December, 2014

Business Entities - Basic Legal Issues

Curtis E.A. Karnow

Business Entities - Basic Legal Issues

Curtis E.A. Karnow (Superior Court, County of San Francisco)

(This note was originally prepared for a video posted in December 2014 on the state courts' judicial education website. It was designed for judges new to the area of civil business litigation, and is written in the narrative form used in the video.)

Introduction

I'll be discussing roughly 7 issues which may arise in these cases. Some of these issues, such as sealing records, arise in other cases too, but they're more frequent in cases involving business entities. I don't have the time to get into detail on any of these issues, but will provide enough to help "issue spot," and the materials that accompany this presentation will provide further leads such as citations to statutes, cases, and secondary authority.

I will briefly talk about these issues: First, vicarious liability- respondeat superior, as well as its inverse; issue number 2, piercing the corporate veil and alter ego liability. Third, I will discuss the rules that govern sealing records; fourth, the requirement that corporations be represented by counsel; fifth, the qualification of domestic (that is, California) corporations; sixth, taking the depositions of persons most knowledgeable, or qualified (PMQ, PMK); and seventh, a short discussion of interesting conflicts of laws issues that can arise in business litigation. But I won't touch on securities law or corporations law as such.

First, let me map out the basic forms of business entities. These are usually: LLCs, or limited liability corporations; partnerships; corporations; and sole proprietorships (or "DBAs", an individual "doing business as" using some trade name).

Partnerships usually have both general partners and limited partners, which in turn might be people or other business entities. General partners usually run the show, and limited partners are often just investors. Limited liability corporations or LLCs will typically be treated as partnerships for tax purposes, and must keep the same detailed books and records as a partnership.[1]

Corporations are often one of three types: Closely held or "close corporations" which have up to 35 shareholders,[2] publically held corporations where shares are traded on an exchange, and "professional corporations"[3] created to render professional services such as medical treatment, architectural, pharmacy, legal and others. Special rules apply to other sorts of corporations, such as nonprofits, public corporations, and so on.[4]

---

[1] 1 CAL. TRANSACTIONS FORMS--BUS. ENTITIES § 1:25

[2] Corp. C. 158(a)

[3] Corp. C. § 200(c). If a sole shareholder of a professional corporation dies, the corporation may not be able to continue operating, which would have the same practical effect as a termination. [See Corp C § 13407.]

[4] *See generally* 9 B. Wiktin, SUMMARY OF CALIFORNIA LAW, Corporations (10th ed. 2005).

1: Vicarious liability- respondeat superior.[5]

Corporations act through their employees and officers, and by the same token corporations are liable for the acts of those people when done within the course and scope of their work. Interesting issues arise when it is not clear that the tort, for example, was done within that scope. So we have the "coming and going rule" which holds that the employer is not liable for the acts of the employee coming and going to work,[6] unless the car used is of some benefit to the employer- for example, the employer told the employee to have a car ready at the office in case she might be sent out on an errand.[7] Office parties, and what happens just after the party on the way home, sometime present interesting issues of course and scope,[8] as do actions by employees which arguably were for the benefit of the employer but which were never specifically requested by the employer,[9] or acts such as assaults which have some connection to employment but perhaps were not foreseeable or otherwise inherent in the working environment.[10]

2: Piercing the corporate veil

Corporations are designed to limit liability of the owners, but the limits do not always hold, and plaintiffs generally wish to pierce the corporate veil to reach assets held by owners, whether the owner be a parent company or wealthy individual owners. The issue is sometimes phrased as alter ego liability, but that doctrine encompasses grounds far broader than simply piercing the corporate veil to get to the corporation's owners.[11] It is possible, under some circumstances, to add an alter ego to a case at any time, even after judgment, if for example, the alter ego controlled the lawsuit.[12] The usual factors for piercing the corporate veil are "undercapitalization of the business, commingling of corporate and personal funds, and failure to observe the corporate formalities."[13]

---

[5] *Lobo v. Tamco,* 230 Cal.App.4th 438, 446 (2014); *Patterson v. Domino's Pizza, LLC*, 60 Cal. 4th 474 (2014); *Montague v. AMN Healthcare, Inc.,* 223 Cal.App.4th 1515 (2014) (plaintiff must prove causal link between act causing injury & employment to show vicarious liability on employer's part).

[6] *Halliburton Energy Servs., Inc. v. Dep't of Transp.,* 220 Cal. App. 4th 87 (2013).

[7] *See generally, Lobo v. Tamco,* 230 Cal. App. 4th 438, 446 (2014); *Lantz v. Workers' Comp. Appeals Bd.*, 226 Cal.App.4th 298, 311 (2014).

[8] *E.g., Harris v. Trojan Fireworks Co.,* 120 Cal.App.3d 157, 165 (1981).

[9] *Halliburton Energy Servs., Inc. v. Dep't of Transp.*, 220 Cal.App.4th 87, 95 (2013) (if employee engaged in ordinary duties, there may be respondeat superior liability "even if [employee's actions are] wholly unauthorized and without benefit to the employer")

[10] "Although an employee's willful, malicious, and even criminal torts may fall within the scope of employment, "an employer is not strictly liable for all actions of its employees during working hours." (*Farmers Ins. Group v. County of Santa Clara* (1995) 11 Cal.4th 992, 1004, 47 Cal.Rptr.2d 478, 906 P.2d 440 (*Farmers*).) For the employer to be liable for an intentional tort, the employee's act must have a "causal nexus to the employee's work." (*Lisa M., supra,* 12 Cal.4th at p. 297, 48 Cal.Rptr.2d 510, 907 P.2d 358.) Courts have used various terms to describe this causal nexus: the incident leading to the injury must be an " 'outgrowth' " of the employment; the risk of tortious injury must be " ' "inherent in the working environment" ' "; the risk must be " ' "typical" ' " or " ' "broadly incidental" ' " to the employer's business; the tort was " 'a generally foreseeable consequence' " of the employer's business. (*Id.* at pp. 298–299, 48 Cal.Rptr.2d 510, 907 P.2d 358.)" *Montague v. AMN Healthcare, Inc.,* 223 Cal. App. 4th 1515, 1521 (2014). For the public policy factors used to determine applicability of respondeat superior, see *Montague,* 223 Cal.App.4th at 1523. A defendant's general *control* over the bad actor is a crucial aspect of imposing respondeat superior liability. *Patterson v. Domino's Pizza, LLC*, 60 Cal.4th 474, 499 (2014).

[11] *Mesler v. Bragg Mgmt. Co.,* 39 Cal. 3d 290, 301 (1985) (alter ego is equitable doctrine).

[12] Weil & Brown, et al., CALIFORNIA PRACTICE GUIDE: CIVIL PROCEDURE BEFORE TRIAL (2014)("Rutter") 6:58.6. *Wells Fargo Bank v. Weinberg*, 227 Cal. App. 4th 1, 7 (2014); *Relentless Air Racing, LLC v. Airborne Turbine Ltd. P'ship,* 222 CA4th 811 (2013) (procedure to add defendants post judgment as additional judgment debtors; inability to collect judgment was an inequitable result which allowed addition of judgment debtors.)

[13] *Toho-Towa Co. v. Morgan Creek Prods., Inc.*, 217 Cal. App. 4th 1096, 1107(2013). *See Twenty-Nine Palms Enterprises Corp. v. Bardos,* 210 Cal. App. 4th 1435, 1451 (2012), relying on *Greenspan v. LADT, LLC* (2010) 191 Cal.App.4th 486, 512–513 [listing 14 factors].

3: Sealing

Business litigation often includes requests to seal papers submitted to the court. In our state, this is an issue of *constitutional* dimension, because it involves open access to the courts, and it is governed by California rule of court 2.550. Lawyers often try to modify the procedures of the state rule in e.g., stipulated protective orders, and judges need to be wary not to sign anything that conflicts with the rules. An important case, *Overstock.com*,[14] is essential reading for judges and lawyers, especially on how to avoid getting swamped by over-designation of documents and useless demands for sealing, as well as dealing with media requests to participate in the decision on what to seal or unseal.

Often judges don't actually need to see the secret data that so concerns the parties, and those papers can be redacted and publicly filed without more. In the materials that accompany this presentation, I provide an article with a series of practical tips on how to deal with sealing problems.[15]

4: Representation by counsel

It's a crime – a misdemeanor—to practice law without a license.[16] Outside of small claims court, corporations must have an attorney, and may not be represented by e.g., a corporate officer. But if a company for example files a complaint without an attorney signature, it's a problem that trial judges should allow to be corrected without dismissing the case.[17]

Judges should tell corporations they need a lawyer[18] and continue matters for a reasonable time, or stay proceedings, to allow them to do so. But if the company refuses, or is unable to obtain counsel, at trial the court may need to note the company's non-appearance, and take a default.[19] Unknown to many, there is a statute, CCP 286,[20] which (when a company is left without a lawyer—but perhaps only if this occurs because of the lawyer's death or suspension[21]) requires opposing parties to serve written notice to get another lawyer, and stays the action in order to allow service of that notice.

5: Qualification, Licenses & Certification

Corporations must not only have a lawyer, they must also be qualified to do business in the state, either as a domestic or 'foreign' company. First, domestic corporations. They may neither sue, nor defend themselves, unless they're in good standing with the secretary of state—which means they have not been suspended for nonpayment of franchise taxes.[22] Serious sanctions may be imposed on lawyers who represent suspended

---

[14] *Overstock.Com, Inc. v. Goldman Sachs Grp., Inc.,* 231Cal.App.4th 471 (2014).
[15] http://works.bepress.com/curtis_karnow/13/
[16] Bus. & Prof. Code § 6126.
[17] *CLD Const., Inc. v. City of San Ramon,* 120 Cal. App. 4th 1141, 1149 (2004) ("a corporation's failure to be represented by an attorney as a defect that may be corrected, on such terms as are just in the sound discretion of the court").
[18] *Gamet v. Blanchard,* 91 Cal. App. 4th 1276, 1284 n.5 (2001) ("it is the duty of the trial judge to advise the representative of the corporation of the necessity to be represented by an attorney").
[19] *Van Gundy v. Camelot Resorts, Inc.*, 152 Cal.App.3d Supp. 29, 31-32 (App. Dep't Super Ct. 1983).
[20] "When an attorney dies, or is removed or suspended, or ceases to act as such, a party to an action, for whom he was acting as attorney, must, before any further proceedings are had against him, be required by the adverse party, by written notice, to appoint another attorney, or to appear in person."
[21] *California Water Serv. Co. v. Edward Sidebotham & Son, Inc.*, 224 Cal.App.2d 715, 734 (1964) ("The section applies only when an attorney has died or ceased to be an attorney and not when he ceased to act for his client in a particular case"); *Aldrich v. San Fernando Valley Lumber Co.,* 170 Cal.App.3d 725, 741 (1985) (applies when "attorney is suspended from the practice of law").
[22] Rutter 2-28.10, 6:53, 2:90.

corporations.[23] Non-California companies can certainly be sued in this state without qualifying to do business here, but they may not *instigate* litigation unless they are qualified with the secretary of state.[24]

There's a further general requirement: a business which must have a license to do a certain kind of work may not sue unless it has that license. Examples are architects, professional engineers, land surveyors, pest control operators, and registered geologists.[25]

Finally, on a related topic, let me remind you of a few peculiar pleading rules specific to certain types of organizations.

- For general contractors: their license status is an essential element of their claim to recover for performance of services.[26]
- For negligence actions against architects, engineers, or surveyors, plaintiffs usually have to first file a 'certificate of merit' that the lawyer has consulted with an expert in the field and on that basis thinks there is merit to the case.[27]
- Plaintiffs must first obtain a court order before making claims[28] for: punitive damages against health care providers[29] or against religious corporations,[30] and negligence claims against volunteer directors or officers of nonprofit corporations.[31]

6: Discovery

There's a type of discovery which is unique to organizations including corporations, and that's the "PMK" or PMQ, person most knowledgeable, or person most qualified, deposition.[32] Under this procedure, the demanding party simply specifies the topics of interest, for example, the company's employment policies, or perhaps, the source of its raw materials, or its marketing practices. Then the responding company decides which, and how many, deponents will appear.

Those deponents are obligated to educate themselves so that they can indeed answer questions related to the topics set by the other side. They are the 'most knowledgeable' not necessarily because they originally knew everything related to the topics, but because they educate themselves in preparation for the deposition. Their testimony then binds the organization.

In this way, the other side does not have to figure out "who in the corporate hierarchy has the information the examiner is seeking. E.g., in a product liability suit, who in the engineering department designed the defective part?"[33]

---

[23] Rutter 2:90.1

[24] Rutter 6:53, 2:105. For more on *dissolved* corporations, see Rutter 2:118. And recall, *trusts* are not legal entities. 1 CAL. TRANSACTIONS FORMS--EST. PLANNING § 5:18. One must sue the trustee, and it is the trustee who sues.

[25] Harry D. Miller and Marvin B. Starr, 10 MILLER AND STARR CALIFORNIA REAL ESTATE § 27:113 (3d ed., database updated September 2014).

[26] Rutter 6:72.1. A California corporation with its principal place of business in California does not need a California contractor's license to contract for and perform work outside the state. *Conderback, Inc. v. Standard Oil Co. of Cal., Western Operations*, 239 Cal. App. 2d 664 (1966). CAL. CONSTR. L. MANUAL § 4:32 (6th ed.)

[27] CCP § 411.35.

[28] *See generally* Rutter 6:326.

[29] CCP § 425.13(a); Rutter 6:327.

[30] CCP § 425.14; Rutter 6:346.

[31] CCP § 425.15; Rutter 6:377.

[32] CCP § 2020.310, 2025.230; *Maldonado v. Superior Court,* 94 Cal.App.4th 1390, 1395 (2002); Rutter 8:468, *et seq*.; CEB, CALIFORNIA CIVIL DISCOVERY PRACTICE §§ 5.8, 5.62, 6.51 (2014).

[33] Rutter 8:474.

7: Conflicts of laws

Conflicts of law issues arise far more often in business litigation because, of course, companies often do business in many places, and so their actions have effects in many places. They may have their headquarters in one state, be incorporated in another, have a principal place of business in one state but have most of their employees somewhere else. And maybe their "domicile" is yet a different place. They may have subsidiaries and corporate parents in various locations, and they may have relevant contracts with different parties with different choice of law provisions, some of which may be enforceable, and some which are not. And because this isn't complicated enough, different jurisdictions have different rules for resolving conflicts of laws, so one first must decide which state's laws –or perhaps which nation's laws—will be used to resolve the substantive conflicts of law problem.[34]

Even better: in a given case, judges have to determine, on a claim by claim basis, what the controlling law is. It may be different for different claims.

Typically, courts will honor a contractual choice of law provision in a contract case. Courts will often look to the law of the state where injury occurred in a tort claim (but certainly not always),[35] and will look to the law of the state of incorporation when internal governance issues are litigated, and because about half of publicly traded companies are registered in Delaware,[36] that means Delaware law.[37] Internal governance includes suits between shareholders and the company, so that California state courts are routinely asked to apply Delaware law, such as on the issue of what sort of pre-litigation demands must be made on a board of directors before a stockholder derivative action can be filed.

✸

[34] *See generally,* L. Brilmayer, CONFLICT OF LAWS (2d ed. 1995).
[35] *Scott v. Ford Motor Co.,* 224 Cal. App. 4th 1492 (2014) (under the 'governmental interest analysis' California, not Michigan, law applies on applicability of punitive damages in asbestos case. While Defendant Ford resided in Michigan, Michigan's interests (as expressed by Michigan courts) do not extend to the policies implemented in California courts, thus there is no true conflict, and so California law prevails.)
[36] http://www.nytimes.com/2012/07/01/business/how-delaware-thrives-as-a-corporate-tax-haven.html?pagewanted=all&_r=0
[37] E.g., *Patrick v. Alacer Corp.,* 167 Cal.App.4th 995, 1009 (2008).