

Cannabis Candy Co. Suit Spotlights Alter Ego Liability Theory

By **Jesse Mondry** (August 30, 2022)

A recently filed cannabis case in Oregon, Drops LLC v. La Mota LLC,[1] demonstrates pleading of two forms of the alter ego theory of liability.

Most lawyers and business owners know that one of the principal reasons to form a business entity is to limit the owners' and shareholders' exposure to liability. This is because a fundamental principle of corporate law is that a business has a separate and distinct legal existence from its owners.[2] So in nearly all circumstances, the entity alone is liable for its debts.



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One exception is the alter ego theory of liability. Commonly known as veil piercing,[3] the alter ego theory of liability attempts to reach beyond the putatively liable business entity and into the pockets of the business owners or into affiliated business entities.

When available, the alter ego theory of liability can be a powerful tool for plaintiffs.

Attempts to pierce the veil and hold principals or affiliated companies liable under an alter ego theory may be accomplished in a few different ways:

- Vertical veil piercing refers to piercing the veil between a subsidiary and its parent to hold the parent company liable or seeking to hold the entity's principals liable.
- Horizontal veil piercing refers to using the alter ego theory of liability to hold a sister or affiliated company liable.
- Reverse veil piercing refers to using the alter ego theory of liability to hold a company liable for the conduct of its owners.[4]

As the U.S. Bankruptcy Court for the District of Minnesota held in 2016 in *In re: Petters Co.*, "Each form of veil piercing is essentially a disregard of corporate separateness." [5]

In *Drops v. La Mota*, the plaintiff is a well-known purveyor of cannabis candies, operating under a license issued by the Oregon Liquor and Cannabis Commission.

The plaintiff markets its candies to licensed marijuana dispensaries throughout the state Oregon. The dispensaries, in turn, sell the candies to their customers.

Since 2020, the plaintiff has done business with a set of dispensaries — the defendants — that operate under the same brand and have the same or substantially the same owners. Each dispensary operates as its own entity, but each is under the common control of the same two individuals.

According to the complaint, filed in Multnomah County Circuit Court, the defendants failed to pay for approximately \$390,000 of cannabis candies. The candies allegedly were delivered by the plaintiff to the various defendants, which accepted the candies without complaint and sold them to consumers.

After demanding and not receiving payment, the plaintiff filed suit against 20 companies and their two principals.

In the absence of an alter ego theory of liability, each defendant — i.e., each dispensary — may only be held liable for the cannabis candies for which it allegedly did not pay. And there is no way for the plaintiff to seek to hold the two principals of the corporate defendants personally liable.

These ordinary limitations on liability may affect the ability and ease of collecting on a judgment and make the prosecution of the case more expensive and difficult.

But the plaintiff pleaded a vertical and horizontal claim for alter ego liability: The plaintiff, Drops, seeks to hold each defendant — comprised of all of the dispensaries under common ownership, as well as the two owners themselves — liable for the cannabis candies purchased and allegedly not paid for by the other.

A claim for alter ego liability is not typically available to an aggrieved party.[6] Claims against affiliated companies are not available just because the same individuals own multiple companies, as is the case in Drops.

Nor are veil piercing claims appropriate just because all of the companies all operate under the same brand or operate in the same industry, as is the case in Drops. The doctrine is a narrow one, and the plaintiff in Drops was required to plead, and ultimately prove, additional facts.[7]

So in what circumstances can a plaintiff allege a claim for alter ego liability?

The specifics differ from state to state. But generally, for the horizontal alter ego theory, a plaintiff needs to allege that the defendants had common supervision, control, management and unity of interest.[8]

For all theories, a plaintiff usually must allege that the defendants failed to follow corporate formalities.[9] That's a way of saying that the owners and companies did not act as though the companies were separate entities or separate from themselves.

This conduct may include failing to hold board meetings, commingling business and personal monies; or commingling of earnings, expenses and losses. It may also include owners treating company accounts as mere piggy banks rather than properly issuing dividends or distributions.

Other factors may include insufficient capitalization, insolvency at the time of the transaction in question, siphoning funds by one or more owners, the absence of corporate records, or nonfunctioning officers or directors.[10]

In theory, cannabis companies and their owners are no more susceptible to veil piercing claims than other businesses. But in practice, we more frequently observe owners of cannabis companies engage in practices that make them more susceptible to these types of claims.

One of the reasons for this may be the lack of access to banking. Since cannabis companies conduct business on a strictly cash basis, the accounting at the retail level is often done on paper by hand in a cash log.

Turning each sale into electronic data for a CPA — e.g., through QuickBooks — is time-consuming and expensive. And in some instances the in-store cash becomes a repository for paying expenses, and not every deposit or withdrawal is properly recorded. The absence of careful bookkeeping practices may give rise to the appearance that owners or others have been treating sales income improperly.

Perhaps another reason is that many of the people who joined at the ground floor of the licensed cannabis industry did not have a traditional business background. So the formalities and importance of things like operating agreements, board minutes and resolutions, maintaining capital account balances, separate bank accounts and accounting practices were viewed unnecessary red tape. To be sure, this is changing as the industry matures.

As the name suggests, the alter ego theory of liability ultimately concerns whether the members or shareholders have treated the corporate entity as a mere instrumentality or alter ego of themselves.[11]

Typically, the bar to pierce the veil is high, and a court's use of its equitable powers is exercised only when there is clear evidence that those in control of a company have used the corporation for improper means, such as fraud.[12]

Of course, a plaintiff must have a reasonable good faith belief that its allegations are true. Oftentimes a plaintiff does not have enough information to allege a veil piercing or alter ego theory. But when such information is available, it allows a plaintiff to reach past the ordinary limitations of liability into the pockets of shareholders, members or sister or parent companies.

This can be a powerful tool in settlement discussions, as well as in the ability to ultimately collect on a judgment.

If the discovery in Drops bears out that the plaintiff may hold the two principals personally liable for the nonpayment of invoices by the 20 company-defendants, I would anticipate a quick settlement.

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[1] Drops, LLC v. La Mota LLC et al., Case No. 22CV23935 (Multnomah County Circuit Court).

[2] See, e.g., Harris v. Stony Clove Lake Acres Inc., 202 A.D.2d 745, 747, 608 N.Y.S.2d 584, 586 (1994). Indeed this concept underlies the Supreme Court's decision in the election law case of Citizens United v. Fed. Election Comm'n, 558 U.S. 310, 130 S. Ct. 876, 175 L. Ed. 2d 753 (2010).

[3] https://www.law.cornell.edu/wex/piercing_the_corporate_veil.

[4] See *In re Petters Co., Inc.*, 561 B.R. 738, 749-50 (Bankr. D. Minn. 2016).

[5] *Id.*

[6] See *Manichaeen Cap., LLC v. Exela Techs., Inc.*, 251 A.3d 694, 706 (Del. Ch. 2021) (veil piercing is permitted in "exceptional" cases).

[7] See *Apple Inc. v. Allan & Assocs. Ltd.*, 445 F. Supp. 3d 42, 52 (N.D. Cal. 2020) (explaining that in California disregarding the corporate form is an "extreme remedy").

[8] See *McCallum Fam. L.L.C. v. Winger*, 221 P.3d 69, 74 (Colo. App. 2009).

[9] See *Econ Mktg., Inc. v. Leisure Am. Resorts, Inc.*, 664 So. 2d 869, 870 (Ala. 1994), as modified on denial of reh'g (Apr. 14, 1995), as modified on reh'g (June 30, 1995).

[10] See *McCallum Fam.*, 221 P.3d at 74.

[11] See *Amfac Foods, Inc. v. Int'l Sys. & Controls Corp.*, 294 Or. 94, 105, 654 P.2d 1092, 1099 (1982).

[12] See, e.g., *First Nat. Bank v. Gamble*, 134 Tex. 112, 119, 132 S.W.2d 100, 103 (Comm'n App. 1939).