Veil-Piercing Under California Law – Heightened Risks for Fund Managers

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We recently posted about the risks associated with veil-piercing claims and the ways in which fund managers can protect themselves from exposure to these claims. Our first post on veil-piercing focused on Delaware standards, while this post discusses California law.

California law differs in several important respects from Delaware law on this topic. If a company is subject to suit in California, there are increased risks *even if the company is incorporated elsewhere*. Courts may assert that California law should apply when the plaintiff is a California resident or when the company operates in California.

And where California law applies, courts may aggressively set aside corporate distinctions, leading to unanticipated results. For example, a Santa Clara Superior Court held in recent years held that a private fund limited partnership entity could be held responsible for the fund GP's obligations to its former employees.

Because the alter ego inquiries are so fact-driven, if an underlying California cause of action against the portfolio company survives, it is likely the alter ego claim may survive too—beyond the dismissal stage, leading to costly litigation involving the fund. That means that a liability of the fund or even its GPs could well become entirely dependent, on a derivative basis, on that of the portfolio company.

What Law Applies?

Most states follow the internal affairs doctrine and apply the law of the state of incorporation to piercing the corporate veil claims. However, no California case has done this. To the contrary, statements made in California cases strongly suggest that the "internal affairs doctrine" would not apply to a veil piercing claim. *See, e.g., Lidow v. Superior Court*, 206 Cal. App. 4th 351, 362 (2012). And a federal district court in the Northern District of California, interpreting California law in a diversity case, concluded that the "internal affairs doctrine" does not apply to choice-of-law questions involving the alter ego/veil piercing doctrine. *Oncology Therapeutics Network Connection v. Virginia Hematology Oncology PLLC*, No. C 05-3033 WDB, 2006 WL 334532, at *17 (N.D. Cal. Feb. 10, 2006).

Instead, California applies the choice-of-law test it traditionally uses for all other claims: the "governmental interest" test. California's "governmental interest" test is complicated and costly to litigate. It involves three basic steps:

1. First, do the competing states' laws differ?

- *In other words, is the substantive law of alter ego/veil piercing different in state X than in state Y California*?
- *If the laws of the competing states do not differ, then either state's law produce the same result, and it doesn't matter which law you apply, you'll get the same result*.

1. If the laws of the competing states do differ, the court then identifies which interests of each state, if any, could be impaired if the court does not apply that state's laws.
2. If both states have interests that would be impaired if its their laws are not applied, the California court conducts an analysis of "comparative impairment" to determine which state has the greater interest in having its laws applied.

- *When the plaintiff is a California resident who claims to have been injured by the defendant, or when the defendant is doing business in California and subject to suit there, California courts tend to find that California has the greater interest.*

- *In either scenario, the court is validating California's interest in policing (California defendant) or giving redress to its own citizens (California plaintiff).*

In short, if a plaintiff can bring the suit in California, there is good chance California law will apply to any veil-piercing claims – even if the company and the fund are located elsewhere.

General Standards in California

California law typically does *not* require a plaintiff to come forward with evidence of fraud in order to apply the veil piercing doctrine. Rather, a California plaintiff only needs to show that honoring the corporate form would “promote injustice” or “bring about inequitable results.”

California utilizes a non-exclusive, multi-factor test to make veil-piercing determinations. This long list of almost twenty factors (including one factor that points to the existence of additional factors as yet unarticulated by the courts) includes the following:

1. commingling of funds and other assets;
2. the holding out by an individual that he is personally liable for the debts of the corporation
3. failure to maintain adequate corporate records;
4. identical equitable ownership in the two entities;
5. identification of the directors and officers of the two entities in the responsible supervision and management;
6. sole ownership of all of the stock in a corporation by one individual or the members of a family;
7. the use of the same office or business location;
8. the employment of the same employees and/or attorney; and
9. failure to maintain arm’s length relationships among related entities.

Morrison Knudsen Corp. v. Hancock, Rothert & Bunshoft, LLP, 69 Cal. App. 4th 223, 249–50 (Cal. Ct. App. 1999). California courts have made it clear that summary judgment is rarely appropriate for veil-piercing determinations. All a plaintiff likely needs to survive summary judgment is a genuine dispute of material fact over *some* of these factors.

Takeaways:

What You Can Do

So, what can you do to protect a fund from piercing claims? Our prior post outlined a list of dos and don’ts to help minimize exposure to alter ego claims. If the portfolio company is potentially subject to claims in California, these concerns are even more heightened. A fund manager might evaluate the structure with the view of a California court: would recognizing the corporate limitation of liability “promote injustice” or “bring about inequitable results?” If so, the manager may want to take steps to further extend its arm’s length relationship with the investment.

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