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Court of Appeal, Second District, Division 2, California.
STINKY LOVE, INC., Plaintiff and Respondent,
v.
N. Lee LACY, Defendant and Appellant.

No. B163377.
(Los Angeles County Super. Ct. No. BC223980).
Aug. 13, 2004.

APPEAL from a judgment of the Superior Court of Los Angeles County. Morris B. Jones, Judge. Affirmed.
O'Laverty & Ungar, Robert M. Ungar for Defendant and Appellant.

Alschuler Grossman Stein & Kahan, Lawrence C. Hinkle II for Plaintiff and Respondent.

BOREN, P.J.

***1** The trial court pierced the corporate veil, holding the chief executive of a limited liability company personally liable for a judgment against the company. The court's decision is supported by substantial evidence. We affirm.

FACTS

Formation and Capitalization of Independent Artists

N. Lee Lacy was the president-and later the chairman-of Independent Artists (Independent), a closely held limited liability company. Lacy sought to enter the field of motion picture distribution. A distributor promotes films, places them in theaters, and sells them abroad. Movie distribution is an enterprise that requires enormous capital to operate successfully. Indeed, it ordinarily costs a distributor millions to meet its financial obligations to distribute a single film.

To accomplish his objectives, Lacy tried to raise $30 million in capital from investors, and hoped to leverage that sum into $100 million. Lacy was unsuccessful in raising outside money for Independent. Instead, he capitalized Independent himself in February 1999, with $1 million of his own money and $150,000 from a company he controls. Lacy entered a loan agreement with Independent that did not require him to loan any money to the company, and he entered an equity agreement with Independent that did not require him to invest any money in the company. Lacy and his family control 100 percent of Independent.

From time to time, Lacy made loans to Independent from his personal line of credit. Three million four hundred fifty-nine thousand dollars was obtained from an outside lender, although the money did not go directly to Independent. Instead, it went to a related company established by Lacy for the sole purpose of paying for movie prints and advertising.

Lacy closely managed the details of Independent's business and approved all expenditures. He did not allow Independent's chief financial officer to have access to the company's financial books or records. Only Lacy and his daughter were privy to Independent's financial information. The chief financial officer did review Lacy's personal balance sheet in 1999, which reflected that Lacy had $30 million in assets.

Independent's Agreement to Distribute Love Stinks

Shortly before Lacy capitalized Independent, in early 1999, the company contacted moviemaker Jeffrey Franklin and offered to distribute a new film made by Franklin called Love Stinks. Franklin had sunk $4 million of his own money into Love Stinks, which he wrote, produced, and directed through his

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production company, Stinky Love, Inc. (Stinky). Franklin was told by Independent's representatives that Independent was bankrolled to the tune of $30 million by its founder, Lee Lacy.

To persuade Franklin to do business with it, Independent sent him a "corporate overview" describing Independent as an award-winning, "premier $85 million per annum international film production company" to which Lacy has committed $30 million as "seed capital." Franklin was duly impressed by this. He decided that Independent was "very well capitalized."

***2** Franklin met with Lacy and other Independent executives in early February 1999. At the meeting, Independent's executive vice-president and chief financial officer reiterated that Lacy had financed Independent with $30 million of his own money. Franklin had no reason to doubt Lacy's financial backing of Independent.

Stinky entered a distribution agreement with Independent, dated February 18, 1999, for the marketing of Love Stinks. Actually, there are two signed distribution agreements dated February 18, 1999. The first version required Independent to spend at least $5 million on prints and advertising. A subsequent, renegotiated version of the agreement in August 1999 required Independent to spend at least $8 million on prints and advertising. It also required Independent to pay Stinky $4.3 million as consideration for the distribution rights to Love Stinks, plus a portion of the gross receipts. The purchase price was due in three installments starting December 10, 1999.

At the Cannes Film Festival in May 1999, Independent marketed the film to foreign distributors, bringing in $2.3 million in foreign sales. Stinky soon began to doubt Independent's marketing strategy and the adequacy of its advertising budget. Lacy made assurances to Franklin's personal manager during a meeting in July 1999 that Independent was adequately capitalized with $30 million of his own money, therefore the company had the capacity to stand behind its guarantees so Franklin should trust and rely on him. Stinky's doubts were allayed by Lacy's guarantees of payment and claims of adequate capitalization of Independent. Moreover, Franklin felt comforted when a newspaper article featured Independent's chief financial officer, who guaranteed payment to Franklin even if total sales of the film were inadequate, because Independent's $30 million in private capitalization would make up any shortfall.

Stinky Love was released in September 1999 and fared poorly at the box office. Nevertheless, Franklin still believed that Independent would honor its financial obligations to Stinky, including payoff of the $4.35 million purchase price. However, when it came time to remit the $2 million due to Stinky on December 10, 1999, Independent's chief financial officer told Franklin that he was not going to be paid. Stinky never received a penny of the purchase price.

Independent's Financial Situation

At the time the first $2 million installment owed to Stinky came due, in December 1999, Independent's sole cash assets consisted of $373 in a checking account and a $50,000 cashier's check. Independent had lost $1.138 million in 1999 and $4.378 million in 2000. Lacy testified that his only source of funds to pay Stinky the $4.35 million purchase price was revenue to be generated by the film itself.

Independent's business expenses were high. For example, Independent rented office space in a building owned by Lacy on Melrose Place. In 1999, Independent paid Lacy over $267,000 in rent. In 2000, Independent paid Lacy over $263,000 in rent. In 1999, Independent spent $304,141 on improvements to the rental space in Lacy's building. Independent's payroll was $485,594 in 1999.

***3** Michael Spindler, an accountant who specializes in fraud, examined Independent's financial records. Spindler identified factors indicating that Independent is the alter ego of Lacy. Spindler listed

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undercapitalization, lack of separateness in related party transactions, and domination and control by Lacy as indicia of alter ego.

a. Undercapitalization

Spindler compared Independent's financial commitments against the amount of funding the company received from Lacy. Given the company's commitments, its ability to pay its obligations wholly depended upon the success of Love Stinks, a risky projection that was unlikely and unreasonable given the film's likely box office receipts. When Independent initially entered the distribution agreement with Stinky, it committed itself to pay $5.4 million, at a time when it had a capital account balance of $347,000. When the distributorship agreement was later renegotiated, Independent committed itself to pay Stinky $4.35 million plus expend at least $8 million on prints and advertising; at the time this commitment was made, Independent had a cash balance of $34,000 and equity of under $1.5 million.

It was unreasonable for Lacy to rely solely on the success of a single film to meet Independent's financial obligations. There was insufficient capital for Independent to meet its obligations and continue business operations. By December 1999, Independent was insolvent; i.e., it was unable to meet its obligations as they came due and had more liabilities than assets. Independent was "thinly capitalized compared to other companies in the [entertainment] industry."

b. Lack of Separateness in Related Party Transactions

Independent made disbursements on behalf of related parties, meaning Lacy himself or Lacy-related companies. In fact, Independent made 750 related-party disbursements in areas such as rent, improvements, auto expenses, and making payroll of other companies. For example, Independent's 1999 rental outlay of $267,000 was in large part ($176,000) related to other Lacy-controlled entities that occupied the same, Lacy-owned building. Independent's 1999 expenditure of $304,000 for leasehold improvements covered $216,000 in bills to other Lacy entities. Independent's 1999 salary expense of $486,000 included $379,000 that related to other Lacy-controlled entities.

Misuses of corporate funds were legion. They included paying off three Mercedes Benz automobiles belonging to Lacy; paying for costs on real property Lacy owned in Colorado (for stream bank stabilization, among other things); and preparation of Lacy's personal state and federal income tax returns. Independent made payments on over 30 credit cards, none of which were in Independent's name. Further, Independent paid $108,862 on the personal credit cards of Lacy's wife. To accomplish this shell game, Lacy had Independent direct its bank to make transfers among various accounts. Independent even paid money directly to Lacy's personal creditors, an unusual event that is an indicia of alter ego, because Lacy's personal finances were so entangled with Independent's finances.

c. Domination and Control

***4** Lacy dominated and controlled Independent through his high ownership interest. He dominated Independent in other ways. For example, Lacy owned the building in which Independent paid great amounts of rent, and he directed money transfers among numerous bank accounts that he controlled, not only for Independent but for other entities as well.

PROCEDURAL HISTORY

Stinky filed suit against Independent and Lacy, then petitioned to compel arbitration pursuant to a binding arbitration clause in the distribution agreement. Lacy declared personal bankruptcy, claiming assets of $38 million, minus liabilities. The arbitration proceeded against Independent, and Stinky prevailed on its breach of contract claim. The arbitrator found that Independent is obligated to pay Stinky $4.3 million. Independent has not paid the arbitration award, which was confirmed by the court and made into a judgment.

At Stinky's request, the bankruptcy court lifted

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the automatic stay and authorized Stinky to continue litigation against Lacy. Stinky then pursued its alter ego claims against Lacy. Following a bench trial, the court found that Lacy is the alter ego of Independent, and it amended the arbitration judgment to add Lacy as a judgment debtor.

In particular, the trial court found that Lacy dominated and controlled Independent; that there was a lack of separateness between Lacy and the company; that Independent was family-owned; that there were extensive related-party transactions; that the agreements between Lacy and Independent were not arm's-length transactions; that Independent paid substantial rent and made leasehold improvements on Lacy's property, and it also paid to prepare Lacy's personal tax returns, for the expenses of other Lacy companies, and for Lacy family credit cards; Independent was financially dependent upon Lacy to meet its financial obligations and Lacy controlled the flow of money to and from Independent and contributed or withdrew money at his whim. Beyond that, the court found that Independent was undercapitalized and insolvent.

DISCUSSION

1. *Effect of Lacy's Bankruptcy Proceeding*

It is undisputed that the bankruptcy court granted Stinky relief from the automatic stay that went into effect when Lacy declared bankruptcy, thereby allowing the trial court to proceed to a resolution of this lawsuit. The parties are currently engaged in a debate in bankruptcy court as to whether Lacy can discharge his debt to Stinky. Lacy asks this Court to interject itself into the ongoing proceedings in bankruptcy court by unilaterally declaring that Lacy's debt to Stinky has been discharged. We decline the invitation to meddle in the decisions of the bankruptcy court, or to usurp its exclusive federal jurisdiction. If the bankruptcy court ultimately grants Lacy a discharge, so be it. Our role is limited to determining whether the trial court's judgment is supported by the law and substantial evidence.

2. *Substantial Evidence Supports a Finding of Alter Ego*

***5** In reviewing the trial court's finding of alter ego, we apply the substantial evidence rule, indulging all reasonable inferences and resolving all conflicts in the evidence in favor of the trial court's judgment. (*Sonora Diamond Corp. v. Superior Court* (2000) 83 Cal.App.4th 523, 535 (*Sonora*); *Associated Vendors, Inc. v. Oakland Meat Co.* (1962) 210 Cal.App.2d 825, 835 (*Associated*).) "[T]he power of the appellate court begins and ends with a determination as to whether there is any substantial evidence, contradicted or uncontradicted, which will support the conclusion reached by the trial judge." (*Associated*, at p. 835 .) The testimony of a single witness may be sufficient, if the trial court finds it credible. (*In re Marriage of Mix* (1975) 14 Cal.3d 604, 614.)

a. Scope of the Alter Ego Doctrine

The alter ego doctrine applies to members of limited liability companies. (Corp.Code, § 17101, subd. (b).) "A corporate identity may be disregarded-the 'corporate veil' pierced-where an abuse of the corporate privilege justifies holding the equitable ownership of a corporation liable for the actions of the corporation." (*Sonora, supra,* 83 Cal.App.4th at p. 538.) "In California, two conditions must be met before the alter ego doctrine will be invoked. First, there must be such a unity of interest and ownership between the corporation and its equitable owner that the separate personalities of the corporation and the shareholder do not in reality exist. Second, there must be an inequitable result if the acts in question are treated as those of the corporation alone." (*Ibid.*)

Among the factors to be considered in applying the doctrine are commingling of funds and other assets; the failure to segregate the funds of the individual and the corporation; unauthorized diversions of corporate funds to noncorporate purposes; the treatment by an individual of corporate assets as his own; disregard of corporate formalities; the ownership of all the stock by a single individual or family; and domination or control of the corporation by the stockholders. An important factor is inadequate

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capitalization. (*Mid-Century Ins. Co. v. Gardner* (1992) 9 Cal.App.4th 1205, 1213, fn. 3; *Sonora, supra,* 83 Cal.App.4th at pp. 538-539; *Roman Catholic Archbishop v. Superior Court* (1971) 15 Cal.App.3d 405, 411; *Associated, supra,* 210 Cal.App.2d at pp. 838-840.) Failure to maintain arm's-length relationships among related entities is a consideration, as is use of the corporation to procure labor, services or merchandise for another person or entity. (*Associated,* at p. 840.)

Mere failure to meet a financial obligation to a creditor does not prove misconduct or injustice. "The alter ego doctrine does not guard every unsatisfied creditor of a corporation but instead affords protection where some conduct amounting to bad faith makes it inequitable for the corporate owner to hide behind the corporate form." (*Sonora, supra,* 83 Cal.App.4th at p. 539.)

b. Unity of Interest and Ownership

***6** The evidence points to the conclusion that Independent was no more than an extension of Lacy. The Lacy family owned Independent and used Independent's assets for their own benefit, paying off personal credit cards, automobile loans, and maintaining family-owned real property in Colorado. Respondent's accounting expert uncovered 750 different related-party disbursements totaling millions of dollars. Lacy did not respect Independent's corporate separateness, drawing no distinction between Independent and other entities he controlled, sharing office space and employees-in a Lacy-owned building-and having Independent pay for it. Independent depleted itself paying for bills that were rightfully the responsibility of other individuals and entities. Money moved freely between the accounts of Independent and Lacy. The evidence even showed that Independent directly paid off Lacy's personal creditors as a result of the entanglement of Lacy's finances with those of Independent. The Lacy family controlled Independent so completely that they denied the company's chief financial officer access to the company's financial books and records. From all of this, the trial court could reasonably deduce that Independent was a mere conduit for the Lacy family's activities.

There was ample evidence of inadequate capitalization. Lacy failed to raise the hoped-for $30 million in outside capital, and wound up capitalizing Independent himself with a little more than a million dollars. Lacy's agreements with Independent did not require him to invest in or loan money to Independent. At the same time that he capitalized Independent, Lacy entered the distributorship agreement with Stinky. At the outset, this committed Independent to spend over $5 million on Love Stinks. Later, Independent upped its financial commitment to $12.4 million. Independent was, in other words, undercapitalized in light of its prospective liabilities. " '[T]he policy of the law [is] that shareholders should in good faith put at the risk of the business unincumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege.' " (*Automotriz etc. De California v. Resnick* (1957) 47 Cal.2d 792, 797 (*Automotriz*).)

" '[T]he attempt to do corporate business without providing any sufficient basis of financial responsibility to creditors is an abuse of the separate entity and will be ineffectual to exempt the shareholders from corporate debts.' " (*Claremont Press Pub. Co. v. Barksdale* (1960) 187 Cal.App.2d 813, 816 (*Claremont*).) In *Claremont,* the defendant contributed only $500 as capital to a venture that incurred costs of $650 to $1,000 per week, and at least $10,000 was needed to adequately capitalize the operation. The defendant's other contributions "were but loans." (*Id.* at pp. 816-817.) Likewise, a shareholder's capital contribution of $5,000 to a car brokerage was deemed to be inadequate where the company's sales volume was between $100,000 and $150,000 per month. (*Automotriz, supra,* 47 Cal.2d at pp. 795, 797-798.)

***7** There was no way that Independent could meet its financial obligations without revenue from

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Love Stinks. Yet the testimony showed that this was an unlikely and unreasonable reliance on the success of a single movie. Independent's duty to pay Stinky the $4.35 million purchase price for Love Stinks was unconditional-it was not contingent upon the film's success.

c. Inequity or Injustice to Stinky

This element does not require proof of actual fraud. (*Associated, supra,* 210 Cal.App.2d at p. 838.) It is satisfied if treating the acts as being those of the corporation alone will produce inequitable results. (*Stark v. Coker* (1942) 20 Cal.2d 839, 846.) "All that is required is a showing that it would be unjust to persist in recognition of the separate entity of the corporation." (*Claremont, supra,* 187 Cal.App.2d at p. 817.)

Independent convinced Stinky to enter the distribution agreement based on repeated assurances that Independent was well capitalized and had adequate financial resources from Lacy. Apart from verbal guarantees that Lacy had committed $30 million to Independent and personally guaranteed the debt to Stinky, Independent also provided Franklin with a "corporate overview" claiming that Independent was a "premier $85 million per annum" production company to which Lacy has committed $30 million in "seed capital." Independent's chief financial officer guaranteed payment to Franklin even if revenues from Love Stinks were inadequate, because private capitalization (i.e., Lacy) would make up any shortfall. (See *Claremont, supra,* 187 Cal.App.2d at pp. 815-817 [a defendant who stated that he had good credit and was financially responsible for the success of the corporation was personally liable to the plaintiff on an alter ego theory, after he undercapitalized the operation]. See also *Lyons v. Stevenson* (1977) 65 Cal.App.3d 595, 606-607 [an inference could be drawn that the plaintiff entered an agreement with the defendant in the belief that the defendant "regarded himself personally obligated to meet the terms of the agreement," allowing the trial court to pierce the corporate veil].)

Movie distribution is an enterprise that requires millions of dollars. Franklin was misled by Independent's claims of ample capitalization, backed by Lacy's personal guarantee of payment. At the time Stinky entered the renegotiated distributorship agreement with Independent, it seemed that Independent would easily be able to pay $8 million for prints and advertising, as well as for the $4.35 million purchase price, given the written and verbal assurances of Lacy's purported $30 million backing. Independent's assets were grossly inadequate to meet the commitment it made to Stinky.

It would be inequitable to allow Lacy to hide behind the corporate formality after using the strength of his personal backing to induce Stinky to deliver Love Stinks to Independent. In all likelihood, Independent would have had adequate funds to pay Stinky the $4.35 million purchase price if Lacy and his family had adequately funded Independent in the first place, then invested the company's assets conservatively rather than using them to pay off personal debts and to pay off obligations incurred by other Lacy companies.

***8** Lacy argues that equity should not intervene in consensual commercial bargains. He assets that the alter ego doctrine should only apply in tort cases, where the victim is taken by surprise. Stinky, unlike a tort victim, had advance opportunity to find out whether Independent was adequately capitalized.

The case law does not support Lacy's theory that the alter ego doctrine applies only to tort cases. In many of the cases where the corporate veil was pierced, the underlying wrong was a breach of contract. For example, in one case the plaintiff agreed to print a corporation's weekly newspaper, then successfully sued under an alter ego theory when the corporation failed to pay the printing bill. (*Claremont, supra,* 187 Cal.App.2d 813, 815-816.) In another case, the defendant was found to be the alter ego of an inadequately capitalized corporation that failed to pay for engineering work that the plaintiff contracted to perform. (*Engineering etc. Corp. v.*

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Longridge Inv. Co. (1957) 153 Cal.App.2d 404, 411-412.) Three individuals were found personally liable for the debts of a corporation that owed money for cars it had purchased from the plaintiff. (*Automotriz, supra,* 47 Cal.2d at p. 794.) In short, a finding of alter ego is not limited to tort cases.

There is sufficient evidence to uphold the trial court's findings.

DISPOSITION

The judgment is affirmed.

We concur: NOTT and ASHMANN-GERST, JJ.

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