Essay Question No. 2

Answer the question in booklet No. 2

John formed "CW Inc." in Alaska 10 years ago and has been selling various home heating systems successfully throughout the state. John is the President and general manager of the business. John learns of a new technology which he thinks will revolutionize home heating in cold climates. Henry, the inventor of the technology, is willing to license his patent to CW Inc. if he can run the business and have a share of the profits. John forms an Alaska limited liability company, Fusion LLC, which will handle the manufacturing and marketing of the new heating systems. The members of Fusion LLC are CW Inc. owning a 60% interest and Henry owning a 40% interest.

Fusion LLC's operating agreement states that Henry will serve as the managing member and that he may resign upon the dissolution of the LLC. The agreement makes no mention of member withdrawal. The agreement calls for twice yearly member meetings. Most decisions require the approval of both members.

CW Inc. contributes $10,000 as start up capital for Fusion LLC and Henry contributes a non-transferable perpetual license in the new heating technology. John contributes resources from CW Inc.'s operations to assist the new business. CW Inc.'s service vehicles are made available to support the new operation and CW Inc. staff is cross-trained so that they can perform installations thereby saving Fusion LLC labor costs. Henry set up the Fusion LLC office at no cost in one of CW Inc.'s stores and he connected to CW Inc.'s telephone and computer systems at no charge. The CW accounting staff handles the invoicing and financial record keeping for Fusion LLC. CW Inc. and Fusion LLC jointly advertise in the newspapers and other media and the ads do not distinguish the two businesses as separate entities, but rather they appear as two co-equal parts of a single business. Because John and Henry work closely with one another daily, they never hold a members' meeting for Fusion LLC. John has his hands full running the day to day affairs of CW Inc., so Henry solely manages the business of Fusion LLC. Within 6 months, Fusion LLC sells and installs over 30 new Fusion systems in Alaska homes and weans itself away from reliance on CW Inc.'s technical staff and vehicles.

After a year, it becomes clear that the technology has serious design flaws. Numerous homeowners demand replacement systems and refunds and Fusion LLC suspends its operations. Susan Homeowner sues Fusion LLC and CW Inc. for reimbursement of her costs to install and later to replace the new technology.

1. Describe the legal theory Susan should pursue to make CW Inc. liable for her damages and how the facts impact the merit of her claim. (Do not discuss direct negligence.)

2. Henry sends a letter resigning as manager of Fusion LLC to John. Discuss whether this letter is effective.

3. Henry sends a second letter to John stating that he is also withdrawing as a member from Fusion LLC. Discuss whether this letter is effective.

Essay Question No. 2
*****Graders' Guide*****
Business Law

1. Describe the legal theory Susan should pursue to make CW Inc. liable for her damages and how the facts impact the merit of Susan's claim (Do not discuss direct negligence.) (75 points)

CW Inc. is a non-managing member of Fusion LLC. Normally, it would have no liability to third persons for the liabilities of Fusion LLC solely because it was a member. AS 10.50.265. However, owners of corporations and limited liability companies can be held liable for the debts of the businesses they own under a theory called "piercing the veil" of the corporation or company. Susan Homeowner should argue that she should be allowed to pierce the veil of the limited liability company (Fusion LLC) to make one of its members, CW Inc., liable for the debts of Fusion LLC. Susan should argue that the same equitable principles that support piercing the corporate veil of a corporate entity also support piercing of the limited liability company veil.

The corporate form of a subsidiary owned by another corporation or business is disregarded in two circumstances: (1) if the parent or owner uses the separate corporate form "to defeat public convenience, justify wrong, commit fraud, or defend crime", *McKibben v. Mohawk Oil Co. Ltd.*, 667 P2d 1223, 1229-30 (Alaska 1983); or (2) if the corporation is a mere instrumentality of the parent or owner and the two businesses "are so closely intertwined that they do not merit treatment as separate entities", *Uchitel Co. v. Telephone Co.* 646 P2d 229, 234 (Alaska 1982). See *Brown v. Knowles,* 307 P3d 915 (August 2013) reaffirming these two stand alone, independent bases for applying the corporate veil piercing doctrine.

There are no facts that would support piercing the corporate veil under the first standard, namely to defeat public convenience or commit fraud. While John intentionally selected the business vehicle of the limited liability company to avoid liability for CW Inc., this action is a rational one, and would not be proof that he was trying to defeat public convenience since limitation of liability is a legitimate and recognized characteristic of the limited liability company.

Rather, the facts suggest that Fusion LLC might be susceptible to having its limited liability company form disregarded under the second theory known as the "mere instrumentality" or "alter ego" test. The facts show that CW Inc. intermeshed the business operations of the two businesses in many ways. The criteria to be considered in determining whether a corporation is acting as a mere instrumentality of its parent are listed in *McKibben,* 667 P2d at 1229-30. They are:

1. The parent corporation owns all or most of the capital stock of the subsidiary.

2. The parent and subsidiary corporations have common directors or officers.

3. The parent corporation finances the subsidiary.

4. The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation.

5. The subsidiary has grossly inadequate capital.

6. The parent corporation pays the salaries and other expenses or losses of the subsidiary.

7. The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation.

8. In the papers of the parent corporation or in the statement of its officers, the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation's own.

9. The parent corporation uses the property of the subsidiary as its own.

10. The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take their orders from the parent corporation in the latter's interest.

11. The formal legal requirements of the subsidiary are not observed.

Applying these criteria by analogy to Fusion LLC, it is a close question on whether the LLC form should be disregarded:

1. CW Inc. was the majority owner of Fusion LLC, owning a 60% interest. Thus, it does have a majority interest but not a dominant interest. Most business decisions require the approval of both members. The other member, Henry, was designated as the managing member, thus reducing the dominance of CW Inc. Therefore, CW Inc. does not appear to control or dominate the enterprise from an ownership perspective. This factor would not support piercing.

2. A limited liability company is not required to have the formal structure of a board of directors and officers. All it is required to have is a manager. The

facts here indicate that Henry was the sole manager of Fusion LLC. Thus CW Inc. (run by John) and Fusion LLC (run by Henry) had different management. This factor would not support piercing.

3. Fusion LLC does not appear to have received any financing from CW Inc.

4. John, not CW Inc., caused the formation of Fusion LLC. But because John is the alter ego of CW Inc., this fact would more likely support piercing.

5. Fusion LLC does not appear to have started with a great deal of initial capitalization. Fusion LLC was started with a $10,000 monetary contribution from CW Inc. and a technology transfer from Henry. The facts do not provide a valuation for the technology license, but one must assume it had a material value since they formed a business around it. The members appear to have started up on the cheap by using the resources housed within CW Inc. However, the facts do not suggest that the low level of capitalization of Fusion LLC caused the failure of the technology design. Therefore, while the monetary size of the capitalization was small, it may be found to have been sufficient under the circumstances. More discovery by Susan might develop facts to show that a better capitalized company could have responded earlier to the design flaws and made engineering corrections that would have avoided the harm. However, without more facts, this factor does not appear to support piercing.

6. CW Inc. shared its business assets and resources with Fusion LLC, helping Fusion LLC avoid costs in its start up. CW Inc. provided office space, telecommunications, vehicles accounting and financial services, and even trained staff. No facts suggest that there was a charge back to the Fusion LLC business for the value of these services. This level of support was significant. While use of the vehicles and technical staff waned after 6 months, the other CW Inc. assets and services continued to be used. This factor would support piercing.

7. Fusion LLC's business appears to be solely with third party customers. There are no facts to suggest that Fusion LLC serviced only CW Inc. The fact that the two companies were in competing businesses would suggest that Fusion LLC also did not service CW Inc.'s customer base. While Fusion LLC used CW Inc's vehicles and some of their employees on start up, one must assume that the manufacturing assets and tools were their own. Over time the use of CW Inc.'s assets diminished. This factor would likely not support piercing.

8. The media buys are the only facts given that could be used to assert that the owner CW Inc. and the subsidiary Fusion LLC were represented to third parties in a tangible way to be joint business enterprises that did not have separate corporate or company forms. More discovery may show that the two

businesses were represented as being closely related to one another elsewhere, such as in reports to government agencies, or statements given to industry publications, or financing institutions. Unless the weight of the advertising evidence can be offset by CW Inc.'s demonstration of other public materials that emphasize the separate nature of the two business entities, this factor would support piercing the veil.

9. There is no evidence that CW Inc. availed itself of the use of any of Fusion LLC's assets or services. This factor would not support piercing.

10. Henry appears to have acted relatively independently in his management of Fusion LLC. The facts state that John was tied up managing CW Inc. and therefore there does not appear to have been much supervision by CW Inc. as a member/owner over the affairs of Fusion LLC. This factor would not support piercing.

11. An LLC has fewer formal legal requirements to be observed than a corporation (no director elections, no annual shareholder meetings, and no corporate resolutions). However, the facts state that Fusion LLC was supposed to hold two member meetings each year and failed to hold any meetings. Thus, the one formality they had was not met. This factor would tip in favor of piercing.

The factors described above present a somewhat close question. An Alaska court could find that the limited liability company form of Fusion LLC should not be disregarded and that CW Inc. should be allowed to avail itself of the statutory protection from liability that members of an LLC would ordinarily enjoy under the Alaska Statutes. Susan would likely not succeed in making CW Inc. liable for the debts of Fusion LLC. (Test examinees can draw either conclusion so long as they analyze the factors and apply the facts.)

2. Henry sends a letter resigning as manager of Fusion LLC to John. Discuss whether this letter is effective. (10 pts)

The letter would not be a lawful resignation, but it would result in Henry no longer serving as the manager. AS 10.50.125(b) states that "A manager may not resign as manager of a limited liability company except at the time or upon the happening of events specified in the operating agreement." If a manager resigns in violation of the operating agreement, the manager ceases to be a manager but remains liable for the damages that flow from his or her breach of the operating agreement. *Id.*

Under the facts, Fusion LLC's operating agreement provided that the manager could only resign upon dissolution of the company. Henry may argue that once the company suspended its operations, this was the first step of dissolution. However, dissolution does not actually occur until events take

place which the operating agreement specifies result in dissolution, the members all consent or a superior court enters a decree of dissolution. AS 10.50.400.

3. Henry sends a second letter to John stating that he is also withdrawing as a member from Fusion LLC. Discuss whether this letter is effective. (15 Points)

The letter is not effective to cause Henry's withdrawal as a member of the Fusion LLC. AS 10.50.185 provides that no member may resign from a limited liability company except "at the time or upon the happening of events specific in the operating agreement of the company and in accordance with the operating agreement." The operating agreement of Fusion LLC makes no provision for member withdrawal.

AS 10.50.185(b) provides that "unless the operating agreement of the company provides otherwise, a member may not resign from a limited liability company before the dissolution and winding up of the limited liability company." Thus the operating agreement must affirmatively state the conditions under which early withdrawal is allowed. Otherwise, no withdrawal can happen before dissolution. Therefore, Henry may not withdraw as a member until dissolution of Fusion LLC, or the membership amends the operating agreement to allow withdrawal.