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PRIVATE EQUITY

I Am Not My Sister's Keeper: Private Equity and the Perils of Alter Ego Liability, Part II

BY HOWARD O. GODNICK

Like many corporate owners, private equity (''PE'') firms will sometimes bundle portfolio company investments within core business groups in order to strategically take advantage of corporate synergies. Such conduct ''lies firmly within the law and is commonplace.''[1]

As a practical example, assume a PE firm owns a group of portfolio companies in the widget industry. One company manufactures widgets (''Widgets Ltd.''), one company sells widgets (''Widgets R Us''), and another company sells and manufactures widget accessories (''Widgets Inc.''). It is perfectly acceptable and lawful that these related companies work together and share resources. They may share a building from which the businesses operate, or perhaps they share business executives with extensive knowledge and expertise in widgets, or take advantage of economies of scale in connection with obtaining life insurance coverage for their respective employees. Doing so may be efficient and may serve to make each independent business stronger and more successful.

In the precursor article, ''My Portfolio Company Did What!? Private Equity and the Perils of Alter Ego Liability,'' we explored the risks attendant upon PE firms being held liable for the contracts or torts of their portfolio companies;[2] but *affiliated portfolio companies* are also exposed to liability for the conduct of *sister companies* within the portfolio.

Although it is axiomatic that sister companies within a PE firm's portfolio are not liable for the contracts and torts of other sister companies within the portfolio, an alternate theory of alter ego liability has emerged in a growing number of jurisdictions that would hold one portfolio company liable for the contracts or torts of another portfolio company, based on little more than common acts of corporate synergy.[3] This alternative liability device in plaintiffs' arsenal is called the ''corporate combine'' theory, also known as ''single entity'' or ''single enterprise'' theory, or other similar nomenclature.

[1] *See SSP Partners v. Gladstrong Invs. (USA) Corp.*, 275 S.W.3d 444, 455 (Tex. 2008) (stating that the creation of affiliated corporations to limit liability while pursuing common goals ''lies firmly within the law and is commonplace''); *see also Gibraltar Sav. v. LD Brinkman Corp.*, 860 F.2d 1275, 1287 (5th Cir. 1988) (''Many wholly-owned subsidiaries and closely-held corporations are not factually distinct from their owners. Many are in fact controlled and operated in close concert with the interests of the owners, and do not have a distinct factual existence. . . . Such conduct is perfectly natural and proper and provides no basis for ignoring legal independence.'').

[2] *BNA Securities Regulation & Law Report*, *Alternative Investment Law Report* and the *Mergers & Acquisitions Law Report* in August 2011 (citing *e.g.*, *D. Klein & Son v. Good Decision, Inc.*, 147 Fed. Appx. 195, 197 (2d Cir. 2005); *Trevino v. Merscorp, Inc.*, 583 F. Supp. 2d 521, 529 (D. Del. 2008)).

[3] The following jurisdictions have adopted at least some variation of the corporate combine theory: Arizona, Arkansas, California, Connecticut, Illinois, Indiana, Louisiana, Massachusetts, Mississippi, New York, North Carolina, Puerto Rico, Virginia, Washington and, possibly, New Jersey (there is conflicting authority about whether New Jersey recognizes the doctrine). STEPHAN B. PRESSER, PIERCING THE CORPORATE VEIL § 1:9 (2010).

Howard O. Godnick is a partner at Schulte Roth & Zabel LLP and a member of the firm's Complex Commercial Litigation Group.

Under the corporate combine theory of alter ego liability, a court may pierce the corporate veil between two sister companies where they share common ownership, have unified administrative control, and share similar or supplementary business functions.[4] In other words, affiliated companies that share resources may be said to be operated as part of one corporate combine and, under certain circumstances, one company can be held to account for the wrongful conduct of any other company that is part of the so-called corporate combine.[5] In such instances, facts that ordinarily evince nothing more than the usual exercise of corporate synergies have been asserted in attempts to apply alter ego claims against sister companies. Such corporate synergies may include sharing office space, equipment, human capital and key executives, among other essential resources.

Although arguably broader and less burdensome than proving alter ego liability, the corporate combine theory is not without limitation. Indeed, because it is an equitable remedy, equity must demand that the theory is warranted. Thus, the doctrine has been applied in cases where the entity that has caused harm has no assets to pay a judgment against it and/or has operated in tandem with related companies in a manner that would cause confusion to third parties. In short, this is an extremely fact-intensive inquiry. For example, if Widget Ltd. began a practice of placing sales orders for Widgets R Us or sharing a telephone line with Widget Inc., a third party may arguably be confused about the entity with which it is dealing.

To defeat a corporate combine claim, it is important to understand the key distinctions between traditional alter ego theory and corporate combine, as well as the impact of corporate combine on general principles of limited liability.

Characteristics of Corporate Combine Claims

Whereas essential elements in traditional alter ego claims are a showing of complete domination and control, and misuse of that control, no such showing is required to assert corporate combine liability against a sister company.[6] Rather, corporate combine claims, although applied differently across the jurisdictions that recognize the theory, share two main characteristics: (1) common ownership and (2) combined operations.[7] In addition, in some jurisdictions that recognize corporate combine, a plaintiff must show that the corporate combine was created for a fraudulent purpose or resulted in harm to third parties.[8]

1. *Common Ownership*

To assert a corporate combine claim, a plaintiff generally must show that two or more related companies share the same common owner(s). Some jurisdictions refer to this as an ''identity of ownership'' and require complete identity of ownership.[9] In one case, for example, the ''single entity'' theory was not available where, although related companies were each owned 60 percent by the same party, they each had different owners of their respective remaining 40 percent interest.[10]

In contrast, traditional alter ego liability is not available in most jurisdictions based on common ownership alone.[11]

2. *Shared Resources*

A common theme among plaintiffs seeking to invoke the corporate combine theory is that a court should disregard the corporate separateness of a group of related companies because their operations are centralized and resources used interchangeably among the entities. Courts have identified the following factors that tend to show the existence of combined operations, among others, none of which are independently dispositive: (1) common employees, (2) common offices, (3) centralized accounting, (4) payment of wages by one corporation to another corporation's employees, (5) common business name, (6) services rendered by employees of one corporation on behalf of another corporation, (7) undocumented transfers of funds between corporations, and (8) unclear allocation of profits and losses between corporations.[12]

No Showing of Misuse of Control or Fraud

Unlike traditional alter ego claims, some jurisdictions that recognize the corporate combine doctrine do not require a separate showing of fraud, injustice, inequity or other indicia of misuse of control.[13] A few jurisdic-

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[4] *See Miners, Inc. v. Alpine Equip. Corp.*, 722 A.2d 691, 695 (Pa. Super. 1998).

[5] Phillip A. Blumberg et al., Blumberg on Corporate Groups § 10.03 (2d ed. 2013).

[6] *See, e.g., Oracle 1031 Exch., LLC v. Borque*, 2011-1133 (La. App. 3rd Cir. Feb. 8, 2012); 85 So.3d 736, 739 (holding that, in Louisiana, if one corporation is ''wholly under the control of another,'' there is no limited liability, as the law considers the former corporation to be merely an alter ego of the latter).

[7] *See, e.g., Miners*, 722 A.2d at 695.

[8] *See, e.g., SSP Partners*, 275 S.W.3d 444.

[9] *Miners*, 722 A.2d at 695.

[10] *See id.*

[11] *See, e.g., Port Chester Elec. Constr. Corp. v. Atlas*, 40 N.Y.2d 652, 656 (1976) (finding that common ownership was not sufficient to pierce the corporate veil where the owner ''carefully respected the separate identities of the corporations, and each corporation was pursuing its separate corporate business, rather than the personal business of the owner''); *My Bread Baking v. Cumberland Farms*, 233 N.E.2d 748, 752 (Mass. 1968) (stating that ''common ownership of the stock of two or more corporations together with common management, standing alone, will not give rise to liability on the part of one corporation for the acts of another corporation or its employees'').

[12] *See In re Carmelita, Inc.*, No. 1:08-CV-00410, 2009 WL 2356488, at *6 (S.D. Tex. July 29, 2009); *see also Grayson v. R.B. Ammon & Assocs., Inc.*, 1999-2597 (La. App. 1 Cir. 11/3/00); 778 So. 2d 1 (listing additional factors); *Green v. Champion Ins. Co.*, 577 So.2d 249, 251-53 (La. Ct. App. 1991) (same).

[13] *See, e.g., Oracle 1031 Exch.*, 85 So.3d at 739 (holding that, in Louisiana, if one corporation is ''wholly under the control of another,'' there is no limited liability, as the law considers the former corporation to be merely an alter ego of the latter); *Scott v. NG U.S. 1, Inc.*, 881 N.E.2d 1125, 1132 (Mass. 2008) (finding that, in Massachusetts, ''corporate formalities also may be disregarded when there is a confused intermingling of activity of two or more corporations engaged in a common enterprise *with substantial disregard of the separate nature of the corporate entities*, or serious ambiguity about the manner and capacity in which the various corporations and their respective representatives are acting'') (internal citations and quotations omitted) (emphasis in original); *Toshiba Am. Med. Sys., Inc. v. Mobile Med. Sys., Inc.*, 730 A.2d 1219, 1223-24 (Conn. App. Ct. 1999) (finding that, in Connecticut, if the plaintiff can show that ''there was such a unity of interest and ownership that the independence of the corporations had in effect ceased or had never begun, an adherence to the fic-

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tions seem wholly unconcerned with moral culpability or wrongful conduct.[14] In Louisiana, for example, there need be no allegation of fraud nor any need to establish moral culpability or wrongful conduct.[15] Likewise, in Massachusetts, the court will pierce the corporate veil of the sister corporation based on corporate combine when entities are confusingly intermingled, even if there is no showing of fraud or injurious consequences.[16]

In most jurisdictions that recognize the corporate combine theory, however, there must be an added element of fraud or wrongful conduct to pierce the corporate veil.[17] New York, for example, requires that a plaintiff allege some fraud or wrongdoing to assert liability under the corporate combine theory.[18]

Texas used to apply the corporate combine theory to pierce the corporate veil, but in recent years has changed course. Now, Texas has expressly rejected the notion that separate entities could be held liable for debts merely because they coordinated operations and combined resources in pursuit of a common business objective.[19] Rather, Texas courts require fraud to pierce the corporate veil.[20]

Plaintiffs tend to assert corporate combine theory on the mistaken assumption that the theory requires a lower hurdle than conventional alter ego claims; and in some jurisdictions, where equity demands, that may be so. Some experts have opined that the corporate combine theory is evidence of a chipping away of limited liability. But there is no evidence of such chipping away in most significant jurisdictions, which apply corporate combine as a tool to reach related entities, such as in New York and Delaware.

Litigation Strategy

The corporate combine theory for piercing the corporate veil is recognized in only a few jurisdictions.[21] Most jurisdictions do not recognize the theory and those that do apply it in very different ways. Jurisdictions that recognize the corporate combine theory include New York, Delaware, Louisiana, and Massachusetts, among others. At least one state, Texas, has flatly rejected the theory (after having applied it for years).[22] Still, some courts have noted that certain states have yet to adopt the corporate combine theory.[23]

Therefore, the litigation strategy for addressing corporate combine claims (*i.e.*, whether to (i) move to dismiss at an early stage in litigation, (ii) engage in discovery and later move for summary judgment, or (iii) negotiate for a voluntary dismissal of the lawsuit), will be

tion of separate identity would serve only to defeat justice and equity by permitting the economic entity to escape liability arising out of an operation conducted by one corporation for the benefit of the whole enterprise'').

[14] *See* Blumberg, *supra* note 5, at § 12.04[B].

[15] *See Pine Tree Assocs. v. Doctors Assocs., Inc.*, 94-1193 (La. App. 1st Cir. Apr. 17, 1995); 654 So. 2d 735, 738 (finding that related companies can be found liable without any allegation of fraud); *In re New Orleans-Train Car Leakage Fire Litig.*, 96-1677 (La. App. 4th Cir. Mar. 5, 1997); 690 So. 2d 255 (finding related companies can be held liable without any mention of morally culpable or wrongful conduct); *Green*, 577 So. 2d at 257-59 (mentioning fraud only in the context that the purpose of disregarding limited liability under the single business entity doctrine is the prevention of fraud or achievement of equity).

[16] *See Lothiam v. Mumford*, 2006 WL 1745064 (Mass. Super. June 9, 2006) (stating that ''[t]his doctrine was devised to assist those who are confused about which corporation they are dealing with''); *Scott*, 881 N.E.2d at 1132 (finding that corporate formalities may be disregarded ''when there is a confused intermingling of activity of two or more corporations engaged in a common enterprise *with substantial disregard of the separate nature of the corporate entities*, or serious ambiguity about the manner and capacity in which the various corporations and their respective representatives are acting'') (internal citations and quotations omitted) (emphasis in original).

[17] *Mid Am. Title Co. v. Transnation Title Ins. Co.*, 332 F.3d 494, 495-97 (7th Cir. 2003) (applying Arizona law and finding that allegations of overlapping corporate officers, commingled operations and consolidated operations after parent company took over, sharing of offices and employees (including counsel), that managers worked for other subsidiaries although drew a salary from only one, and that dealings among managers were not at arms-length, were insufficient to pierce the corporate veil under the single entity theory because plaintiff did not allege that any of the companies ''were sham corporations formed to siphon off [the subsidiary's] business'').

[18] *See D. Klein & Son*, 147 Fed. Appx. 195 (applying the ''second veil-piercing factor,'' which was either ''a showing of fraud or upon complete control . . . that leads to a wrong against third parties''); *Walkovszky v. Carlton*, 223 N.E.2d 6 (N.Y. 1966) (dismissing plaintiff's complaint against the owner of 100 taxicabs across 10 corporations upon a finding that the owner did not operate the companies as a fraud or sham); *see also Hamlet on Olde Oyster Bay Home Owners Assn., Inc v. Holiday Org., Inc.*, 824 N.Y.S.2d 763, 12 Misc. 3d 1182A, at *14-15 (N.Y. Sup. Ct. 2006) (notwithstanding plaintiff's claim that related entities should be treated as a single entity because they ''indiscriminately interchanged letterhead, respond to inquiries, attending meetings and intermingling funds, and they shared on overlap of ownership, officers, functions, office addresses and telephone numbers,'' the court rejected the claims due to plaintiff's failure to allege a fraud); *Jack LaLanne Fitness Ctrs., Inc.*, 884 F. Supp. 162, 166 (D.N.J. 1995) (holding that ''because defendants have not included even conclusory allegations as to fraud, injustice, or any sort of illegality, defendants' claims could not survive scrutiny''); *Las Palmas Assocs. v. Las Palmas Ctr. Assocs.*, 1 Cal. Rptr. 2d 301, 235 Cal. App. 3d.1220, 1249 (Cal. Ct. App. 1991) (finding a single enterprise existed, but applying the test for alter ego liability to pierce the corporate veil).

[19] *See SSP Partners*, 275 S.W.3d 444.

[20] *See id.*

[21] It appears that Louisiana has most readily embraced corporate combine, confirming in a recent case that if a corporation is ''wholly under the control'' of another, the law considers the former corporation simply an alter ego of the latter, and the corporate veil can be pierced as to all related companies (including both the parent and sister companies). *See Oracle 1031 Exch.*, 85 So. 3d at 739. Even so, Louisiana courts have looked at certain domination and control factors before deeming affiliated companies to be a single entity, including intermingled management and the respective independence of the affiliated companies. *See id* at 740.

[22] *Carmelita,* 2009 WL 2356488, at *6 (''Texas does not recognize the common law doctrine of single business enterprise,'' therefore plaintiffs' claims that ''rely on that doctrine to pierce the corporate veil . . . must fail as a matter of law.'').

[23] *See, e.g., Lentz v. Trinchard*, 2010 BL 312345, No. 02-1235, at **10 (E.D. La. Aug. 2, 2010) (holding that ''Wisconsin has not adopted the single business enterprise doctrine and, therefore, this particular remedy is not available against [defendant].''); *In re LMcD, LLC*, 405 B.R. 555, 564 (Bankr. M.D. Pa. 2009) (stating that the ''single entity theory has not yet been adopted by the Commonwealth of Pennsylvania,'' but then ''attempting to determine how the Pennsylvania Supreme Court would address the issue should it hear such case.''); *Verni ex rel. Burstein v. Stevens*, 903 A.2d 475 (N.J. Super. Ct. App. Div. 2006) (''The single business enterprise or single entity rule has not been adopted in [New Jersey]'').

guided largely by the jurisdiction in which the lawsuit is filed and the place of incorporation of the entity whose corporate veil is sought to be disregarded, as well as other relevant facts. Application of the corporate combine theory, like all other alter ego and veil piercing claims, requires a delicate balancing of principles of limited liability and equity.

Practice Points

The best laid plan still may be insufficient to deter the lawsuit of a plaintiff determined to reach the deepest, or all available pockets, by asserting corporate combine claims against related companies within a PE firm's portfolio; however, the following pointers may help to thwart those plans.

1. *Incorporate Wisely*

Generally, choice of law principles provide that the place of incorporation determines the substantive alter ego/veil piercing law to be applied in a given action, irrespective of where the lawsuit was filed. Before incorporating or acquiring a company, research the alter ego/veil piercing laws and principles of the state in which the company is (to be) incorporated. To the extent practicable, consider avoiding jurisdictions with lax or overly broad alter ego rules (*i.e.*, rare jurisdictions that would pierce the corporate veil based on ownership and sharing resources alone).

2. *Unique Nomenclature*

PE firms should try to avoid operating different portfolio companies under similar names. It may seem obvious, but the easiest way for a plaintiff to demonstrate that portfolio companies are indistinguishable is for them to share a similar name. Having a similar (or even the same) name is often a key indicator that companies are susceptible to confusion by third parties and/or are not separate and independent entities. Such a determination will not be afforded the benefit of limited liability.[24]

3. *Separate Directors and Officers*

Each sister company should have its own officers and directors, and each individual should have clear and delineated roles and responsibilities. The intermingling of officers and directors, although not improper, is a frequently used factual allegation in alter ego claims and a common corporate combine trigger.

4. *Observe Corporate Formalities and Deal at Arm's Length*

If sister companies share resources, it is essential that all dealings be at arm's length and proper corporate formalities are observed in the process. This includes, for example, entering into property leases and/or subleases if entities share real estate and other property. It also includes signing appropriate board resolutions, properly approving and documenting corporate action, and maintaining distinct corporation assets and records.

5. *Preserve Separateness*

Separate entities should not be held out as being a representative of a related company, especially if that is not the case. Clearly distinguish between companies in all contractual dealings. Courts are more likely to pierce the corporate veil based on corporate combine where multiple corporate entities represented that they were the same entity, confusing a contractual party about the contractual partner with which he was dealing.[25]

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[24] *See D. Klein & Son*, 147 Fed. Appx. at 198 (subsidiaries were both named ''Good Decision''); *Green*, 577 So. 2d 249 (affiliated companies all named ''Champion Insurance''); *Grayson*, 778 So. 2d at 16 (both corporations used the name ''Temp Staffers''); *Culp v. Econ. Mobile Homes, Inc.*, 895 So. 2d 857, 860 (Ala. 2004) (both corporations used the name ''Free State Homes Manufacturing.'').

[25] *See id.* at 197 (finding that in a breach of contract action, a plaintiff must allege that two or more companies were so interrelated that the plaintiff was inextricably confused about which party it was dealing with at the time of the contract).

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