

GIBSON DUNN



Strategies Regarding Corporate Veil
Piercing and Alter Ego Doctrine

July 31, 2018

Robert A. Klyman
John M. Pollack

Lori Zyskowski
Sabina Jacobs Margot

Strategies Regarding Corporate Veil Piercing and Alter Ego Doctrine

Overview

1. “Piercing the Corporate Veil” and “Alter Ego” Liability
2. Case Studies
3. Minimizing the Risk of “Veil-Piercing” and “Alter Ego” Liability
4. Key Takeaways

“Piercing the Corporate Veil” and “Alter Ego” Liability

“Piercing the Corporate Veil”

Limited Liability The Hallmark of the Corporate Entity

“A basic tenet of American corporate law is that the corporation and its shareholders are distinct entities.”

Dole Food Co. v. Patrickson, 538 U.S. 468 (2003)

“In the interests of justice, in an ‘appropriate case,’ a party wronged by actions taken by an owner shielded by the veil of a corporate shell may exercise its equitable right to pierce that screen and ‘skewer’ the corporate owner.”

David v. Mast, 1999 WL 135244 (Del. Ch. Mar. 2, 1999)

“Piercing the Corporate Veil” (cont’d)

The Basic Test: Two Key Elements

Fraud / Injustice / Inequitable Result

- The failure to disregard the separateness of the corporate entity would sanction a fraud or promote injustice.

Single Economic Entity

- “Alter Ego”
- A unity of interest and ownership between the corporate entity and its equitable owners.
- Insufficient corporate separateness.

***Mason v. Network of Wilmington, Inc.*, 2005 WL 1653954 (Del. Ch. 2005)**

“Piercing the Corporate Veil” (cont’d)

“Alter Ego” Fact-Intensive Inquiry

- Inadequate capitalization
 - Insolvency
 - Lack of corporate formalities
 - Siphoned company funds
 - Façade for controlling shareholder
- Plus Fraud, Injustice, or Unfairness**

Winner Acceptance Corp. v. Return on Capital Corp.
2008 WL 5352063 (Del. Ch. 2008)

“Piercing the Corporate Veil” (cont’d)

Veil Piercing under Delaware Law

“[I]n the interest of justice, when such matters as fraud, contravention of law or contract, public wrong, or where equitable consideration among members of the corporation require it, are involved.”

Pauley Petroleum Inc. v. Continental Oil Co., 239 A.2d 629 (Del. Ch. 1968)

- The failure to observe corporate formalities by itself is not enough to justify piercing the corporate veil.
- Typically, some element of fraud, deceit, or asset-stripping is required to pierce the corporate veil.

“Piercing the Corporate Veil” (cont’d)

Piercing the LLC Veil

- Courts generally apply the same rules for LLC veil piercing.
- Except somewhat less emphasis is placed on whether the LLC observed internal formalities because fewer such formalities are legally required.

NetJets Aviation, Inc. v. LHC Communications, LLC
537 F.3d 168 (2d Cir. 2008)

“Piercing the Corporate Veil” (cont’d)

Which Law Applies?

- Traditional principles (“internal affairs doctrine”) dictate that if there is a conflict of law then the law of the place of incorporation should apply.
- Practically speaking, it is far better to fend off a veil piercing attack in Delaware than in other states (e.g., California).

***In re Washington Mutual, Inc.*, 418 B.R. 107 (Bankr. D. Del. 2009)**

“Piercing the Corporate Veil” (cont’d)

How Often Is Delaware Law Used to Pierce the Corporate Veil?

- 34%
- Statistic includes non-Delaware courts applying Delaware law.
- Veil-piercing between parent and subsidiary (versus individual and closely held corporation) is less frequent.

**Peter B. Oh, *Veil-Piercing*
89 TEX. L. REV. 81 (2010)**

“Persuading a Delaware Court to disregard the corporate entity is a difficult task.”

***Harco Nat’l Ins. Co. v. Green Farms, Inc.*
1989 WL 110537 (Del. Ch. Sept. 19, 1989)**

Case Studies

Unsuccessful Veil-Piercing Claim

In re Opus East, LLC

538 B.R. 30 (Bankr. D. Del 2015)

- Opus E., LLC (Delaware LLC) is developer and seller of commercial real estate projects.
- Part of a large network of real estate companies (a.k.a. the Opus Group).
- Separate holding and operating companies for different geographical areas.
- Opus E., LLC operated in the Northeast and Mid-Atlantic areas of the U.S.
- Successful business from 1994 to 2008.
- Real estate and financial crisis in 2008.
- Ultimately, Opus E., LLC filed for bankruptcy (Chapter 7) in 2009.
- Chapter 7 Trustee filed “veil-piercing” claim against parents and affiliated entities of Opus E., LLC.

Unsuccessful Veil-Piercing Claim

In re Opus East, LLC

538 B.R. 30 (Bankr. D. Del 2015) (cont'd)

- “Piercing the Corporate Veil” factors analyzed:
 - ✓ Insolvency/undercapitalization – against piercing corporate veil
 - ✓ Façade for shareholder – against piercing corporate veil
 - ✓ Corporate formalities – against piercing corporate veil, but “not dispositive” with respect to the analysis
 - ✓ Siphoning of funds – against piercing corporate veil
 - ✓ Element of Injustice of unfairness – against piercing corporate veil
- Affirmed on appeal: *In re Opus E., LLC*, 528 B.R. 30 (Bankr. D. Del. 2015), *aff'd*, 2016 WL 1298965 (D. Del. Mar. 31, 2016), *aff'd*, 698 F. App'x 711 (3d Cir. 2017)

Successful Veil-Piercing Allegations

Winner Acceptance Corp. v. Return on Capital Corp.,
2008 WL 5352063 (Del. Ch. 2008)

- Plaintiff: Winner Acceptance Corporation and Winner Group Leasing, Inc. are truck leasing companies.
 - Jubb's Mail Service, Inc. (lessee of trucks and trailers); Mid-Atlantic Postal Express, Inc. (assumed leases).
- Defendants: Postal Express of America, Inc. (guaranteed lease obligations); Return on Capital or Return on Equity Group, Inc. (parent); Edward M. Daspin (CEO), and Jeffrey Hitt and Ronald Stella (directors and officers).
- Winner sued Defendants to recover judgment for unpaid lease obligations under “alter ego” and “piercing the corporate veil” theory.
- Court denied Defendants’ motion to dismiss “veil-piercing” and “alter ego” claim.

Successful Veil-Piercing Allegations

Winner Acceptance Corp. v. Return on Capital Corp.,
2008 WL 5352063 (Del. Ch. 2008) (cont'd)

- “Piercing the Corporate Veil” factors analyzed:
 - ✓ Unreasonably small capital – favors veil piercing
 - ✓ Insolvency – favor veil piercing
 - ✓ Failure to observe corporate formalities – favors veil piercing
 - ✓ Siphoning funds – favors veil piercing
 - ✓ Corporate façade – favors veil piercing
 - ✓ Exclusive control – favors veil piercing
 - ✓ Element of fraud – favors veil piercing

Successful Veil-Piercing Allegations

In re Autobacs Strauss, Inc.

473 B.R. 525 (Bankr. D. Del. 2012)

- Third chapter 11 case of Strauss Discount Auto (auto parts and services).
- AB7 purchased Strauss in second chapter 11 case through newly formed subsidiary – ABST.
- Sellers were still owed \$8 million (\$45 million purchase price).
- ABST filed for chapter 11.
- Sellers and chapter 11 debtor sued AB7, claiming that ABST is an “alter ego” of AB7.
- Court denied AB7’s motion to dismiss “veil-piercing” and “alter ego” claim.

Successful Veil-Piercing Allegations

In re Autobacs Strauss, Inc.

473 B.R. 525 (Bankr. D. Del. 2012) (cont'd)

- “Piercing the Corporate Veil” factors analyzed:
 - ✓ Unreasonably small capital – favors veil piercing
 - ✓ Insolvency – favor veil piercing
 - ✓ Failure to observe corporate formalities – favors veil piercing
 - ✓ Absence of corporate records – favors veil piercing
 - ✓ Non-payment of dividends – no allegations
 - ✓ Siphoning funds – favors veil piercing
 - ✓ Corporate façade – favors veil piercing
 - ✓ Element of injustice of unfairness – favors veil piercing

Minimizing the Risk of “Veil-Piercing” and “Alter Ego” Liability

Tip 1

Adequately Capitalize Each Subsidiary

- Each subsidiary should be sufficiently capitalized to fund expected losses, particularly at formation.
- Courts consider whether a parent and a subsidiary (or affiliated entities) can separately support their own business operations.
- The parent of an undercapitalized subsidiary is a target for a “veil-piercing” claim and “alter ego” liability.

Tip 2

Solvency of Subsidiaries

- Current assets exceed current liabilities of each subsidiary.
- Each subsidiary is able to pay its debts as they become due.
- If subsidiary remains solvent, it can pay its own debts and no creditor needs to seek to pierce the corporate veil.

Tip 3

Adequate Separation in Management

- The goal is to minimize – to the extent possible – the amount of parental control over a subsidiary’s day-to-day operations.
- The parent does not necessarily excessively control the subsidiary merely by being involved with subsidiary operations (e.g., setting general policies for FCPA compliance), or by exercising a measure of supervision or control.
- Some courts have held that the level of “domination” must rise to the level of intrusive, hands-on, day-to-day control with the parent often leaving little discretion whatsoever to the subsidiary.

Tip 4

Avoid Excessive Parental Control

If feasible, try to avoid:



Continuous, day-to-day parental participation in daily operations.



Parental determination of important subsidiary policy decisions that should be made by the subsidiary.



Parental determination of subsidiary business decisions while bypassing existing subsidiary managers.

Tip 5

Comply with Corporate Formalities

- Failure to comply with basic corporate formalities can create a problem from a corporate separateness perspective.
 - Form a board of directors for each subsidiary.
 - Hold regular board meetings where the board considers substantive matters in depth.
 - Document the election of officers and directors on an annual basis or, as needed, to address vacancies.
 - No majority overlap of board members among parent and its subsidiaries.
 - Document the corporate decision making process as necessary (e.g., keep contemporaneous minutes for meetings, or support board action with properly executed written consents and resolutions).

Tip 6

Consolidate Each Business's Essential Assets in Separate Subsidiary

- Where feasible, separate assets that are uniquely used to run each business division (e.g., intellectual property and key assets) from assets that are commonly used by affiliates.
- Shared corporate assets can stay with a parent company or another affiliate as long as:
 - a) the subsidiary compensates the parent or affiliate for their use through written intercompany agreements, and
 - b) intercompany agreements are on market terms.

Tip 7

Each Subsidiary Should Conduct Its Business In Its Own Name

- Courts have considered whether third parties view the parent and subsidiary as separate entities or see them as a single entity.
- To evidence separateness, use separate email addresses, letterhead, and invoices when communicating internally and with outside parties. This includes using separate names and logos on websites.
- Ensure that the correct entity signs all relevant legal agreements.

Tip 8

Separate Offices and Signage

- Maintain separate offices clearly identified by signage and separate telephone and address listings.
- Courts consider whether a parent and a subsidiary, or affiliated entities:
 - share common office space,
 - have the same publicly listed telephone numbers, and
 - each have signs that identify their separate places of business.

Tip 9

Maintain Separate Bank Accounts

- If feasible, maintain separate and independent bank accounts, leases, titles.
- Use a separate bank account for payments made on behalf of the entity.
- Ideally, have only officers with signatory authority on the account who are officers of the applicable corporate entity.
- If separate cash accounts for each subsidiary is not feasible, then carefully research and evaluate any cash management program.

Tip 10

Maintain Separate Books and Records

- Courts have considered whether the parent and subsidiary have comingled assets and liabilities.
- Implement and maintain a practice of producing separate balance sheets and P&L statements.
- Overall, maintain the ability to determine the value of assets, liabilities, revenues, and expenses for each subsidiary.

Tip 11

Maintain Financial Integrity

- With the help of advisors, maintain strict compliance with applicable laws and guidelines for declaring dividends and adequate capitalization, insurance, and ability to support the business.
- Courts have analyzed whether the dominant stockholder or member is taking assets or funds from the subsidiary without fair consideration.



Tip 12

Separate Employees

- If practicable, each subsidiary should employ its own employees, including its own officers.
- Each subsidiary should have its own employee handbook, even if it is essentially identical to the policies of the parent.
- Each subsidiary should make its own decisions about hiring and firing its employees.

Tip 13 Document Intercompany Transactions

- Courts have considered whether the parent company uses its subsidiary's assets without documentation or some type of consideration or payment.
- Set forth the relationship between the companies in a service agreement or other similar agreement.
- Document the terms of all material intercompany transactions, including:
 - funds flowing between affiliates, including an accounting of such funds,
 - the use of affiliate's assets, including shared services,
 - joint development or marketing efforts,
 - licenses for IP and service agreements for web hosting, and
 - use by affiliates of web hosting services.

Tip 14

Intercompany Transactions Should Be Fair

- Courts have considered the interactions between affiliates with a particular emphasis on whether the terms are fair to both parties.
- For most intercompany transactions, using market-based terms for intercompany transactions is recommended.
- For example, if your subsidiary uses the parent's servers, this arrangement should be documented in an intercompany service agreement and the subsidiary should pay reasonable compensation to the parent for use of the servers.

Tip 15

Be Mindful About Officers and Directors

- Where feasible, it is ideal to avoid a situation where you have complete overlap of officers and directors.
- This can help address two issues considered by courts:
 - the degree of control exercised by the parent company, and
 - the subsidiary's employment of managers who focus on day-to-day operations and whose duties run solely to the subsidiary.
- Senior level executives who provide services solely to the subsidiary should be employed by the subsidiary.
- The best practice (which may not always be practical) is to ensure that the board of each subsidiary has at least one independent member who is focused solely on the subsidiary.

Key Takeaways

Key Takeaways

- Veil piercing is a fact-intensive inquiry. There is no one factor that, alone, is likely to justify veil piercing (nor is there any one factor that will protect you from it).
- Overall, strive to observe corporate formalities, avoid complete domination and control by the parent company, and set up each subsidiary so that it can function as its own entity, with sufficient capitalization, personnel, records, and without commingling funds or causing confusion about its identity.
- In practice, many companies are unable to act in accordance with all of these tips. The bottom line is that the more of these tips you are able to follow, the less likely you are to face veil piercing and alter ego claims.
- Other considerations can sometimes trump corporate separateness concerns from a risk/reward perspective.

Professional Profiles

Robert A. Klyman

333 South Grand Avenue, Los Angeles, CA 90071
Tel: +1 213.229.7562
RKlyman@gibsondunn.com



Robert A. Klyman is a partner in the Los Angeles office of Gibson, Dunn & Crutcher and Co-Chair of Gibson Dunn's Business Restructuring and Reorganization Practice Group. Mr. Klyman represents debtors, acquirers, lenders and boards of directors. His experience includes advising companies in connection with out-of-court restructurings, as well as, traditional, prepackaged and “pre-negotiated” bankruptcies; representing lenders and other creditors in complex workouts; counseling strategic and financial players who acquire debt or provide financing as a path to take control of companies in bankruptcy; structuring and implementing numerous asset sales through Section 363 of the Bankruptcy Code; and litigating complex bankruptcy and commercial matters arising in chapter 11 cases, both at trial and on appeal.

Turnarounds & Workouts named Robert Klyman to its 2016 list of Outstanding Restructuring Lawyers which honors 12 attorneys each year who are leaders in the bankruptcy field. In addition, Mr. Klyman has been widely and regularly recognized for his debtor and lender work as a leading bankruptcy and restructuring attorney by Chambers USA; named as one of the world's leading Insolvency and Restructuring Lawyers by *Euromoney*; listed in the K&A Restructuring Register, a leading peer review listing, as one of the top 100 restructuring professionals in the United States; named as a “Top Bankruptcy M&A Lawyer” by *The Deal's Bankruptcy Insider*; named as one of the 12 outstanding bankruptcy lawyers in the nation under the age of 40 (in 1999, 2000, 2002 and 2004) by *Turnarounds & Workouts*; and one of “20 lawyers under 40” to watch in California by the Daily Journal. Mr. Klyman was recently selected by his peers for inclusion in *The Best Lawyers in America*® 2017 in the field of Bankruptcy and Creditor Debtor Rights.

Mr. Klyman developed, and for the past 20 years co-taught, a case study for the Harvard Business School on prepackaged bankruptcies and bankruptcy valuation issues. He has also taught classes on dealmaking in the bankruptcy courts at the University of Michigan Business School and UCLA Law School. Mr. Klyman is also a member of the ABA Subcommittee that drafted the recently released ABA Model Bankruptcy Asset Purchase Agreement.

Mr. Klyman received both his J.D. from the University of Michigan Law School in 1989 and his B.A. degree from the University of Michigan in 1986. Mr. Klyman is admitted to the California Bar.

John M. Pollack

200 Park Avenue, New York, NY 10166

Tel: +1 212.351.3903

JPollack@gibsondunn.com



John M. Pollack is a partner in the New York office of Gibson, Dunn & Crutcher. He is a member of the Mergers and Acquisitions, Private Equity, Aerospace and Related Technologies and National Security Practice Groups.

Mr. Pollack focuses his practice on public and private mergers, acquisitions, divestitures and tender offers, and his clients include private investment funds, publicly-traded companies and privately-held companies. Mr. Pollack has extensive experience working on complex M&A transactions in a wide range of industries, with a particular focus on the aerospace, defense and government contracts industries.

Mr. Pollack has been recognized as a leader in his field by *Chambers USA*, which praised him for being “fantastic to work with, very bright and very attentive to detail.” He also was named one of *Law360’s* Rising Stars of 2013 for Private Equity.

Mr. Pollack’s private equity clients have included and include Liberty Hall Capital Partners, Veritas Capital and Cerberus Capital Management.

Mr. Pollack has also represented various public companies in change of control transactions, including Aeroflex Holding Corp. (\$1.5 billion sale to Cobham plc), Dyncorp International (\$1.5 billion sale to Cerberus Capital) and Charming Shoppes (\$900 million sale to Ascena Retail Group).*

Mr. Pollack graduated *magna cum laude* from The George Washington University and The George Washington University Law School, the latter bestowing upon him High Honors, Order of the Coif and an award for Highest Overall Proficiency in Securities Law.

Mr. Pollack serves on The George Washington University Law School Board of Advisors, as well as is a member of the Law School’s Center for Law, Economics & Finance (C-LEAF) Advisory Board.

**Representations were made by Mr. Pollack prior to his association with Gibson Dunn.*

Lori Zyskowski

200 Park Avenue, New York, NY 10166
Tel: +1 212.351.2309
LZyskowski@gibsondunn.com



Lori Zyskowski is a partner in Gibson Dunn's New York office and Co-Chair of the Firm's Securities Regulation and Corporate Governance Practice Group. Ms. Zyskowski advises public companies and their boards of directors on corporate governance matters, securities disclosure and compliance issues, executive compensation practices, and shareholder engagement and activism matters.

Ms. Zyskowski advises clients, including public companies and their boards of directors, on corporate governance and securities disclosure matters, with a focus on Securities and Exchange Commission reporting requirements, proxy statements, annual shareholders meetings, director independence issues, and executive compensation disclosure best practices. Ms. Zyskowski also advises on board succession planning and board evaluations and has considerable experience advising nonprofit organizations on governance matters.

Before joining Gibson Dunn, for over a decade Ms. Zyskowski served as internal securities and corporate counsel at several large publicly traded companies, including most recently at General Electric Company. Her in-house experience provides a unique insight and perspective on the issues that her clients face every day.

Ms. Zyskowski is a frequent speaker on governance, proxy and securities disclosure panels and is very active in the corporate governance community. She is a former member of the board of directors of the Society for Corporate Governance and served as the President of its New York Chapter from 2016-2017.

She graduated from Columbia University School of Law in 1996 and was a Harlan Fiske Stone Scholar. Ms. Zyskowski received her undergraduate degree from Harvard University.

Sabina Jacobs Margot

333 South Grand Avenue, Los Angeles, CA 90071
Tel: +1 213.229.7381
SJacobs@gibsondunn.com



Sabina Jacobs Margot is an associate in the Los Angeles office of Gibson, Dunn & Crutcher. She is a member of the Business Restructuring and Reorganization and Global Finance practice groups.

Ms. Jacobs Margot practices in all aspects of corporate reorganization and handles a wide range of bankruptcy and restructuring matters, representing debtors, lenders, equity holders, and strategic buyers in chapter 11 cases, sales and acquisitions, bankruptcy litigation, and financing transactions. Ms. Jacobs Margot also represents borrowers, sponsors, and lending institutions in connection with acquisition financings, secured and unsecured credit facilities, asset-based loans, and debt restructurings.

Ms. Jacobs Margot has published and presented on various topics, including bankruptcy issues, make-whole premiums, spin-offs, consignment issues, alter ego and veil piercing exposure, retail distress, and underfunded pension plan liabilities.

Ms. Jacobs Margot has served as Treasurer and Sponsorship Chair for the Southern California Network of the International Women's Insolvency & Restructuring Confederation, and is a member of the American Bankruptcy Institute. She also served as a staff attorney for the ABI Commission to Study the Reform of Chapter 11 and edited the *Final Report and Recommendations* of the ABI Commission.

Ms. Jacobs Margot is a member of the Leadership Council of the Los Angeles Center for Law & Justice and has handled various pro bono matters in partnership with the Inner City Law Center, Neighborhood Legal Services, Alliance for Children's Rights, Bet Tzedek, and Public Counsel.

Prior to joining Gibson Dunn, Ms. Jacobs Margot served as the law clerk to the Honorable Brendan L. Shannon of the United States Bankruptcy Court for the District of Delaware from 2010 to 2011 and was an associate with Latham & Watkins LLP from 2011 to 2014. Ms. Jacobs Margot earned her Juris Doctor cum laude in 2010 from Loyola Law School, Los Angeles, where she served as Editor-in-Chief of the Loyola of Los Angeles Law Review and was elected to the Order of the Coif. While in law school, she also held judicial externships with the Honorable Richard M. Neiter and the Honorable Thomas B. Donovan, both of the United States Bankruptcy Court for the Central District of California.

Disclaimer

Although this presentation may provide information concerning potential legal issues, it is not a substitute for legal advice from qualified counsel. This presentation is not created nor designed to address the unique facts or circumstances that may arise in any specific instance. You should not, nor are you authorized to, rely on this content as a source of legal advice. This material does not create any attorney-client relationship between you and Gibson Dunn.

© Copyright 2018 Gibson, Dunn & Crutcher LLP. All Rights Reserved.

Our Offices

Beijing

Unit 1301, Tower 1
China Central Place
No. 81 Jianguo Road
Chaoyang District
Beijing 100025, P.R.C.
+86 10 6502 8500

Brussels

Avenue Louise 480
1050 Brussels
Belgium
+32 (0)2 554 70 00

Century City

2029 Century Park East
Los Angeles, CA 90067-3026
+1 310.552.8500

Dallas

2100 McKinney Avenue
Suite 1100
Dallas, TX 75201-6912
+1 214.698.3100

Denver

1801 California Street
Suite 4200
Denver, CO 80202-2642
+1 303.298.5700

Dubai

Building 5, Level 4
Dubai International Finance Centre
P.O. Box 506654
Dubai, United Arab Emirates
+971 (0)4 370 0311

Frankfurt

TaunusTurm
Taunustor 1
60310 Frankfurt
Germany
+49 69 247 411 500

Hong Kong

32/F Gloucester Tower,
The Landmark
15 Queen's Road Central
Hong Kong
+852 2214 3700

Houston

1221 McKinney Street
Houston, Texas 77010-2046
+1 346.718.6600

London

Telephone House
2-4 Temple Avenue
London EC4Y 0HB
England
+44 (0) 20 7071 4000

Los Angeles

333 South Grand Avenue
Los Angeles, CA 90071-3197
+1 213.229.7000

Munich

Hofgarten Palais
Marstallstrasse 11
80539 Munich
Germany
+49 89 189 33-0

New York

200 Park Avenue
New York, NY 10166-0193
+1 212.351.4000

Orange County

3161 Michelson Drive
Irvine, CA 92612-4412
+1 949.451.3800

Palo Alto

1881 Page Mill Road
Palo Alto, CA 94304-1125
+1 650.849.5300

Paris

166, rue du faubourg Saint Honoré
75008 Paris
France
+33 (0)1 56 43 13 00

San Francisco

555 Mission Street
San Francisco, CA 94105-0921
+1 415.393.8200

São Paulo

Rua Funchal, 418, 35° andar
Sao Paulo 04551-060
Brazil
+55 (11)3521.7160

Singapore

One Raffles Quay
Level #37-01, North Tower
Singapore 048583
+65.6507.3600

Washington, D.C.

1050 Connecticut Avenue, N.W.
Washington, D.C. 20036-5306
+1 202.955.8500