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PRIVATE EQUITY

"MY PORTFOLIO COMPANY DID WHAT!?"

BY HOWARD O. GODNICK

Private Equity and the Perils of Alter Ego Liability

A private equity ("PE") firm has been named as a defendant in an action arising out of an alleged breach of contract, or tort committed, by its portfolio company. The PE firm is not a party to the contract; nor did the PE firm have notice of the negligence. However, recognizing a deep (or deeper) pocket when it sees one, and seizing on a perceived opportunity to gain leverage in the litigation towards a hefty settlement, the plaintiff names the PE firm as a defendant, alleging that the portfolio company is a mere alter-ego of the PE firm, and asking the court to pierce the portfolio company's corporate veil, disregard the PE firm's limited liability, and hold the PE firm liable for the portfolio company's breach of contract or negligence.

The foregoing scenario is lifted straight from the plaintiff playbook, and has cost PE firms and other parent companies millions of dollars in motion practice, invasive (and, at times, potentially embarrassing) discovery into the relationship between the PE firm and the portfolio company, settlements and judgments.[1] Indeed, given the inherently fact-based nature of an alter-ego claim, even the most frivolous of piercing-the-corporate-veil lawsuits will often survive a motion to dismiss, opening the door for a plaintiff to engage in a discovery fishing expedition in an effort to substantiate what had been conclusory claims of the PE firm's domination and control of, or improper relationship with, the portfolio company.

PE firms are not without defense to claims designed to pierce their portfolio companies' corporate veil, and those lawsuits *can* be defeated at the early stages of litigation. To do so requires an understanding of and adherence to the general principles that form the basis for limited liability in the management of, and relationship with, a portfolio company.

[1] *See, e.g., Nassau Construction Co., Inc. v. Pulte Homes, Inc.*, No. 07-5536, 2008 WL 2235609, at *5 (D.N.J. May 29, 2008) (court refused to allow plaintiffs to impose the expense of discovery and depositions on defendants when no specific allegations of wrongdoing were made regarding the defendant's undercapitalization).

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The Rule: Limited Liability

Limited liability is a privilege of the corporate form that is "deeply ingrained in our economic and legal systems."[2] It is the bedrock of American corporate law that a corporation is recognized as a legal entity separate and apart from its shareholders, including a parent corporation, and that a parent corporation will not be held liable for the acts of its subsidiary. Of course, the same holds true for the limited liability relationship between a PE firm and its portfolio company. As Justice Douglas of the U.S. Supreme Court put it: "Limited liability is the rule, not the exception; and on that assumption large undertakings are rested, vast enterprises are launched, and huge sums of capital attracted."[3]

In light of those fundamental precepts of limited liability, courts recognize a "presumption of separateness" with respect to all corporations, which a litigant must overcome to impose liability on a parent company for the debts of its subsidiary.[4] Typically, to overcome this presumption, a plaintiff must show that a controlling person or entity of the subsidiary used the subsidiary as a sham to perpetuate a fraud, or has otherwise conducted the business of the subsidiary in a fraudulent or inequitable manner.

The Exception: Piercing the Corporate Veil

Plaintiffs seeking to avoid the presumption of limited liability for corporations and reach the deep pockets of a PE firm often assert claims designed to pierce the corporate veil. Although veil-piercing is an extraordinary remedy reserved for rare circumstances,[5] the high threshold hardly deters plaintiffs from trying to pick the deep pocket of a parent corporation regardless of the circumstances. Thus, veil-piercing complaints are often littered with conclusory catchphrases borrowed from decisions and hornbooks, such as "dominated and controlled," "alter-ego," "mere instrumentality" and "puppet-master." But, such catchphrases are not (or should not be) enough to either impose liability on a parent company, or even allow a case to proceed beyond a motion to dismiss.

The elements for piercing the corporate veil vary from one jurisdiction to another. As a general rule, however, to pierce the corporate veil, a litigant must demonstrate all or some combination of the following elements: (1) complete domination and control; (2) fraud, inequity or misuse of that control; and (3) proximate causation.[6] Thus, to survive a motion to dismiss, the complaint must set forth non-conclusory allegations establishing those elements, at a minimum.[7] And, from the PE firm's perspective, to prevail on a motion to dismiss — or, if necessary, a later motion for summary judgment — an understanding of how courts typically break down and analyze those elements is critical to managing a PE firm's relationship with its portfolio company.

1. Complete Domination and Control. Although plaintiffs are required to plead — and later, prove — all required elements of a veil-piercing claim, the outcome of a motion to dismiss or summary judgment motion often centers upon the element of domination and control. Thus, the evil twins of every "veil-piercing" complaint are the words "dominated and controlled," as if the mere repeated regurgitation of the conclusory phrase will single-handedly erase centuries of limited liability jurisprudence. In fact, mere domination and control of a portfolio company, in and of itself, will not expose a parent corporation to the liabilities of its subsidiary. The level of control and domination must be "complete," such that "the subservient corporation's finances, policy and business practices so that at the time of the challenged transaction the subservient corporation had no separate mind, will or existence of its own."[8] Nonetheless, some level of domination and control *is* a factor in most veil-piercing analyses, and not all courts will be so literal in their analysis of the level of control, so an understanding of what it means to "dominate and control" is warranted.

Most courts recognize that all owners, to some degree, exert control over their subsidiaries.[9] To that end,

[2] *United States v. Bestfoods*, 524 U.S. 51, 61 (1998) (internal quotations omitted).

[3] *Anderson v. Abbott*, 321 U.S. 349, 362 (1944).

[4] *Kashfi v. Phibro-Salomon, Inc.*, 628 F. Supp. 727, 732-33 (S.D.N.Y. 1986); *see, e.g.*, *Bestfoods*, 524 U.S. at 61; *Oxford Furniture Cos. v. Drexel Heritage Furnishings, Inc.*, 984 F.2d 1118, 1126 (11th Cir. 1993); *Simmons v. Clark Equip. Credit Corp.*, 554 So.2d 398, 400 (Ala. 1989); *Laborers' Pension Fund*, 580 F.3d at 610; *Fontana v. TLD Builders, Inc.*, 840 N.E.2d 767, 775 (Ill. App. Ct. 2005).

[5] *See, e.g.*, *Dole Food Co. v. Patrickson*, 123 S.Ct 1655, 1661 (2003) ("The doctrine of piercing the corporate veil is the rare exception, applied in the case of fraud or certain other exceptional circumstances. . ."); *Kingsman Enter., Inc. v. Bakerfield Elec. Co.*, 339 So.2d 1280 (1st Cir. 1976) (". . .[C]oncept of separation of the corporate entity. . .is the general rule and is firmly established. . .such principal should be disregarded in only exceptional circumstances."); *In re Silicone Breast Implants Prods. Liab. Litig.*, 837 F. Supp. 1128, 1133 (N.D. Ala. 1993); *Gilbert v. James Russell Motors, Inc.*, 812 So. 2d 1269, 1273 (Ala. Civ. App. 2001).

[6] *See, e.g.*, *Trevino v. Merscorp, Inc.*, 583 F. Supp. 2d 521, 529 (D. Del. 2008); *D. Klein & Son v. Good Decision, Inc.*, 147 Fed. Appx. 195, 197 (2d Cir. 2005); *K.C. Roofing Ctr. v. On Top Roofing, Inc.*, 807 S.W.2d 545, 549 (Mo. Ct. App. 1991); *Messick v. Moring*, 514 So. 2d 892, 894 (Ala. 1987); *Angelo Tomasso, Inc. v. Armor Constr. & Paving, Inc.*, 447 A.2d 406, 410 (Conn. 1982); *see also Huard v. Shreveport Pirates, Inc.*, 147 F.3d 406, 410 (5th Cir. 1998).

[7] *See, e.g.*, *In re BH S & B Holdings LLC v. Bay Harbour Master Ltd.*, 420 B.R. 112, 134 (Bankr. S.D.N.Y. 2009) (". . .[A]t the motion to dismiss stage, it is insufficient to make conclusory '[a]llegations of mere domination or control by one entity over another. . . .' ").

[8] *See, e.g.*, *Duff v. So. Ry. Co.*, 496 So. 2d 760, 762 (Ala. 1986); *Kwick Set Components, Inc. v. Davidson Indus., Inc.*, 411 So. 2d 134, 137 (Ala. 1982); *see also Broussard v. Meineke Discount Muffler Shops, Inc.*, 155 F.3d 331, 349 (4th Cir. 1998).

[9] *Bestfoods*, 524 U.S. at 55 (a parent company that actively participates in and exercises control over the operations of its subsidiary, without more, is not subject to liability for the acts of the subsidiary); *Berger v. Columbia Broad. Sys., Inc.*, 453 F.2d 991, 997 (5th Cir. 1972) (control over subsidiary's board of directors, authority of employees of subsidiary, and inclusion of subsidiary on organizational chart as division of parent, are "business practices common to most parent-subsidiary relationships."); *Hinds Cnty, Miss. v. Wachovia Bank N.A.*, No. 08 Civ. 2516, 08 MDL No. 1950, 2010 WL 1727965, at *14 (S.D.N.Y. Apr. 26, 2010) ("Indeed, a parent corporation may be involved directly in certain aspects of its wholly-owned subsidiary's affairs without subjecting itself to alter ego status. For example, as long as it maintains corporate formalities, a parent may provide financing to its subsidiary or approve expen-

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complete domination and control must be viewed in light of ''real world'' considerations of corporate control.[10] Therefore, if a PE firm oversees its portfolio company — monitors the company's performance, supervises its finance and budget decisions, and sets its general policies and procedures — those acts should not give rise to alter ego liability. Indeed, any successful PE firm will closely monitor the performance of its portfolio companies and exercise some control over the companies' operations. Indeed, the modern PE firm is characterized as ''interventionist'' because it is actively involved in the affairs of its portfolio companies.[11] Rather, the critical inquiry is to what degree and detail the PE firm engages in such activities, and whether the domination and control is complete.

A non-exhaustive list of the factors a court may examine when assessing the extent of a parent's domination and control of a subsidiary include: (i) whether the PE firm owns a majority interest in the portfolio company; (ii) whether the PE firm and portfolio company share common officers, directors, or other employees, and those persons do not act independently in the interest of the portfolio company; (iii) whether the PE firm finances the portfolio company; (iv) whether the portfolio company was inadequately capitalized or does not have sufficient capital to carry on its activities; (v) whether the PE firm pays the salaries or covers other expenses or loses of the portfolio company, or holds the portfolio company out as a division or department of the PE firm; (vi) whether the PE firm uses the property or assets of the portfolio company as its own, or the portfolio virtually has no assets other than those conveyed by the PE firm and no other business other than with the PE firm; (vii) whether the PE firm and the portfolio company deal with each other informally, and do not observe corporate formalities; and (viii) whether the PE firm subscribes to all the capital stock of the portfolio company or otherwise causes its incorporation.[12] No one factor is dispositive.[13] Typically, some, but not all, factors are relevant to a court's analysis.

Significantly, majority ownership alone does not amount to control.[14] Rather, there must be such complete domination and control over the portfolio company's finances and policies, that the portfolio company manifests no separate, mind, will, or existence of its own, but instead, exists only to accomplish the directives of the PE firm. In most cases, when companies observe corporate formalities in their dealings with each other, the corporate veil between them will not be pierced and alter ego liability will not attach.[15] The key inquiry is whether or not the subsidiary can operate on its own legs, without support from the parent company.

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ditures or sales by the subsidiary.''); *Whatley v. Merit Distrib. Servs.*, Nos. Civ. A. 99-0166-CB-S, Civ. A. 99-0167-CB-S, 2001 WL 228053 (S.D. Ala. Feb. 5, 2001) (''a parent corporation is expected-indeed, required-to exert some control over its subsidiary.''); *Joiner v. Ryder Sys. Inc.*, 966 F. Supp. 1478, 1481 (C.D. Ill. 1996) (a holding company ''engaged in the business of investing and acquiring other companies'' exerted permissible control over its ''corporate offspring.'').

In *Joiner*, all of the following facts, even taken together, constituted a permissible level of corporate control: (i) the parent and subsidiary had common officers; (ii) the parent company elects the officers and has the power to elect the board of directors of the subsidiary; (iii) the parent company transferred funds to and from the subsidiary; (iv) the parent must approve the subsidiary's acquisitions; (v) the parent company approves the subsidiary's capital budget; (vi) the parent company implemented certain policies and codes of ethic with which the subsidiary must comply; and (vii) the parent company provides certain services, such as legal, printing, and cash management services, to its subsidiary. *Joiner*, 966 F. Supp. at 1485-86.

[10] Daniel O. Kleir et al., *The Changing Face of Private Equity: How Modern Private Equity Firms Manage Investment Portfolios*, Journal of Private Equity, Fall 2009, at 8.

[11] *Id.*

[12] *See* Frederick J. Powell, Parent and Subsidiary Corporations: Liability of a Parent Corporation for the Obligations of its Subsidiary 9 (1931); 1 William Meade Fletcher et al., Fletcher Cyclopedia of the Law of Corporations § 41.30 (perm. ed., rev. vol. 2006); *see, e.g.*, *Judson Atkinson Candies, Inc. v. Latini-Horberger Dhimantec*, 529 F. 3d 371 (7th Cir. 2008); *Hystro Products, Inc. v. MNP Corp.*, 18 F.3d 1384 (7th Cir. 1994) (applying Illinois law); *Wm. Passalacqua Builders v. Resnick Developers. S.*, 933 F.2d 131, 139 (2d Cir. 1991) (applying New York law); *Shisgal v. Brown*, 801 N.Y.S.2d 518, 584 (N.Y. App. Div. 2005); *Duff v. S. Ry.*, 496 So. 2d 760, 763 (Ala. 1986); *Taylor v. Standard Gas & Electric Co.*, 96 F.2d 693, 704-05 (10th Cir. 1938); *Baker v. Raymond Int'l, Inc.*, 656 F.2d 173 (5th Cir. 1981); *Garrett v. Southern Ry.*, 173 F. Supp. 915 (E.D. Tenn. 1959).

[13] *See Mid-Century Ins. Co. v. Gardner*, 11 Cal. Rptr.2d 918, 922-23 (1992) (''courts have cautioned against relying too heavily in isolation on the factors of inadequate capitalization or concentration of ownership or control . . . [and] warn against stretching the concept of inequity too far.''). *United States v. Jon-T Chemicals, Inc.*, 768 F.2d 686, 695-96 (5th Cir. 1985), provides an illustrative example of the types of activities that give rise to a finding of complete domination and control. In *Jon-T Chemicals*, ''all of the directors and officers of [the subsidiary] served as directors and officers of [defendant Jon-T Chemicals, the parent]; [the subsidiary] was wholly owned by [the parent]; [the parent] paid many of the bills, invoices, and expenses of [the subsidiary]; it covered [the subsidiary's] overdrafts; it made substantial loans to [the subsidiary] (at one time amounting to $7 million) without corporate resolutions authorizing the loans and without demanding any collateral or interest; [the parent] and [the subsidiary] filed consolidated financial statements and tax returns; [the subsidiary] used the offices and computer of [the parent] without paying any rent; the salary of [the subsidiary's sole] regular employee was paid by [the parent]; and employees of [the parent] performed services for [the subsidiary] without charging for their time. [The parent] also advanced money and provided services on an informal basis to the joint ventures.'' *Id.*

[14] *See, e.g.*, *Albright v. Attorney's Title Ins. Fund*, 504 F. Supp.2d 1187, 1210 (D. Utah 2007) (''Majority stock ownership and control of the board is not a basis for piercing the corporate veil as a matter of law.''); *United States v. Fidelity Capital Corp.*, 920 F.2d 827, rehearing denied, 933 F. 2d 949 (11th Cir. 1991) (''Mere fact that person owns and controls corporation will not justify finding abuse of corporate entity. . .'') (applying Georgia law); *Hambleton Bros. Lumber Co. v. Balkin Enterprises*, Inc., 397 F.3d 1217 (9th Cir. 2005) (''. . .[S]hareholder control is necessary, but not alone sufficient to pierce the corporate veil.'') (applying Oregon law); *In re Captiol Hill Healthcare Group*, 242 B.R. 199 (Bkrtcy. D.Dist. Col. 1999) (more than just single ownership must be shown).

[15] *See, e.g.*, *In re BH S&B Holdings, LLC*, 420 B.R. 112, 134 (Bankr. S.D.N.Y. 2009); *Trustees of Nat. Elevator Indus. Pension v. Lutyk*, 140 F. Supp. 2d 447, 460 (E.D.Pa. 2001). Observation of corporate formalities generally means that the portfolio company is lawfully registered as a corporation, it keeps its own corporate records, it holds its own shareholder and/or board meetings, its has its own officers, directors, and employees (even if some of those persons are shared with the parent company), and those individuals act independently in the interest of the company.

2. Fraud, Inequity or Improper Use. A PE firm's domination and control of a portfolio company, in and of itself, should not expose the firm to alter-ego liability. Thus, even assuming a parent is found to have dominated and controlled its subsidiary, in order for the parent to face alter ego exposure, usually the parent must also have ''misused'' that domination and control, such as to circumvent a statute, commit a fraud, or perpetuate an inequity.[16] In most cases the fraud or inequity element is satisfied upon a showing that the subsidiary was established as a ''sham'' or ''dummy corporation.''[17] In other cases, courts have found inequity where owners made personal (improper) use of their subsidiary's funds or assets, or otherwise used the subsidiary's funds or assets for purposes other than for the benefit of the subsidiary.[18]

As one court explained, inequity may exist in the following circumstances:

> where a corporation is set up as a subterfuge, where shareholders do not observe the corporate form, where the legal requirements of corporate law are not complied with, where the corporation maintains no corporate records, where the corporation maintains no corporate bank account, where the corporation has no employees, where corporate and personal funds are intermingled and corporate funds are used for personal purposes, or where an individual drains funds from the corporation.[19]

3. Causation. Normally, for alter-ego liability to lie, not only must the PE firm have misused its complete domination and control over its portfolio company, but the PE firm's misuse must have proximately caused the litigant's harm. Generally, that means that the litigant's harm was a natural and foreseeable consequence of the fraud or injustice. For that reason, among others, it can be difficult for litigants' alter ego claims to succeed against a PE firm.

Litigation Strategy

Typically, a PE firm that has been thrust into a lawsuit by a corporate veil-piercing claim is faced with three options: (1) make a motion to dismiss, (2) answer, engage in costly discovery, and later make a motion for summary judgment, or (3) negotiate for a voluntary dismissal. Indeed, given the extraordinary nature of the veil-piercing remedy, under the right circumstances, litigants can be persuaded to voluntarily dismiss a claim. When that is not an option, the ultimate decision whether to move for dismissal or wait and move for summary judgment following discovery will depend on the facts and circumstances of each case, and on the pleading standard of the applicable jurisdiction.

It is, indeed, possible to get an alter ego claim dismissed at the motion to dismiss stage of the litigation proceedings.[20] In a fact-pleading jurisdiction, a motion to dismiss becomes a very viable option because a litigant must support its alter ego claim with sufficient, specific, facts.[21] Even in a notice-pleading jurisdiction, where it is generally unnecessary to plead specific facts,[22] a litigant still must do more than make conclusory allegations that simply mimic the elements for piercing the corporate veil.[23]

But, even under the most optimal circumstances, there is no guarantee that a motion to dismiss will be granted; and, because veil-piercing is very much a fact-intensive inquiry, discovery may be required to determine the existence of facts giving rise to alter ego liabil-

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[16] *See, e.g., Lowendahl v. Baltimore & Ohio R.R. Co.*, 247 A.D. 144, 157 (1st Dep't 1936); *but see Huard v. Shreveport Pirates, Inc.*, 147 F.3d 406, 410 (5th Cir. 1998) (indicating that proof of a high disregard for the corporate form, without any showing of fraud, can be sufficient to pierce the corporate veil).

[17] *See, e.g., K.C. Roofing*, 807 S.W.2d at 545, 548 (shareholder routinely changed corporation's name to achieve a ''fresh start''); *Laborers' Pension Fund v. Lay-Com, Inc.*, 580 F.3d 602, 614 (7th Cir. 2009) (''Sham corporations can be mere figments, little more than corporate names held up like picket signs by an individual who is individually responsible for the putative corporation's actions.''); *Samuels & Associates, Inc. v. Boxcar Foods, USA, Inc.*, 286 Fed. Appx. 708, 715 (Ala. 2008) (the company's sole shareholder contracted using a nonexistent entity and a company with no stock value and no insurance with which to satisfy a judgment).

[18] *See, e.g., Renee Unlimited, Inc. v. Atlanta*, 687 S.E.2d 233, 239 (Ga. Ct. App. 2009) (evidence was sufficient to support alter ego finding where owner commingled loan funds among jointly held subsidiaries and owners used funds for purposes other than for the benefit of the subsidiary); *Sea-Land Services, Inc. v. Pepper Source*, 993 F.2d 1309 (7th Cir. 1993) (applying Illinois law) (owner manipulated funds of entity intentionally and improperly making it impossible for a creditor to collect on a default judgment levied against the entity); *Idylwoods Associates v. Mader Capital, Inc.*, 915 F. Supp. 1290, on reconsideration in part 956 F. Supp. 410 (W.D.N.Y. 1996) (evidence sufficient where parent commingled all of its funds with that of subsidiary and paid all of subsidiary's expenses and other corporate formalities weren't followed).

[19] *Simmons v. Clark Equip. Credit Corp.*, 554 So. 2d 398, 401 (Ala. 1989).

[20] *See, e.g., De Jesus v. Sears, Roebuck & Co.*, 87 F.3d 65, 70 (2d Cir.1996); *Koninklijke Philips Elec., N.V. v. The ADS Group*, 694 F. Supp.2d 246, 253 (S.D.N.Y. 2010); *Partners Coffee Co., LLC v. Oceana Servs. & Products Co.*, No. 09-236, 2010 WL 1177436, at *1-2 (W.D.Pa. Mar. 25, 2010); *Heartland Barge Mgmt. v. Dixie Pellets, LLC*, No. 09-00585-KD-B, 2010 WL 703183 (S.D. Ala. Feb. 22, 2010); *Spagnola v. Chubb Corp.*, 264 F.R.D. 76, 82 (S.D.N.Y. 2010); *Trevino v. Mescorp, Inc.*,583 F. Supp. 2d 521 (D. Del. 2008); *Rehabcare Group East, Inc. v. Certified Health Mgmt*, 2007 U.S. Dist. Lexis 82952 (N.D. Ill. Nov. 8, 2007).

[21] *See, e.g., Jannetty Racing Enterprises, Inc. v. Site Development Technologies, LLC*, No. CV054004820S, 2006 WL 410973, at *5 (Conn. Super. Ct. Jan. 31, 2006) (striking the plaintiff's alter ego allegations, which ''constituted nothing more than a recital of the elements of [alter ego]'' and stated only ''legal conclusions rather than facts.''); *City of Chicago v. Beretta U.S.A. Corp.*, 821 N.E.2d 1099, 1112 (Ill. 2004) (''Fact pleading imposes a heavier burden on the plaintiffs, so that a complaint that would survive a motion to dismiss in a notice-pleading jurisdiction might not do so in a fact-pleading jurisdiction.'').

[22] Typically, in a notice pleading jurisdiction, pleadings (*i.e.*, complaints, answers, counterclaims, etc.) need only provide an adversary with notice of the claims or defenses asserted, and need not provide specific factual support for those assertions. Most jurisdictions in the United States are notice-pleading jurisdictions, including federal courts.

[23] *Spagnola*, 264 F.R.D. at 82 (''courts routinely consider, and grant, motions to dismiss for failure to adequately allege facts sufficient to support the imputation of liability on an alleged alter-ego.''); *accord Koninklijke Philips*, 694 F. Supp.2d at 253 (dismissing veil piercing claims that were merely conclusory); *Partners Coffee*, 2010 WL 1177436, at *13 (noting that the defendant did ''nothing more'' than list veil-piercing factors identified in the relevant case law).

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ity.[24] For example, although a PE firm is generally not liable for the contracts of its portfolio company, if the PE firm was heavily involved in the contract negotiations, ultimately decided to enter into the contract, and approved the final contract, it will make no difference that the portfolio company executed the contract and is the actual contractual party — the PE firm may be subject to alter ego liability based on its pre-contractual involvement.[25] Such facts subject to dispute tend to make a motion for summary judgment untenable.

Naturally, the best litigation strategy is to avoid litigation altogether. PE firms can lower their risk of being named in an alter ego complaint if they manage their portfolio companies in a manner that does not cross the alter ego line. Not only is that the most effective approach to defeating a veil-piercing claim, but it can also deter plaintiffs from even considering the bulge of a PE firms' pocket.

Practice Points

The following are the top five ways to maintain the integrity of your portfolio company's separate corporate existence, and to avoid alter ego liability.

1. Observe corporate formalities. The PE firm and its portfolio company should observe corporate formalities. Portfolio companies should hold regular board meetings or shareholder meetings, and maintain thorough meeting minutes that demonstrate the portfolio company's independence.[26] Strict adherence to corporate formalities is not necessary.[27] The key, here, is to be able to demonstrate that the portfolio company does not simply follow directives dictated by the PE firm, but rather, it carefully considers a particular course of action and decides for itself about how to proceed.

2. Deal with your portfolio company at arms length. PE firms sometimes bundle their portfolio company investments in core industry groups to take advantage of corporate synergies.[28] This is an acceptable course of conduct that should not give rise to alter ego liability. Indeed, separate corporations may integrate their resources and operations to achieve a common business objective, if they are not doing so to evade liability.[29] However, to avoid having their corporate veils pierced, it is important that portfolio companies deal with their PE firms and sister-companies at arms length.[30]

Accordingly, intercompany transactions between the PE firm and its portfolio companies, such as the utilization of the other's facilities, equipment or other property, should be supported by board approval and documented in board resolutions or written consents. Additionally, such transactions should be memorialized in writing, such as a lease or rent agreement. Whenever appropriate, related companies should enter into consulting or management agreements, or confidentiality agreements, rather than interacting with each other informally.

3. Make sure that dual officers and directors wear the right hat. Because PE firms play an active role in the management of their portfolio companies, it is not uncommon to find that officers and directors of a PE firm also serve as officers or directors of its portfolio company. Such sharing of officers and directors, without more, will not give rise to alter ego liability.[31] This is because there is a presumption that common officers and directors can and do ''change hats'' to fulfill their dual roles.[32]

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[24] *Cf.*, *Mid-Century Ins. Co.*, 11 Cal. Rptr.2d at 922 (''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.''); *see, e.g.*, *Thomson-CSF, S.A. v. American Arbitration Ass'n*, 64 F.3d 773 (2d Cir. 1995) (''Veil piercing determinations are fact specific and differ [ ] with the circumstances of each case''); *In re Shelby Yarn Co.*, 306 B.R. 523, 540 (W.D.N.C. 2004) (noting that the federal standard is ''imprecise and fact-intensive''); *Allied Corp. v. Frola*, 701 F. Supp. 1084, 1089 (D. N.J. 1988) (every veil piercing case is *sue generis*).

[25] *See, e.g.*, *Environmental Waste Control v. Browning-Ferris Indus.*, 711 So. 2d 912, 915 (Ala. 1997) (veil-piercing may be appropriate where subsidiary scheduled negotiation meetings, but parent company conducted contract negotiations, made the decision to enter into the contract, and approved the contract).

[26] *See* Kleir, *supra*, note 12 at 10-11; *see also* John J. McDonald, *Actions that Private Equity Fund Representatives on Corporate Boards Can Take to Help Avoid Liability*, Journal of Private Equity, Fall 2008, at 7-11.

[27] *PayPhone LLC v. Brooks Fiber Communications of Rhode Island*, 126 F. Supp. 2d 175, 181 (D. R.I. 2001). Generally, minor failures to observe corporate formalities will not amount to alter ego liability. *Alfa Mut. Fire Ins. Co. v. Memory (In re Martin)*, 184 B.R. 985, 993 (M.D. Ala. 1995) (''A failure to follow minor corporate formalities is not sufficient to invoke the lowering of the protective corporate shell.'').

[28] Kleir, *supra*, note 12 at 10-11.

[29] *See* 1 William Meade et al., Fletcher Cyclopedia of the Law of Corporations § 43, at 307-08 (perm. ed., rev. vol. 2006).

[30] Under what is referred to as ''corporate combine'' or ''single entity'' liability, plaintiffs have been able to pierce corporate veils to reach a company's sister affiliates. *See, e.g.*, *D. Klein & Son v. Good Decision, Inc.*, 147 Fed. Appx. 195, 198 (2d Cir. 2005); *Gartner v. Snyder*, 607 F.2d 582, 588 (2d Cir. 1979); *Walkovszky v. Carlton*, 18 N.Y.2d 414, 418 (1966). While that theory of liability is appropriately reserved for sister entities, aggressive plaintiffs have attempted to include the parent in the corporate ''combine'' where its subsidiaries have intermingled operations and assets at the direction of, or with the knowledge of, the parent.

[31] *See, e.g.*, *Cima v. Wellpoint Health Networks, Inc.*, No. 05-CV-4127-JPG, 2008 WL 4671707, at *3-4 (S.D. Ill. Oct. 22, 2008) (refusing to pierce corporate veil because sharing officers and directors ''is a common business practice that exists in most parent and subsidiary relationships''); *In re Silicone Breast Implants Prods. Liab. Litig.*, 837 F. Supp. 1128, 1135 (N.D. Ala. 1993) (noting that overlapping officers and directors is insufficient to pierce the corporate veil and ''is a practice frequently found in parent and subsidiary relationships''), *vacated in part on other grounds*, 887 F. Supp. 1455 (N.D. Ala. 1995); *Gardemal v. Westin Hotel Co.*, 186 F.3d 588 (5th Cir. 1999) (applying Texas law) (parent was not the ''alter ego'' even though the corporations had shared stock ownership and officers); *Joiner v. Ryder System Inc.*, 966 F. Supp. 1478 (D. Ill. 1996) (court found that the overlap of officers among three corporations insufficient even when combined with other factors such as 100% ownership of the subsidiary's stock being owned by the holding company).

[32] *See e.g.*, *Bestfoods*, 524 U.S. at 69 (''recognition that the corporate personalities remain distinct has its corollary in the well established principle [of corporate law] that directors and officers holding positions with a parent and its subsidiary can and do change hats to represent the two corporations separately, despite their common ownership'') (citations and quo-

To avoid alter ego liability, PE firms should keep in mind that when they act as officers and directors of their portfolio company, they must, at all times in that capacity, act in the interest of the portfolio company, and avoid conflicts of interest.[33] After all, when acting as a director of a portfolio company, a PE firm owes fiduciary duties of care and loyalty to the portfolio company, and must not discharge their duties in a self-interested manner.[34] It can be helpful to require officers and directors serving dual roles to use the appropriate business cards, stationary and e-mail domains of the company they are representing when communicating or transacting on behalf of either company.

4. Maintain separate operations. The portfolio company should, at all times, demonstrate that it can and does exist on its own, as a separate entity. To that end, ideally, the PE firm should not refer to the portfolio company as a department or division of its operations. Additionally, although sharing operations alone is typically insufficient to pierce the corporate veil, it is less likely to raise scrutiny if the portfolio company maintains separate operations — its own offices, telephone and fax numbers, email addresses, letterhead, facilities, employees, and other indicia of independent operations.

Moreover, employees of the PE firm who are not also employees of the portfolio company should not have a permanent office with the portfolio company; and, certainly, employees of the PE firm should not hold themselves out to be representatives of the portfolio company, and vice versa. Just as with the officers and directors who wear different hats, dual employees should be required to use the business cards, stationary and e-mail domains corresponding with the company for which they are performing work. They should also be required to allocate their time appropriately. If they receive a single paycheck for work performed on behalf of the PE firm and a portfolio company, the companies should account for those salary payments with written documentation.

5. Keep your hands out of your portfolio company's pockets. The surest way to be subject to alter ego liability is to intermingle funds and assets.[35] The portfolio company should have its own bank accounts and maintain its own payroll. It is not improper for the PE firm to extend loans to its portfolio company. However, it becomes problematic if the portfolio company is so dependent on such loans that it cannot fulfill its obligations without them. All intercompany loans should be well documented. And, it should go without saying, that such loans must be actual, and not just pretextual. A loan that goes unpaid, or bears no interest, may be scrutinized.

Additionally, a PE firm must be careful not to impose greater burdens or new obligations on its portfolio company if the company does not have sufficient cash to meet those burdens and obligations. While a PE firm is not required to ''throw good money after bad'' by recapitalizing a failing portfolio company, the imposition of new obligations, without an infusion of new cash, may be construed as undercapitalization, for purposes of corporate veil-piercing.[36]

tation marks omitted); *Judson Atkinson Candies, Inc. v. Latini-Hohberger Dhimantec*, 529 F.3d 371, 380 (7th Cir. 2008) (''While having common officers and directors is generally a prerequisite to piercing the corporate veil, this factor is insufficient to justify disregarding the corporate form because it is a common business practice that exist[s] in most parent and subsidiary relationships'') (citations and quotation marks omitted); *Doe v. Unocal Corp.*, 248 F.3d 915, 927 (9th Cir. 2001) (''A parent corporation may be directly involved in financing and macro-management of its subsidiaries . . . without exposing itself to a charge that each subsidiary is merely its alter ego.''); *Fletcher v. Atex, Inc.*, 68 F.3d 1451, 1459-61 (2d Cir.1995) (parent company's exertion of control over subsidiary's major expenditures, stock sales and asset sales, its ''dominating presence'' on the subsidiary's board of directors, and use of a cash management system, involve the ''type of conduct [that] is typical of a majority shareholder or parent corporation.''); *In re TicketPlanet.com*, 313 B.R. 46, 70 (Bankr. S.D.N.Y. 2004) (overlapping of officers and directors and responsibilities ''is not uncommon or impermissible'').

[33] James M. Hill and John S. Gambaccini, *The Private Equity Paradox: When Is Too Much Control a Bad Thing?*, Journal of Private Equity, Spring 2003, at 38-39.

[34] *Id.*

[35] *See, e.g., Trs. of Nat'l Elevator Ind. Pension v. Lutyk*, 140 F. Supp. 2d 447, 460 (E.D.Pa. 2001) (use or commingling of corporate funds can form the basis to pierce the corporate veil); *Hystro Products, Inc. v. MNP Corp.*, 18 F.3d 1384, (7th Cir. 1994) (applying Illinois law) (commingling of funds and assets is evaluated in determining the relationship between two corporations); *Helder v. Whittenberg Liquidating Co.*, 522 F. Supp. 480, 483 (E.D. Pa. 1981) (commingling of funds may be sufficient to pierce the corporate veil under Pennsylvania law).

[36] *Secon Serv. Sys., Inc. v. St. Joseph Bank & Trust Co.*, 855 F.2d 406, 412, 415 (7th Cir. 1988) (the mere fact that an investor eventually stops ''throwing good money after bad'' does not justify piercing the corporate veil); *Lifschultz Fast Freight*, 132 F.3d at 352 (''Owners owe no duty to recapitalize a failing firm, and courts should not introduce one through the back door by retrospectively finding undercapitalization by proof of 'eventual failure.' '').

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