

Using Alter Ego to Your Client's Advantage by Leonard H. Sansanowicz

The Empty Pocket Problem

As civil lawyers, we can't heal wounds, bring back the dead or revive a lost business opportunity. All the civil justice system allows us to do is obtain money for our clients.

Which is all well and fine, as long as there is money to recover from a wrongdoer. Sometimes, though, the target defendant does not have the resources to make good for the damage it caused. There may be a corporation operating as a front for its owner or another organization, without sufficient assets to satisfy a judgment. Or, perhaps a limited-liability company has passed through all its profits to its owner, leaving an empty shell with a net worth far less than your hard won verdict. There may even be an offshore irrevocable trust in the chain of ownership.

The law provides a tool to address these problems called the alter-ego doctrine. Sometimes referred to as "piercing the corporate veil," alter ego allows a plaintiff to look through the corporate fiction in order to achieve justice. While you may have pled that defendant "A" is the alter ego of defendant "B" in your complaint, chances are you have never fully explored just how the doctrine can work in your client's favor. The fact is, effective use of the alter-ego doctrine can help convince even the most difficult defendant that the civil justice system has teeth.

The Alter Ego Doctrine

You may already be familiar with the alter-ego doctrine in the context of suing a parent corporation along with its subsidiary in order to tap a deeper pocket. However, the alter-ego doctrine can also be utilized by a court to disregard a corporate entity and treat its acts as if they were the acts of an individual who controls the corporation. (See *Shapoff v. Scull* (1990) 222 Cal. App. 3d 1457, 1466, 1469, 1471 [overruled on other grounds by *Applied Equipment Corp. v. Litton Saudi Arabia, Ltd.* (1994) 7 Cal. 4th 503, 521].) The latter is especially useful where a high net worth individual is acting wrongfully through a corporate front as a way of avoiding or severely limiting liability. Even communists recognize the utility of this capitalist legal doctrine when bourgeois assets are at stake. (*Communist Party v. 522 Valencia* (1995) 35 Cal. App. 4th 980, 993-94, 995 [alter ego used to prevent two parties with the same interest from inequitably using the corporate form to thwart the Communist Party's rights].)

The theory of alter-ego is simple. When a corporation is used by an individual or another entity to perpetrate a fraud, circumvent a statute or accomplish some other wrongful or inequitable purpose, a court may disregard the corporate entity and treat its acts as if they were done by the controlling party. (*Communist Party*, supra, at 993.) The doctrine does not disregard the corporate fiction for all purposes. Instead, the issue is whether in the particular case and for the purposes of that case, "justice and equity

can best be accomplished and fraud and unfairness defeated by a disregard of the distinct entity of the corporate form." (Kohn v. Kohn (1950) 95 Cal.App.2d 708, 718.)

Utilizing the alter-ego doctrine, then, is akin to Toto unmasking the Wizard of Oz. The goal in pursuing alter-ego as a remedy is looking through the corporate veil and holding accountable the evil wizard who actually pulled the levers that damaged your client.

The burden of proving alter-ego liability lies with the plaintiff. (Minifie v. Rowley (1921) 197 Cal. 481, 488.) The standard is by a preponderance of the evidence. (Wollersheim v. Church of Scientology Int. (1999) 69 Cal. App. 4th 1012, 1018.) This standard generally is met by establishing two elements: "(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 del Golfo de California v. Resnick (1957) 47 Cal. 2d 792, 796.) Note that direct ownership of the subject corporation by the individual is not required; rather, the individual-corporate relationship can be established merely by showing that the individual will benefit. (See Riddle v. Leuschner (1959) 51 Cal. 2d 574, 580 [holding that the right to share in ownership or profits is sufficient to establish a strong unity of ownership and interest].) What should be of greater interest to the court is the second prong of this two-part test, avoiding inequity.

Fairness Has Its Day in Court

Corporations are often useful legal fictions and are treated as "persons" in the eyes of the law. In our capitalist society, we want to encourage people to take calculated risks and enter into as many transactions as possible in order to stimulate the economy. Thus, we encourage the creation of corporate entities behind which investors can shield their personal liability, so that they may feel emboldened to make business decisions they might otherwise consider too risky.

Under alter-ego, however, the law recognizes that we must at times ignore this legal fiction in order to achieve a fair resolution for someone who has been harmed and cannot be compensated for his loss. In pursuit of the truth, courts will use concepts such as justice, equity and fairness to justify piercing the corporate veil. These ideas take on heightened importance, as courts measure the alter ego doctrine's usefulness in those terms. (Kohn v. Kohn (1950) 95 Cal. App. 2d 708, 718 ["justice and equity can best be accomplished and...unfairness defeated by a disregard of the distinct entity of the corporate form"]; Shapoff, supra, at 1471 ["There must be some equitable purpose which will be served by ignoring the corporate form"]; Communist Party, supra, at 995 ["our Supreme Court has stated that the corporate form will be disregarded...only when the ends of justice so require"].)

Courts, after all, are trying to achieve some measure of justice. The alter-ego doctrine recognizes that in some instances courts will produce an unjust result if a defendant is allowed to hide behind a corporate entity. (Shapoff, supra, at 1471 ["The

alter ego doctrine is applied to avoid inequitable results”]; *Mesler v. Bragg Management Co.* (1985) 39 Cal. 3d 290, 301 [“The law of this state is that the separate corporate entity will not be honored where to do so would be to defeat the rights and equities of third persons” (quoting *Kohn*, supra, at 720)]; see also *Lebastchi v. Sup. Ct* (1995) 33 Cal. App. 4th 1465, 1470.)

So the law provides us with a useful tool. Now how do we go about using it?

Due Process Limitations

The best way to impose alter-ego liability is to name all possible defendants in the initial complaint at the beginning of the case. The reason is that this forces everyone who is potentially liable to participate in the entire action, which heads off an objection down the road that attempting to add an alter ego post judgment violates due process.

The general rule is that there is only one final judgment in an action. (See Cal. Civ. Proc. Code § 577 (2007) [“A judgment is the final determination of the rights of the parties in an action or proceeding.”]; see also *Vallera v. Vallera*, 64 Cal. App. 2d 266, 270 (1944) [“There can be but one final judgment in an action, and that is one which in effect ends the suit in the court in which it was instituted, and finally determines the rights of the parties.”].)

Still, there are exceptions to the one-final-judgment rule. (See *Howe v. Key System Transit Co.*, 198 Cal. 525, 533-34 (1926) [recognizing an exception where there was a determination of the rights of one or more defendants as to Plaintiff]; *Nicholas v. Henderson*, 25 Cal. 2d 375, 379 (1944) [noting that “it [i]s within the discretion of the trial court to enter two final determinations”]; *Cuevas v. Truline Corp.*, 118 Cal. App. 4th 56, 60-61 (2004) [“The one final judgment rule for appellate proceedings does not . . . prohibit separate or partial judgments against some, but not all, defendants. Such incomplete or partial dispositions are familiar in our jurisprudence”].)

The exceptions to the one-final-judgment rule give counsel and the court some options when dealing with multiple responsible parties, particularly where an action is bifurcated on liability, damages and alter ego lines. The court might, for example, enter a judgment against a primary defendant and then, later, enter a second judgment against a secondary defendant once alter-ego liability is established. Alternatively, the court has latitude to amend its original entry of judgment to incorporate the secondary defendant, should it agree to pierce the corporate veil and find that defendant jointly and severally liable. (See Cal. Code of Civ. Proc. § 187 (2007); *Dow Jones Co. v. Avenel* (1984) 151 Cal. App. 3d 144 [“A trial court has the authority to amend a judgment in order to add additional judgment debtors.”]; *Hall, Goodhue, Haisley & Barker v. Marconi Conf. Ctr. Bd.* (1996) 41 Cal. App. 4th 1551 [holding that the trial court erred in refusing to consider a motion to amend judgment under CCP § 187 because “[a]s a general rule, a court may amend its judgment at any time so that the judgment will properly designate the real defendants”].)

Convincing a court to look past the one final judgment rule, however, can be a tricky proposition. Trial courts are loathe to stray too far from precedent, for fear of being overruled. Be sure to cite the recent trend of appellate courts approving such decisions, to help your trial court feel comfortable with this unfamiliar terrain. (See *Cuevas v. Truline Corp.* (2004) 118 Cal. App. 4th 56, 60-61 [“The one final judgment rule for appellate proceedings does not...prohibit separate or partial judgments against some, but not all, defendants. Such incomplete or partial dispositions are familiar in our jurisprudence.”].) Also be sure to remind the trial court why you are seeking an alter-ego remedy in the first place: to better achieve the justice that is the primary business of a trial court.

Alter-Ego Interruptus: The Irrevocable Offshore Trust

Some defendants will try to further cut off their potential liability by using an off-shore irrevocable trust as part of an "asset protection scheme." Usually this means setting up a trust which becomes the legal owner of the corporate shell that performed the wrongdoing. Moreover, the trust is established in some favorable jurisdiction – the Cook Islands are one favorite – and the evil wizard of our story becomes the beneficiary to the trust and has control over it by means of a complex trust document. The defense to alter-ego then becomes, "I am not the owner of the empty corporate shell, the offshore trust is; go bother them."

While this presents a puzzle to plaintiffs' counsel, it is not unsolvable given the current state of the law.

U.S. Courts recognize the potential for abuse under these asset protection schemes, given that they are sometimes used "to frustrate and impede the United States courts by moving assets beyond those courts' jurisdictions" in an attempt to defraud creditors. (*F.T.C. v. Affordable Media, LLC*, (9th Cir. 1999) 179 F.3d 1228, 1240 [“Anderson”].) The courts understand that defendants often count on the fact that creditors will be discouraged by the expense and complexity of litigating claims in faraway places like the Cook Islands under legal systems with which they have little to no familiarity, and that the defendant's objective is to persuade creditors to settle for much less than their case is worth or to cease pursuing their claims entirely. Such a jurisdiction:

[D]oes not recognize U.S. judgments or other legal processes, such as asset freezes....Perhaps most importantly, situs courts typically ignore United States courts' demands to repatriate trust assets to the United States. A situs court will not enforce a United States order from a state court compelling the turnover of trust assets to a creditor that was defrauded under United States law, or assets that were placed into a self-settled settlement trust. (Anderson, *supra* at 1240.)

Moreover, trustees of asset protection trusts established in jurisdictions such as the Cook Islands are usually empowered to actively ignore any legal process other than

that of the trust location when there is “duress.” (Id.) “Duress” is generally defined as “[t]he issuance of any order, decree or judgment of any court or tribunal in any part of the world which in the opinion of the Protector will or may directly or indirectly, expropriate” or otherwise negatively impact the trust res, or property. (Id.) Often, the trustees of such trusts are working directly for the trustors, or settlors, of the trust, as the settlors are also beneficiaries of the trust assets. Thus, when a trustee is allowed to disregard U.S. law, in effect the defendant settlor himself is authorized to thumb his nose at U.S. creditors, since the trustee/protector is completely under the settlor’s dominion and control.

Understandably, courts don't like asset protection mechanisms that allow wrongdoers to ignore U.S. law with impunity. Even so, the challenge for any court in asserting its own authority is that, as noted in Anderson, often the only thing that remains in the court’s jurisdiction is the physical person of the defendant, not the asset itself. (Anderson, *supra* at 1240.) Typically, a court’s only recourse would be to hold the defendant in contempt until he paid his debt. However, under asset protection trusts, defendants often will transfer their powers of control to another party and assert that compliance with the court’s request is impossible, since they no longer control the assets in the trust.

As the Anderson court noted, “Impossibility of performance is a complete defense to a civil contempt charge.” (Id.) However, the burden of proving impossibility lies with the defendant. Furthermore, such a burden is “particularly high because of the likelihood that any attempted compliance with the court’s orders will be merely a charade rather than a good faith effort to comply.” Anderson, *supra* at 1241.

For this reason, U.S. courts have demonstrated a distaste for offshore asset protection schemes and have been noticeably pro-plaintiff on this issue. So, in imposing alter-ego liability, a court may disregard the existence of an intervening self-settled trust and find that ownership and control of the assets lie with the settlor-defendant. (As referred to in Anderson, a “self-settled trust” is one in which the settlor who supposedly is contributing assets to the trust is also a beneficiary; however, because she is a beneficiary, courts consider the trust’s assets as remaining on the settlor’s balance sheet. (See *In re Stephen J. Lawrence* (11th Cir. 2002) 279 F.3d 1294, 1297-1299; *SEC v. Bilzerian* (D.C. 2001) 131 F.Supp.2d 10, 15-18; see also *SEC v. Brennan* (2d Cir. 2000) 230 F.3d 65; *Bank of America v. Weese* (D.Md. 2002) 277 B.R. 241.))

In Anderson, the court recognized that just as the settlor/trustor had the power to appoint new trustees, so, too, did he have the power to find that the trust was not under “duress” and “therefore [could] force the foreign trustee to repatriate the trust assets to the United States.” (Anderson, *supra* at 1242.) In other words, the court looked through the fiction of the offshore trust just as a court will look through a corporate fiction under the alter-ego doctrine.

So, where the evidence shows our evil wizard (1) had the power to appoint trustees, (2) retained control over those trustees, and (3) was the primary beneficiary of

the trust account, the court may apply the alter-ego doctrine and pierce both the corporate veil and the intermediary trust in imposing liability directly against the controlling defendant with the money.

Recovery becomes possible; justice prevails.

Conclusion

The alter ego doctrine is rooted in a trial court's discretion to reach a decision based on what justice and fairness compels. Where an individual defendant is hiding behind a corporate identity, the court should pierce the corporate veil and find a merger of the personalities of the two. Where the individual party is attempting to hide his personal assets not merely through a corporation but also through a Cook Island trust in which he is a principal beneficiary, the court should recognize the outlandishness of the conduct and invalidate the trust on its face. What you as the plaintiffs' attorney must accomplish is to convince the court that these decisions must be made in a timely manner so as to maximize your client's potential recovery. By consolidating these issues into a single trial, you bypass any concerns the court may have with respect to the one-final-judgment rule and achieve a true measure of civil justice.

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