Bloomberg BNA

Securities Regulation & Law Report™

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JURISDICTION AND PROCEDURE

Which State Wants to Pierce Your Veil? Private Equity and the Perils of Alter Ego Liability, Part III

BY HOWARD O. GODNICK AND NANCY DURAND

Private equity firms often conduct their business through a variety of legal entities, and when they invest in portfolio companies, they are often empowered to determine the jurisdiction in which the portfolio company will be incorporated — or reincorporated. Of course, the presumption of limited liability treats each such legal entity as a distinct company, separate and apart from its shareholders or corporate parent. This enables and encourages private equity firms to invest in new corporations without trepidation that they will be held liable for the acts of their portfolio companies. As Justice William O. 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.'' In prior articles, we discussed litigation strategy available to private equity firms that are thrust into litigation based on corporate veil-piercing claims, i.e., when plaintiffs seeking deeper pockets try to disregard a portfolio company's separate corporate existence and hold its owners, shareholders, and related entities liable for the acts of the portfolio company. In this article, we address strategies for combating veil-piercing claims before the corporation is even formed.

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The decision about where to incorporate a portfolio investment may greatly impact the outcome of future litigation seeking to pierce the corporate veil of a portfolio company and hold the private equity firm liable for the portfolio company's debts and liabilities. That is because when analyzing veil-piercing claims, the general rule dictates that the law of the state in which the portfolio company is incorporated determines whether to pierce the company's corporate veil. Knowing a state's veil-piercing rules and its courts' prevalence towards granting or denying veil-piercing claims *before* incorporating in that state is the logical starting point in de-

fending against veil-piercing claims before they are even filed.

Veil-Piercing Standards Vary Across Jurisdictions

Piercing the corporate veil is an ostensibly rare and extraordinary legal remedy that allows a court to discard an entity's separate corporate existence in order to hold the corporation's owners and shareholders personally liable for the corporation's debts and liabilities. To obtain this extraordinary remedy, plaintiffs must generally 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. While these factors pervade veil-piercing standards across jurisdictions, no two jurisdictions apply exactly the same standard in exactly the same way, and jurisdictions vary substantially in their willingness to pierce the corporate veil.

Indeed, some states' veil-piercing laws are notably liberal, while other states apply the veil-piercing elements rather rigidly. Which state is chosen for the place of incorporation can therefore make it easier or more difficult for a litigant to prevail in potential litigation seeking to pierce the corporate veil.

Beware of States With Lax Veil-Piercing Standards

States with lax veil-piercing laws (in fact or in application) tend to have vague, inconsistent or multiple standards for piercing the corporate veil. They also do not require a showing of fraud or illegality and seem to rely largely on equitable considerations in determining whether to disregard the corporate fiction. California, Wyoming and Connecticut exemplify lax standards and unpredictable veil-piercing case law.

California is ''one of the jurisdictions most likely to pierce the corporate veil.'' According to one study of over 2,900 veil-piercing cases across the United States between 1958 and 2006, California had a 50.28 percent veil-piercing rate in individual shareholder cases and a 51.79 percent rate for corporate parents. Commentators have noted that California courts are ''unusually willing to pierce the [corporate] veil'' and ''may be ready to pierce the veil on scanty evidence.'' California veil-piercing law is fact-specific, incoherent and unpredictable. This lax, confusing standard likely originates from a leading California case that enumerates 15 factors that courts may consider in deciding whether to pierce the corporate veil. Since California has such a large economy, many companies may choose to incorporate there regardless of judicial hostility to the corporate fiction. Companies that choose to incorporate in California, however, should be diligent in avoiding undercapitalization, which is a major, generally dispositive factor in veil-piercing cases in that jurisdiction.

Like California, Wyoming has unclear, unpredictable and seemingly liberal veil-piercing standards. No single veil-piercing standard has been adopted in that jurisdiction. Fraud is not required, and the veil may be pierced in the interest of public policy — a potentially amorphous ''standard'' that appears to allow a court to ignore the bedrock concept of limited liability. Indeed, unlike most other jurisdictions, Wyoming's leading veil-piercing case suggests that a court may pierce the corporate veil on the basis of shareholder control, lack of formalities or undercapitalization alone. While later Wyoming cases have applied veil-piercing law in a more reasonable manner, ''the broad language of [the seminal case is] still quoted with approval in the later cases.'' Private equity firms should therefore proceed cautiously with respect to portfolio companies formed under Wyoming law.

California, Wyoming and Connecticut exemplify lax standards and unpredictable veil-piercing case law.

While mainstream Connecticut veil-piercing law is ''predominately conservative,'' the state's leading case on the issue, *Zaist v. Olson*, which is still good law, established an extremely liberal standard in the parent-subsidiary context. *Zaist* sets forth two tests: (1) a standard instrumentality test (requiring control, injustice or fraud, and proximate causation); and (2) what is now referred to as the ''identity test,'' which is more troublesome. Under the identity test, a plaintiff can reach a parent corporation's pockets to compensate for its subsidiary's liabilities if ''there was such a unity of interest and ownership'' between the corporations that ''the independence of the [subsidiary] had in effect ceased or had never begun,'' such that ''an adherence to the fiction of [a] separate identity would serve only to defeat justice and equity'' by allowing the parent corporation to escape liability ''arising out of an operation conducted by one corporation for the benefit of the whole enterprise.'' Though the Connecticut courts have limited *Zaist*'s identity test and have only applied this test in cases where there has been a clear abuse of the corporate form, those considering Connecticut as a place to incorporate should be aware that the test is still technically good law and thus creates uncertainty and ambiguity in Connecticut's veil-piercing law in the parent-subsidiary context.

Other Jurisdictions Show Greater Deference to the Corporate Form

States with high veil-piercing thresholds generally require a showing of actual fraud, common law fraud, illegality or egregious misconduct before the court will disregard the corporate form. These states include Delaware, Nevada, Maryland, New York and Texas. The application of veil-piercing law in these states is often consistent and predictable.

Unsurprisingly, Delaware's veil-piercing law is corporation-friendly. According to one comprehensive veil-piercing study, Delaware state courts have a ''very low 34.29% veil-piercing rate.'' Delaware courts require ''fraud or something like it'' before they will disregard the corporate form.

Like Delaware courts, Nevada courts will not pierce the corporate veil absent a showing of fraud or injustice. While proof of actual fraud is not necessary, and while injustice is a vague concept, ''the corporate cloak is not lightly thrown aside'' in Nevada.

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Indeed, Nevada courts pride themselves on their corporate protectionism and almost never find that this factor has been satisfied. This is likely because Nevada ''has been a fierce competitor in the market for corporate charters.'' Unless the plaintiff can demonstrate that ''the financial setup of the corporation is only a sham and caused an injustice,'' Nevada courts are unlikely to pierce the corporate veil absent exceptional circumstances.

Statistically, Maryland has the most stringent veil-piercing laws. Commentators have described Maryland law as ''inordinately protective of limited liability for shareholders.'' Maryland, like Delaware, takes a ''markedly restrictive approach'' to piercing the corporate veil, requiring proof of actual common law fraud or evasion of a statute to justify veil-piercing. Maryland courts have described piercing the corporate veil in their state as a ''herculean task.'' Absent a showing of fraud or illegality, Maryland courts have consistently refused to pierce the corporate veil. Moreover, fraud must be shown by ''clear and convincing proof'' rather than by a mere preponderance of the evidence.

While New York and Texas courts do not require a showing of actual fraudulent conduct to pierce the corporate veil, courts in those states will generally respect the corporate form absent egregious misconduct. Because fraud is not required and veil-piercing cases are fact-specific, however, individual outcomes may be somewhat unpredictable in these states.

Ultimately, a court's decision whether to pierce the corporate veil is a highly fact-intensive inquiry. While patterns may emerge from the case law, results and dispositive factors often vary from case to case, even within a single jurisdiction. Courts often enumerate a laundry list of factors of varying degrees of importance and relevance to the case, causing further confusion in the veil-piercing and alter ego arena. Given the complexity, murkiness and inconsistency of veil-piercing laws, careful analysis of a jurisdiction's veil-piercing law is advisable prior to deciding to incorporate in that jurisdiction.

Practice Point

While many factors should be taken into consideration when deciding upon a place of incorporation, the place of incorporation could prove outcome-determinative in litigation involving veil-piercing claims. Regardless of where a veil-piercing claim is filed, the law that is applied to veil-piercing claims likely will be the law of the place of incorporation of the company sought to be pierced. Therefore, it is critical to know the veil-piercing laws of the jurisdiction in which a portfolio company is incorporated.