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The Return Of Alter Ego

By Michael W. Peregrine, McDermott Will & Emery LLP

It's not a true horror story, but for nonprofit corporate structuring purposes, it might as well be. In the recent decision, *Network for Good v. United Way of the Bay Area*, the San Francisco Superior Court applied the hoary legal concept of *alter ego* to allow a small charity to "pierce the corporate veil" of a United Way affiliate and attribute millions of dollars in liability to the larger parent organization.[1] In so doing, the court confirms application of *alter ego* and related "ascending liability" theories to the nonprofit sector. It also raises a significant "yellow flag" to nonprofit organizations, including health systems, in their efforts to streamline system governance and management, and achieve system-based operating efficiencies. Indeed, some control practices utilized by nonprofit systems to achieve efficiencies through subsidiary operations may unintentionally expose the parent to greater liability based upon *Network for Good*-type facts. As such, the decision is a useful guide for nonprofit corporate counsel.

The Facts. *Network for Good* arises from circumstances not unfamiliar to many nonprofit organizations—the 2000 "spin-off" of administrative/"back office" functions by a principal operating charity (here, the United Way of the Bay Area (UWBA)) to a controlled affiliate (the newly created "PipeVine"), in order to lower the operating charity's overhead costs. Overhead expense was a significant factor tracked by UWBA partners and donors and thus was closely monitored by UWBA leadership. Following the spin-off, a major activity to be conducted by PipeVine was pledge processing for UWBA and its national and local contributors (an activity that previously had been conducted by an unincorporated department of UWBA).[2] Plaintiff Network for Good is a charitable organization that provides the public with the opportunity to research, and contribute to, nonprofits. Network had entered into a contract with UWBA (which contract was subsequently assigned to PipeVine as part of the spin-off) to provide pledge processing services for charitable donations made online through Network's website. Less than three years after the spin-off, PipeVine ceased operations when its board determined that it was "seriously under water" with major losses, with checks outstanding that were approximately $1 million in excess of its cash account balance, and with over $4.5 million owed to charities in the form of processed but undistributed donations. The California Attorney General quickly moved to appoint a receiver for PipeVine.[3]

When PipeVine collapsed financially, Network (and its nonprofit customers) incurred a substantial harm (according to the court). In particular, it was forced to satisfy over $2.3 million in charitable donations that PipeVine was supposed to process but that Network ultimately had to pay out to its own charitable donees. Network also was forced to replicate in-house the transaction-processing functions PipeVine had provided; suffered from customer attrition due to the disruption in payment processing; lost revenue in excess of $375,000; and incurred a material capital crisis.

It was these circumstances involved with the collapse of PipeVine that provided the basis for the court to apply *alter ego* treatment against UWBA and in favor of Network.

The Law. The concept of "piercing the corporate veil" serves as an exception to the fundamental rule of limited liability afforded by the corporate form.

It is a basic tenet of corporate law that the corporation is a specific legal entity, distinguishable from its shareholders.[4] A particular advantage of such separate recognition is that the use of corporate form provides shareholders with limited liability, protecting them from liability for the debts and obligations of the corporation.[5] Rather, shareholder liability exposure is limited to the amount of their capital contributions.[6]

This tenet also applies to the parent-subsidiary relationship. A parent corporation and its subsidiary are generally regarded as separate, distinct legal entities.[7] Much like an individual shareholder, a parent is not held liable for the debts and obligations of the subsidiary beyond what is at risk as its capital contributions.[8] In part, it is this

concept of limited liability that has prompted many nonprofit organizations, including health systems, to protect certain assets and activities from regulated or high risk business lines by transferring the assets or activities into separate corporations controlled by a common parent holding company.

However, the courts of virtually all states recognize that, in some unique instances, fairness requires that the corporate entity be disregarded and liability imposed upon its members.[9] “Piercing the corporate veil” is an equitable remedy, the application of which depends largely on the facts and circumstances of each case. This remedy will be applied in order to avoid unjust results arising from strict adherence to the notions of corporate separateness and limited liability. Organizing a corporation for the purposes of avoiding liability will not alone serve as a basis for piercing the corporate veil; the law typically requires evidence that the corporate structure was used to defeat public convenience or perpetrate or protect a crime or fraud before liability will affix.[10] In the parent/subsidiary context, courts will disregard corporate separateness when three factors have been met: (a) the subsidiary is not operated as a separate corporate entity, but rather as the “alter ego” or “instrumentality” of the parent; (b) the defendant parent’s conduct in using the subsidiary was somehow unjust, fraudulent, or wrongful towards the plaintiff; and (c) the plaintiff had actually suffered harm as a result of the conduct of the defendant parent.[11]

Courts are historically reluctant to apply *alter ego* treatment.[12] It will arise (and corporate separateness will be disregarded) only when the parent uses the subsidiary to advance its own purposes, or if the subsidiary operates solely for the parent’s benefit or has no separate existence or “will” of its own. Although no one factor is determinative of whether a subsidiary will be regarded as the *alter ego* or instrumentality of its parent, courts often will look to the following factors to determine whether to pierce the corporate veil:

- The parent corporation owns all or most of the stock of the subsidiary.
- The parent and subsidiary have common directors, officers, and employees.
- The parent corporation initially and continuously finances the subsidiary.
- The subsidiary has inadequate capital to meet its reasonably foreseeable needs.
- The parent corporation pays the salaries and other expenses of the subsidiary.
- The subsidiary has substantially no business except with the parent or no assets except those conveyed by the parent.
- The subsidiary is described as a department or division of the parent, or its business or financial responsibility is referred to as the parent’s own in the papers of the parent or the statements of its officers.
- The parent owns the property used by the subsidiary in carrying out its business.
- The directors or executives of the subsidiary do not act independently in the interest of the parent, but take their orders from the parent in the parent’s interest.
- The formal legal requirements of the subsidiary are not observed.
- Intra-corporate transactions are not at arm’s-length (i.e., contracts between the corporation are more favorable to the parent corporation).
- Decision-making for the subsidiary is carried out by the parent.
- The two operations are so integrated through the commingling of funds, activities, common direction, and supervision that they should be considered one enterprise.
- The subsidiary is operated without a profit.[13]

It is important to note that a claim based on the *alter ego* theory is procedural, as opposed to a claim for substantive relief. In other words, a determination of *alter ego*, on its own, establishes no cause of action. Rather, it serves as a basis for a plaintiff to assert a cause of action against a second corporation or individual that otherwise would have existed only against the first corporation. Thus, an effort to “pierce the corporate veil” is a vehicle for applying liability on an underlying cause of action (e.g., tort, or breach of contract).[14]

Indeed, Network for Good asserted multiple causes of action, based on breach of contract, breach of fiduciary duty, negligent misrepresentation, constructive fraud, fraud, promissory estoppel, conversion, and unjust enrichment. The court observed that the case was not “your garden variety breach of contract between two entities seeking implementation of alter ego liability."[15] Here, application of the alter ego doctrine in this case also reflected “the fiduciary relationship between a charity and any person soliciting on behalf of a charity, and the person for whom a charitable contribution is being solicited.”[16] According to the court, this triggered a “higher level of accountability” on the part of UWBA and its development of PipeVine. (The actual weight applied by the

court to this "higher level" is unclear.) How such a charitable trust-based accountability would apply in other situations involving nonprofits would likely depend upon the nature of the relationships and the extent to which parent and subsidiary were intertwined.

Why We Care. The particular relevance of *alter ego* treatment, and of the *Network for Good* decision, lies in efforts by nonprofit organizations and systems (e.g., health systems) to transition from the traditional (but looser) holding company governance and management model, to the (tighter) corporate enterprise model.[17] The attributes of the latter model include greater influence and (in some cases) outright control at the "top"/parent level over system assets, governance, management, and quality.[18] Sometimes referred to as "systemness," this model reflects the goal of acting more like a single integrated organization rather than as a collection of independent entities under common control.[19] Specific indicia of "systemness"/corporate enterprise model include, at the conceptual level, shifting decision-making responsibility and authority from subsidiary operating units to the parent level, and centralizing/standardizing key management systems and processes.[20] On a more practical level, this may involve indicia such as use of overlapping directors and officers, holding simultaneous board meetings between parent and subsidiaries, and basing key system committees (e.g., audit, finance, and compliance) and key corporate services (e.g., legal, audit, compliance, and human resources) in the parent. However, as *Network for Good* suggests, it is in the aggressive use of these control and efficiency mechanisms that the risk of *alter ego* treatment may arise.

Triggering Liability. The Superior Court relied on multiple factors, arising from the planning for and implementation of the PipeVine "spin-off," in concluding that the operations, finances, and personnel of UWBA and PipeVine were so intertwined as to justify *alter ego* treatment.[21] According to the court, these factors (all of which could be relevant to a "systemness" scenario) included the following:[22]

1. Poor Planning. UWBA did not consider the issues of PipeVine's capitalization or liquidity prior to its separation from UWBA. Minutes from UWBA Board and Committee meetings indicated that the primary focus of corporate governance was on the benefits to UWBA of the PipeVine spin-off and how it would protect UWBA's interests. Little consideration was given to PipeVine capitalization and business planning.[23] The only financial analysis of the spin-off was contained in a draft business plan, which focused on PipeVine's post-separation operating expenses and revenue, and which did not address capital needs.

2. Under Capitalization. The court's interpretation of PipeVine's financial statements was that PipeVine was significantly undercapitalized when it was spun-off from UWBA. Indeed, the court was highly critical of UWBA's PipeVine-related accounting. For example, PipeVine's opening balance sheet showed that its liabilities exceeded its liquid assets by over $640,000. Furthermore, of those liabilities, the "amounts due to agencies" were almost $220,000 more than cash available to pay those amounts. This meant that PipeVine could not pay those existing obligations (as well as to pay its own operating expenses) without using new donations to do so (which it did from "day one" of operations). Certain subsequent adjusting journal entries hid important facts regarding amounts owed by PipeVine to charities and amounts owed PipeVine by UWBA. UWBA never funded certain grants and receivables owed to PipeVine. The court stressed that the degree of undercapitalization of PipeVine tolerated by UWBA was "flagrant and critical to the legal issues of the case."

3. No Separation. From and after the spin-off, UWBA and PipeVine operated as though no corporate separation had occurred. For example, UWBA and PipeVine continued to rely on the pre-spin-off practice of using intercompany accounts for transactions between themselves, rather than by invoicing or billing. After the spin-off, UWBA and PipeVine continued to occupy the same office space. Later they both moved to a new location where they occupied the same floor without physical barrier or partition. UWBA's chief financial officer had no staff and could not write checks, but rather relied on PipeVine to perform such essential financial functions. Post-separation, UWBA and PipeVine continued to use shared vendor accounts because it was easier than establishing new separate accounts. PipeVine also had signing authority on UWBA accounts and the ability to move funds between accounts.[24]

4. Exertion of Control. UWBA exerted a degree of control over PipeVine that it would not otherwise have had in a traditional, arm's-length outsourcing relationship. This control related primarily to the ability to manipulate financial statements of both organizations to make UWBA "look better." It also involved UWBA's (a) retention of a right to obtain an equity interest in PipeVine should it subsequently convert to for-profit status and be sold; (b) retaining the right to reclaim PipeVine's resources, functions, and assets for UWBA's use in the event PipeVine was not financially successful; (c) failure to secure separate counsel for PipeVine in connection with the separation; (d) failing to pay PipeVine service fees for the first year of PipeVine's existence; (d) repeatedly "pulling back" PipeVine employees and services previously spun-off and reducing service fees without amending the service agreement (making it difficult for PipeVine to operate); (e) requesting and receiving extra services from PipeVine without paying for them; (f) charging a senior UWBA volunteer to analyze PipeVine's business model; (g) taking possession of PipeVine computers, software, and donor data, and "cherry picking" PipeVine personnel upon its

collapse, to continue UWBA pledge processing without interruption; (h) maintaining overlapping officers, directors, counsel, and auditors with PipeVine; and (i) commingling assets, books and records with PipeVine.

5. Note: Inequitable Result. The court concluded that failure to pierce the corporate veil would yield an inequitable result. Cited in support of this conclusion was that UWBA (a) abused the corporate form in "spinning-off" an undercapitalized PipeVine; (b) ignored repeated warnings about the viability of PipeVine (preferring instead to act in its own self interest); (c) continued to deny that PipeVine was owed $4.7 million for UBWA expenses paid by PipeVine before the spinoff; (d) continued to deny that PipeVine paid $5.2 million in liabilities "due to agencies" within a few months following the spin-off; and (e) repudiated all fees owed to PipeVine under the services agreement; and that great harm was caused to charitable giving (particularly online charitable giving) by the PipeVine collapse. In essence, because UWBA and PipeVine were so intertwined, UWBA became aware early of PipeVine's looming distress and was in a position to take action that *Network for Good*, and PipeVine's other customers, could not.

Conclusion

The Superior Court's decision provides very useful guidance to corporate counsel on application of *alter ego* treatment to nonprofit organizations in general, and on the types of actions, relationships, and arrangements that create the basis for *alter ego* treatment. This is guidance which, when shared with corporate strategists, can help reduce the legal risks that "systemness" structures and similar efficiency mechanisms can sometimes unknowingly create. Even if the decision is ultimately reversed on appeal, *Network for Good* is a helpful reminder that *alter ego*-based actions can be successfully asserted—at least through the trial court level—against nonprofit organizations.

The "yellow flag" raised by *Network for Good* becomes considerably brighter when considered in connection with the 2005 decision in *Forsythe v. Clark USA, Inc.*[25] That case essentially "re-introduced" the "direct participant" theory of liability, a well established but lesser known exception to the general rule that the corporate veil will not be pierced in the absence of a large-scale disregard of the separate existence of a subsidiary corporation. Forsythe held a parent corporation liable for the actions of its subsidiary when it so dominated and controlled the subsidiary that it was considered to have no separate existence. *This was despite the fact that the subsidiary had implemented the traditional measures to assure corporate separateness. Forsythe* serves as a reminder that circumstances may support "piercing the corporate veil" even where many of the "separateness factors" fundamental to the *Network for Good* decision did not exist.

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[1] Case Number CGC-04-436186, Filing Date October 19, 2007, TENTATIVE FINDINGS OF FACT AND CONCLUSIONS OF LAW (henceforth, "Decision").

[2] The full services "spin-off" to PipeVine also included human resources, accounting, finance, and campaign management.

[3] *See* California Office of the Attorney General, Press Release (dated July 2, 2003), http://ag.ca.gov/newsalerts/release.php?id=1003&year=2003&month=7. Ultimately, it was determined by the receiver that PipeVine had received $17.7 million in donations that had not been distributed to charities.

[4] *Fletcher Cyclopedia of the Law of Corporations*, 2006 Revised Volume (by Carol A. Jones, J.D.) Vol. 1, Sec. 41 (henceforth, "Fletcher").

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] *Id.,* Sec. 41.10; *see also* Henry W. Ballantine, *Separate Entity of Parent and Subsidiary Corporations*, 14 Cal. L. Rev. 12 (1925).

[9]Fletcher, *supra* note 4, at Sec. 41; *see also* Stephen B. Presser, *Piercing the Corporate Veil*, (Thomson-West 92004) at Sec. 1.6 (henceforth, "Presser").

[10] Fletcher, *supra* note 4, at Sec. 41.10; *see also*: "[A] corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons." Presser, *supra* note 9, at 1-7, citing *United States v. Milwaukee Refrigerator Transit Co.*, 142 F. 247, 255 (C.C. E.D. Wis. 1905).

[11] Presser, *supra* note 9, at 1-30 to 1-31, citing Powell, *Parent and Subsidiary Corporations: Liability of a Parent Corporation for the Obligations of Its Subsidiary*, Callahan and Company, 1931 (henceforth, "Powell").

[12] Fletcher, *supra* note 4, at Sec. 41.10.

[13] Presser, *supra* note 9, p. 1-30 to 1-31. *See also* Peregrine, Roach and Glaser, "Ascending Liability and Attribution: Corporate Concerns for the 1990s," *Journal of Health and Hospital Law*, February, 1993, Vol. 26, No. 2 (henceforth, "Peregrine, Roach and Glaser").

[14] Fletcher, *supra* note 4, Sec. 41.10, p. 136.

[15] Decision, p. 67.

[16] Decision, p. 66.

[17] Barry Bader, Edward A. Kazemek, Roger W. Witalis and Carlin Lockee, *Pursing Systemness: The Evolution of Large Systems*, The Governance Institute, San Diego, California 2005, www.governanceinstitute.com.

[18] *Id.*, p. 9.

[19] *Id.*

[20] *Id.*

[21] In this regard, the court concluded that actual fraud or bad faith need not be shown, and it was sufficient that refusal to recognize the unity of result in an injustice (Decision, p. 71).

[22] The following discussion is based solely upon the court's Findings of Fact and is not based on any independent evaluation of the facts.

[23] The potential benefits of a director insisting that a dissenting view be recorded in minutes is reflected by the record here, which shows two directors expressing concern with the speed of the project and the adequacy of business planning.

[24] Interestingly, UWBA's "yes" response to certain related party questions on its Form 990 submitted to the IRS was cited by the court as additional evidence of lack of separateness.

[25] 361 Ill. App. 3d 642, 836 N.E.2d 850 (2005).