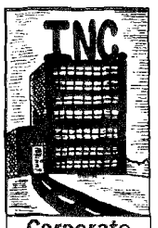
Bad Faith Can Pierce Corporate Shield

By Daniel Lee Jacobson

"Let who will boast their courage in the field, I find but little safety from my shield."

— Samuel Butler

Humankind has long been concerned about the safety afforded by a shield. That safety is dependent upon the strength of the shield relative to the strength of an offending spear.



Corporate Law

In law the shield that protects the owners of a corporation is the corporation itself. The weapon of choice, the spear used against the corporate shield, is the alter ego doctrine. How and when that doctrine works defines the spear and the shield used in the battle to reach shareholders' assets.

"Normally, a corporation is a legal person or entity which has a separate existence from that of its shareholders." Thus, a corporate debt should not be a debt of the corporation's shareholders. *Say & Say v. Ebershoff,* 20 Cal.App.4th 1759 (1993). The alter ego doctrine is one of equity. *Hall, Goodhue, Haisley, & Barker Inc. v. Marconi Conf. Center,* 41 Cal.App.4th 1551 (1996); *Doney v. TRW Inc.,* 33 Cal.App.4th 245 (1995). The outcome of an alter ego allegation "rests largely upon the facts peculiar to each case." *Harris v. Curtis,* 8 Cal.App.3d 837 (1970). "[T]he determination as to whether or not these requirements [regarding the application of the alter ego doctrine] have been established by the evidence is primarily one for the trial court." *Jack Farenbaugh v. Son & Belmont Construction,* 194 Cal.App.3d 1023 (1987).

Sometimes the process of reaching through a corporation to get to the shareholders' assets is called "piercing the corporate veil." *Automotriz del Golfo de California S. A. de C. V. v. Resnick,* 47 Cal.2d 792, dissent of Carter, J. (1957). Sometimes it is called "disregarding the corporate entity." *People v. Clauson,* 231 Cal.App.2d 374 (1964).) Notwithstanding the flexibility of equity, the alter ego doctrine can be applied only in limited circumstances. *Webber v. Inland Empire Invs.,* 74 Cal.App.4th 884 (1999).

The California Supreme Court has laid out the general test for application of the alter ego doctrine: "It has been stated that the two requirements for application of this doctrine are 1) that there be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist; and 2) that if the acts are treated as those of the corporation alone, an inequitable result will follow." *Automotriz,* citing *Stark v. Coker,* 20 Cal.2d 839 (1942); and *Watson v. Commonwealth,* 8 Cal.2d 61 (1936).

Mid-Century Insurance v. Gardner, 9 Cal.App. 1205 (1992), describes considerations for a court to weigh in deciding if there is "such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist," the first prong of the *Automotriz* test.

"The relevant considerations include 1) the commingling of funds and other assets; 2) the failure to segregate funds of the individual and the corporation; 3) the unauthorized diversion of corporate funds to other than corporate purposes; 4) the treatment by an individual of corporate assets as his own; 5) the failure to seek authority to issue stock or issue stock under existing authorization; 6) the representation by an individual that he is personally liable for corporate debts; 7) the failure to maintain adequate corporate minutes or records; 8) the intermingling of the individual and corporate records; 9) the ownership of all the stock by a single individual or family; 10) the domination or control of the corporation by the stockholders; 11) the use of a single address for the individual and the corporation; 12) the inadequacy of the corporation's capitalization; 13) the use of the corporation as a mere conduit for an individual's business; 14) the concealment of the ownership of the corporation; 15) the disregard of formalities and the failure to maintain arm's-length transactions with the corporation; and 16) the attempts to segregate liabilities to the corporation."

Equitable considerations such as those listed above are not elements that all have to be present in order for the doctrine to apply; rather they are factors for the court to weigh. In a particular case there might be only a couple of the factors present, but those factors may exist in egregious abundance; a court might find the first prong of the *Automotriz* test satisfied under such a circumstance. In another case there may be more factors present, but only in tiny quantities; a court might find in that case that the shareholder and corporate identities are separate.

The second prong of the *Automotriz* test is an inquiry into whether, "[i]f the acts are treated as those of the corporation alone, an inequitable result will follow." Some courts have called for "inequitable result" "fraud or injustice" (see *Westinghouse Electric Corp. v. Superior Court of Alameda County,* 17 Cal.3d 259 (1976)), but the cases make it clear that, "it is not necessary that actual fraud be shown," (*Wenban Estate Inc. v. Hewlett,* 193 Cal. 675, 698 (1924); "inequitable results" are "sufficient." *Minifie v. Rowley,* 187 Cal. 481, (1921).

There is an issue as to whether the act preceding the inequitable result must be done in bad faith. In *Claremont Press Publishing Company v. Barksdale,* 187 Cal.App.2d 813 (1960), there was no bad faith; in fact there was no act constituting any sort of moral reprehensibility.

For some reason, perhaps the obviousness of the facts or the malleability of equity, bad faith is not always stated as a requirement, but it is virtually always present as a fact.

But, a survey of reported cases suggests that *Claremont Press* is an anomaly. The Supreme Court has ruled on this issue twice, and in both instances it has said that "bad faith in one form or another" is a prerequisite to a finding of alter ego. *Westinghouse*; and *Hollywood Cleaning & Pressing Co. v. Hollywood Laundry Service Inc.,* 217 Cal. 124 (1932). And while there are many reported cases wherein the appellate court has not expressly ruled that bad faith is an element, in the vast majority of such cases surveyed bad faith did exist, whether the court said so or not; the acts upon which the alter ego findings were based smelled of bad faith.

For instance, in *Wilson v. Stearns,* 123 Cal.App.2d 472 (1954), the court never mentioned the words bad faith, but the facts in Wilson suggest that a very purpose of forming the corporation was to hide behind that corporation. Similarly, in *Talbot v. Fresno-Pacific Corp.,* 181 Cal.App.2d 425 (1960), the court did not rule on the issue of bad faith, but the individual defendant whose assets were sought was evasively transferring assets amongst various corporate and non-corporate entities that she owned. For some reason, perhaps the obviousness of the facts or the malleability of equity, bad faith is not always stated as a requirement, but it is virtually always present as a fact.

Both *Associated Vendors Inc. v. Oakland Meat Co.,* 210 Cal.App.2d 825 (1962), and *Pearl v. Shore,* 17 Cal.App.2d 608 (1971), call bad faith an "underlying consideration." In the context of these two cases the word consideration could be elevated so that it has the binding power of the words requirement or element because both cases say that the bad faith consideration, "will be found in some form or another in those cases wherein the trial court was justified in disregarding the corporate entity."

This all leads to the inescapable conclusion that the great weight of authority teaches that the acts in the second prong of the *Automotriz* test must be done in bad faith in order for an alter ego finding to be sustained.

The *Automotriz* dictate that an inequitable result must follow the acts seems to carry with it a requirement of proximity.

In all of the cases surveyed where the alter ego doctrine was said to apply, the inequitable result was proximately related to the acts; one led to the other. In *Retail Clerks Union v. Bloom Sons Co.,* 173 Cal.App.2d 701 (1959), the doctrine did not apply; in that case the alleged injustice was far removed in both time and purpose from the alleged act. A union entered into a contract with three retail stores (all owned by the same corporation), and then sought enforcement of that contract with a fourth store that was owned by a separate corporation. The union claimed that the owner of the fourth store was the alter ego of the owner of the three stores. But, the entity that owned the fourth store was formed long before the dispute with the union arose, and the purpose of forming that entity had nothing to do with the dispute with the union. The court would not allow the plaintiff to reach the entity that owned the fourth store; the injustice did not follow the act; one did not lead to the other. There was no nearness in time, purpose, or relationship.

The corporation is a shield, a good shield when properly constructed and maintained. But, when that shield and its owners, the shareholders, no longer have separate personalities, and there is a bad faith act that would result in an inequity if the corporate existence were recognized, the spear of the alter ego doctrine can pierce the corporate shield.

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