931, 940, 947, 949 (2021). A subsequent study of Westlaw/LEXIS cases from 1990 to April 1, 2008 under a regression analysis showed that U.S. courts pierced the corporate veil 31.86% of the time (29.53% federal versus 34.19% state), with no individual California reporting. John H Matheson, Why Courts Pierce: An Empirical Study of piercing the Corporate Veil, 7 Berkeley Business L.J. 1, 10, 14, 17 (2010). Another survey of 2,908 piercing cases through 2006 found that U.S. corporate veil piercing happened 48.51% of the time, with no large discrepancy between state/federal courts and with piercing in California occurring 50.86% of the time. Peter B. Oh, Veil-Piercing 89 Texas L Rev. 81, 99, 107-08, 115, 118-19 (2010).

The upshot, here, is that alter ego piercing does not occur, statistically, as sparingly as judicial decisions say it should; rather,

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piercing happens a third to one half of the time even discounting for statistical error and differences in methodology.

Contest in Which Piercing Occurs: Again, Some Surprising Results; Others Not So Much

Although there are some variations in empirical study results, a summary of what they show yields some more surprises as far as the contexts in which alter ego piercing occurs.

First of all, a synopsis of these studies—and they are not uniform in consensus —surprisingly suggests that courts pierce more in contract rather than tort cases. Thompson, McPherson and Raja, and Matheson, in their studies, agreed with this trend. Hodge and Sachs as well as Oh found piercing more likely in tort cases (especially fraud situations). rather than nonfraudulent contract or nonfraudulent tort cases. This is a surprising result with respect to piercing frequency happening more often in contract cases, if the prevalent data is correct.

Second, the studies uniformly agreed that piercing occurred more frequently where a sole shareholder or small group of closely held owners were involved, as opposed to a corporation with a large number of shareholders (such as where a publicly held company was involved). Put another way, the likelihood of piercing increased as the number of shareholders decreased. Closely aligned with these findings is that alter ego piercing does not occur as much for passive versus active shareholders. This is not a surprising result.

Third, in the parent-subsidiary corporate context, it appears as shown by most of the studies and one targeted study, that piercing in this cont4ext occurs half as often as piercing does generally. The targeted study concluded that parent-subsidiary piercing happened 20. 56% of the time, as compared to the overall 40%-plus piercing on an across-the-board comparison for all situations. John H Matheson, e Modern law of Corporate groups; An Empirical Study of Piercing the Corporate Veil in the Parent-Subsidiary Context, 87 N.C. L. rev. 1091, 1114-15 (2009). Although this may be a somewhat counterintuitive result in the parent-subsidiary context, it may be explained by the fact that these situations involve larger entities such that the “smaller gets pierced more” theme resonates

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in more cases than not for purposes of explaining the "delta" discrepancy in piercing.

Finally, in this area, piercing does occur very frequently for government plaintiffs where there is a strong statutory or policy reason to support piercing (examples: environmental; ERISA; labor relations; tax fraud; bankruptcy fraud). These frequencies in piercing would seem to be what would be expected, as the empirical studies uniformly confirm. With respect to qualitative factors which were impactful in this area, use of such words as "workmen's compensations;" "hazardous substances;" 'release was hazardous;" "CERCLA;" "Statutory scheme;" "trustee power;" "reorganize debtor;" "trustee avoidance;" and "debtor incurred" scored well in situations where alter ego piercing occurred.

Factors That Give Rise to Piercing: Some Are Pretty standard, but Surprises Again Abound

Then the empirical studies are synthesized somewhat (because there are variances), here are the Associated Vendors and injustice factors that have the most persuasive impact when it comes to frequency of alter ego piercing.

- Fraud/Misrepresentation. In all of the empirical studies, the presence of these factors was huge when it came to actual piercing. Thompson reported that the absence of misrepresentation results in no piercing 92.33% of the time. Thompson, supra, at 1065-65 n. 141. Other studies have confirmed that the presence/absence of these factors are huge in determining whether piercing occurs. 1010 Matheson, supra, at 52-53, 60 [presence of fraud increased the odds of piercing by a 10.788 factor where contract was the reference category and by 11.288 when tort was the reference category and by 11.288 when tort was the referent; data suggests that fraud, above all other factors, may be necessary to prove in order to attain a pierce]; Oh, supra at 125 {civil veil-piercing rate for fraud exceeds that of any other type of civil substantive claim]; McPherson & Raja, supra, at 957-61 [92.31% pierce rate for presence of misrepresentation and no piercings at all where was a lack of the misrepresentation

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factor]; Macey & Mitts, Finding order in the Morass: The Three real Justifications for Piercing the Corporate Veil, 100 Cornell L. Rev. 99, 148 (2014) [misrepresentation was a strong topical category].

- Undercapitalization. Curious as seems, case law is not crystal clear that undercapitalization alone is a factor which can support an alter ego finding. Compare Harris v. Curtis, 8 Cal. App. 3d 837, 841 (1970); Sakata v. Cook, 2006 WL 164915 at *5 (Jan. 24, 2006 unpublished) [rejecting notion that undercapitalization, per se, can establish alter ego piercing] with Mechitech Motorsports, Inc. v. All Mechtech, LLC, 2014 WL 6970905 at *5 n.5 [not deciding the issue, with the appellate court observing that Associated Vendors did not rule it out]. Tow well-regarded legal practitioners have opined that one of the most important, powerful factors in alter ego analysis in undercapitalization, See A. Jabagchourian, Establishing "Alter Ego" Liability, Plaintiff Magazine (Dec. 2009); E Susolik, Piercing the Corporate Veil to Collect Damages, Plaintiff Magazine (June 2019). Empirical research casts doubt on the strength of this conclusion, however, when compared to factors like misrepresentation. Thompson found undercapitalization led to piercing 73% of the time where piercing actually occurred (Thompson, supra, at 1064), Matheson clocked in at 77.3% (2010 Matheson, supra, at 33), Oh found 61.56% piercing under this rationale (Oh, supra, at 134), Macey & Mitts found this Matheson, in parent-subsidiary piercing, found that undercapitalization resulted in 70.5% of piercings versus 92.3% where fraud was present (2009 Matheson, supra, at 1124, 1130)—much less than piercing where fraud was present or was present in tandem with undercapitalization. While undercapitalization is not to be ignored, it is weaker factor than one might supposed based on available studies.
- Owner Dominion and Control/Commingling. Owner dominion and control, as well as commingling, were strong factors which militated in favor of alter ego piercing, with words such as "instrumentality," "dummy," "lack of substantive separation," "dominion and control," and "intertwining" getting receptive

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treatment. See Thompson, supra, at 1063-64 [85.11-97.33% piercing]; McPherson & Raja supra, at 962 [94.12-100% piercing]; 2010 Matheson, supra, at 53-55 [presence of dominance/control increased the odds of a pierce by a factor of 5.854 for contract cases and 5.663 for tort cases; for commingling, 4.376 odds increase as a factor in contract cases and 4.277 increase for tort cases]; and 2009 Matheson, supra, at 1124-28, 1130 [in parent-subsidiary context, parent absolved from liability 97.9% of the time if commingling not there].

- Commonality in Office Space/Ownership, and Overlap in Officers, Directors of Employees. Consistently, the empirical studies show that these factors are much weaker as far as leading to piercing unless other indicia of intertwining of non-existent management are present, although overlapping officers, directors, and employees were stronger than the other factors. See Thompson, supra, at 1063-64 [common employees: 69% of the time; common management: 65%; common offices: 59%; common officers: 50%; common directors: 43%; common owners: 49%; total overlap: 56.53%]; McPherson & Raja, supra, at 958-60 [common officers: 46.67%; common officers: 66.67%; common directors: 69.23%; common owners: 59.38%]; 2010 Matheson, supra, at 1124 [overlap resulted in piercing 48% of the time]. This is overall consistent with case law assigning little or lesser weight to these factors. See, e.g., Tomaselli v. Transamerica Co., 25 Cal. App. 4th 1269, 1285 (1994) [Parent's 100% ownership of subsidiary's stock, sharing of office space/policy manuals, an preparation of consolidated financial statements fell short of proving alter ego relationship].
- Failure to Follow Corporate Formalities. This was a weaker factors than one might intuitively surmise on the alert ego "persuasiveness" bell curve. See Thompson, supra, at 1064 [66.89% piercing]; McPherson & Raja, supra at 960, 964 [74.29%; compared to other factors, the least important consideration according to the authors]; 2010 Matheson, supra, at 55 [this factor not statistically significant in the models, although corporate formality more important in the

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individual liability than parent-subsidiary context]; Oh, supra, at 133 [61.30% overall]; 2009 Matheson, supra, at 1124, 1131 [75% piercing in parent-subsidiary situation].

- Injustice/Fairness. As one would suspect, these are huge factors which will support an alter ego finding. See Oh, supra at 134, 137 [although isolated rate is 51.35%; piercing leaps to 64.27% when cases involving fraud are excluded, suggesting that fraud and misrepresentation are predominant piercing factors such that injustice is an important construct]; 2009 Matheson, supra at 1124, 1131 [in parent-subsidiary setting, piercing in 92.6% of cases where this factor setting, piercing in 92.6% of cases where this factor was present; courts refused to pierce in 95.2% of cases where unfairness was not present].

Conclusion

Several judges and legal commentators have lamented that application of the alter ego doctrine is "enveloped in the mists of metaphor" or "seems to happen freakishly' like lightning in rare, severe, and unprincipled fashion. Aside from the fact that piercing occurs more frequently than practitioners and judges might think, it does occur in situations where there is fraud, misrepresentation, owner dominion/control, and/or injustice. Other factors are less predictable, with a raging debate on whether piercing occurs more in contract versus tort cases. All of these variables give great leeway to legal practitioners to shape the law in this area—either bearing out the empirical trends or slanting them in a different direction in the future. However, knowing what the studies show may help guide litigation strategies when confronting alter ego issues in ongoing cases.

For more information, please contact any attorney with Frost Brown Todd's Business & Commercial Litigation.

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