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Smoothline Ltd., Greatsino Electronic Ltd. v. North American Foreign Trading Corp., U.S. District Court for the Southern District of New York, 00 Civ. 2798 (DLC), 30 December 2002

Jason R. Absmithel

Headnotes

The U.S. District Court for the Southern District of New York held that plaintiff corporations' indirect owner was plaintiffs' alter ego and thus was compelled to arbitrate its disputes with defendant.

Summary

Defendant, North American Foreign Trading Corp. ("NAFT") entered into several agreements with plaintiffs Smoothline, Ltd and Greatsino Electronic Ltd., two subsidiaries of Universal Appliances, Ltd. ("UAL"). Plaintiffs sold telephones and provided telephone repair services to NAFT. These agreements, including several letters of credit, provided for mandatory arbitration of any dispute with respect to their subject matter. Plaintiffs sued defendant for breach of the letters of credit and defendant moved to compel arbitration against both plaintiffs and UAL. The United States District Court for the Southern District of New York granted defendant's motion, holding that UAL could be compelled to arbitrate as plaintiffs' alter ego.

The Court held that defendant had satisfied the two-part requirement set forth under New York law for piercing the corporate veil. To satisfy this requirement, a party must show: 1) that the owner of a corporation, exercised complete control over that corporation with regard to the transaction at issue, and 2) that such domination was used to commit a wrong which injured the party seeking to pierce the veil. Considering ten factors which it held were relevant to determining the issue of domination, the Court found that UAL and the plaintiffs were essentially one company with plaintiffs acting as a specialized divisions. The Court also found fraud sufficient to justify piercing given that UAL had drained assets from plaintiffs so as to leave them judgment proof.

DENISE COTE, United States District Judge

By Opinion dated February 27, 2002, Smoothline, Ltd. v. North American Foreign Trading Corporation, No. 00 Civ. 2798 (DLC), M19-375, 2002 WL 273301 (S.D.N.Y. Feb. 27, 2002) (the "February 27 Opinion"), this Court granted the motion brought by defendant North American Foreign Trading Corporation ("NAFT") to compel arbitration against plaintiffs Smoothline Ltd. ("Smoothline") and Greatsino Electronic Ltd. ("Greatsino") with respect to Smoothline's dispute with NAFT involving tooling costs and NAFT's dispute with Greatsino involving customer returned units ("CRUs"). Consideration of NAFT's motion to compel arbitration against Universal Appliances, Ltd. ("UAL"), (1) the indirect owner of Smoothline and Greastino, was deferred pending the completion of discovery on the alleged alter-ego status of UAL, Smoothline, and Greatsino. That discovery having been completed, NAFT now renews its motion to compel with respect to UAL. For the reasons stated, NAFT's motion is granted.

Background

The facts of this case are described in Smoothline, Ltd. v. North American Foreign Trading Corporation, 249 F.3d 147 (2d Cir. 2001), the February 27 Opinion, 2002 WL 273301, at *1-3, and Smoothline, Ltd. v. North American Foreign Trading Corporation, 00 Civ. 2798 (DLC), M19-375, 2000 WL 1015949, at *1-3 (S.D.N.Y. July 24, 2000) (the "July 24 Opinion"), familiarity with which is presumed. The facts relevant to the instant motion are set forth here.

NAFT is a New York corporation that is the principal supplier of BellSouth-brand telephones and other consumer telecommunications devices to BellSouth Corporation. UAL is a Hong Kong corporation listed on the Hong Kong Stock Exchange. Plaintiffs describe UAL as an "investment holding company." Kwan Wing Holdings, Ltd. ("Kwan Wing"), a private British Virgin Islands company, holds a controlling interest in UAL. Johnson Ko is, inter alia, the sole shareholder of Kwan Wing and the Chairman of UAL. Smoothline is a Hong Kong corporation that manufactured cordless telephones for NAFT beginning in 1989. In 1994, UAL, through its wholly-owned subsidiary Tecbond Manufacturing Limited, acquired Smoothline from a group of investors led by Yang Seung Chun ("Yang"). Greatsino is a British Virgin Islands corporation. In 1996, UAL acquired Greatsino when it purchased a factory complex in Zhuhai, China (the "Zhuhai Complex") from Paul Yap ("Yap"). In 1997,

Greatsino began manufacturing telephones for NAFT.

The Underlying Dispute

As set forth in the February 27 Opinion, 2002 WL 273301, at *1-3, in March 1993, NAFT and Smoothline entered into an Agreement and Guaranty (the "March 1993 Agreement") pursuant to which NAFT agreed to open letters of credit directly to certain Smoothline subcontractors. The agreement provided that NAFT would open additional letters of credit if, inter alia, Smoothline and its subcontractors fulfilled their obligation to repair or replace at no cost to NAFT any defective goods which NAFT returned to them. Id. at *2. The agreement further provided that any dispute with respect to the subject matter of the agreement be settled by arbitration. Id. In December 1993, Smoothline and NAFT entered into a letter agreement (the "December 1993 Agreement") in which NAFT agreed to "perform our obligation" to pay Smoothline's tooling costs when and if Smoothline "fully performed [its] obligations to repair or replace" defective units returned to it by NAFT. Id. In 1996, NAFT brought a demand for arbitration against Smoothline's subcontractors for their alleged failure to repair or replace CRUs in a timely manner. In 1997, NAFT demanded arbitration against Smoothline as well. Id.

In 1997, NAFT began placing orders with Smoothline for the manufacture of 900 megaherz cordless phones. Id. at *3 Smoothline requested that its affiliate Greatsino produce the telephones, and NAFT agreed. NAFT paid Greatsino, as it had paid Smoothline and its subcontractors, through letters of credit which contained an arbitration clause. Id. When Greatsino surrendered documents to obtain payment under the letters of credit, the documents included a "Sworn Certificate" in which Greatsino agreed to all of the terms of the letters of credit. Specifically, Greatsino stated: "Smoothline Ltd [sic] also guarantees all the above points, and everything which is written of [sic] this 1c, the content of which is being attached separately to this guarantee." All parties agree that the reference to Smoothline is a typographical error and should instead read "Greatsino Limited also guarantees . . . ." Id.

NAFT alleges that by 1998, Smoothline and Greatsino were delivering a large percentage of defective telephones and failing to meet their obligations to repair or replace CRUs in a timely manner. Id. Litigation ensued.

The UAL Group

UAL and its numerous subsidiaries (the "UAL Group") essentially form a single vertically integrated manufacturing company with the UAL subsidiaries specializing in the different tasks that are essential to the operation of the company as a whole and functioning as if they were divisions of the unified company. Plaintiffs' expert provided a chart identifying the functions of various UAL subsidiaries, each of which performed a function in connection with UAL's cordless telephone business. Progress One is responsible for "[r]esearch and development for the 900 MHz cordless phone." Central Base Enterprises Limited ("Central Base") is the "[p]urchasing center." Englehart International Limited ("Englehart") is responsible for "[l]easing of manufacturing equipment." Several other divisions specialize in "[m]anufacturing." Significantly, plaintiffs' expert refers to Greatsino and Smoothline as involved not in manufacturing, but in "[s]ales." Several other companies provided support to each of the other companies. For instance, Global Assets Ltd. ("Global Assets") serves a "[t]reasury function." Systems Asia Limited ("Systems Asia") provides "[a]dministrative services," and appears to be the formal employer of UAL Group employees, including Dominic Yuen ("Yuen"), who stated that he "work[s] for Systems Asia," but that he holds the position of "financial controller" of the "UAL [G]roup," and Cecil Ho ("Ho"), who is, inter alia, a Systems Asia director. The other evidence presented by the parties for this motion confirms that neither Smoothline nor Greatsino were independent companies.

Smoothline

After a transition period during which Smoothline's original management remained in charge of its operations, directors of UAL took over the management of Smoothline. Thus, from 1994, when UAL acquired Smoothline, until 1996, UAL retained Smoothline's original personnel, including Yang. In 1996, Yang left Smoothline. Wong Siu Kang ("Kang") took over the day to day operations until the end of that year. Thereafter, Yap managed Smoothline until August 1998. Ken Cohen managed it until April 1999. Patti Chan ("Chan") managed it until August 1999. Ho then took over as manager of Smoothline, a position which he still holds. NAFT alleges, and Smoothline does not deny, that Yap, Chan, and Ho have been UAL directors. UAL's Ko was a director of Smoothline, although it is not clear at what time.

Robert Schweitzer ("Schweitzer"), NAFT's agent and attorney-in-fact, states that after Yang left Smoothline, Schweitzer routinely communicated by telephone with Ko regarding Smoothline's production of telephones for NAFT. In his deposition testimony, Ko does not deny that he spoke to Schweitzer regularly, but states that he has little memory of what they discussed. He does concede, however, that he listened to Schweitzer's concerns about pricing. Ko asserts that he took Schweitzer's calls merely as a courtesy, because NAFT was the principal customer of one of UAL's subsidiaries.

Schweitzer states that, in late 1998, he made detailed requests to Ko regarding how

Smoothline could improve its performance. Schweitzer then received a letter dated November 10, 1998, on UAL stationary, apparently signed by Ko (the "November 10 Letter"), which sets forth specific actions Ko had taken in response to Schweitzer's concerns:

It is a difficult year to Smoothline, the mistakes we have made have damaged the confidence of NAFT on Smoothline. In fact, my last meeting with the engineers and senior management of Smoothline, I have insisted that they must be more responsible and more customer oriented. The biggest mistake Smoothline has made, as I have seen is that it has committed something beyond its capabilities to deliver. What I am trying to make sure is that whatever is promised or committed, they have by all means to deliver. I have insisted on our Engineer Dept. to get more than enough engineers in order to meet the tight delivery time table. In this case, there is no excuse for delay. Enough financial and other resources will be allot[t]ed to them. I am instilling strong sense of responsibility. I told them we will be able to make money only if our customers make money.

For your information, we are looking at to move into the new factory in Dongmun sometime in February next year. A lot of resources have been put in to ensure no mistakes will be made next year with your planned quantity. Thank you very much for your support and I will make sure that your suggestions implemented. (Emphasis supplied.)

Ko states that he does not remember writing this letter and speculates that someone else in his organization may have written it. When asked what he thought was meant by the statement in the November 10 Letter that "[e]nough financial and other resources will be allot[t]ed to them," Ho responded that it meant that the Board of Directors of UAL will make the decision as to what resources are allotted to Smoothline. Schweitzer states that he routinely received documents on UAL or Greatsino letterhead which discussed Smoothline's obligations.

By letter dated November 26, 1998 (the "November 26 Letter"), Ko wrote to Schweitzer — this time on Smoothline letterhead — to describe the measures he had taken to ensure the on-time delivery and quality of Smoothline's products. The three-page single-spaced letter sets out in great detail various changes that would be made at Progress One, a wholly-owned subsidiary of UAL in Korea that did engineering work for Smoothline, as well as within Smoothline after its move to a new factory. As with the November 10 Letter, Ko states that he has no memory of writing the November 26 Letter.

Greatsino

Plaintiffs' expert describes Greatsino as an entity responsible for sales of telephones designed and manufactured by other UAL subsidiaries. When UAL acquired it, Greatsino had no employees and no manufacturing operation. According to Ho, in approximately 1997, Greatsino began to pay commissions to salespeople selling printed circuit boards ("PCBs") manufactured by another UAL subsidiary that was part of the factory complex purchased from Yap. Sometime in 1997, Ho became Greatsino's only employee.

In the fall of 1997, Yap began to negotiate with NAFT regarding the terms of Greatsino's "production" of 900 megaherz telephones. Although Yap was a director of UAL, plaintiffs concede that he was acting as the "de facto" manager of Greatsino. On September 18, 1997, Yap wrote to Schweizer on UAL stationary a cover letter attached to proposed terms "in relation to the sales of new cordless telephone products under Greatsino Limited, a subsidiary of Universal." Yap proposed in the letter that, in the future, "similar arrangements be made for sales under Smoothline Limited."

In late 1997, Greatsino began to supply 900 megaherz telephones to NAFT. Up to 1999, Greatsino subcontracted the manufacturing of these telephones to other entities in the Zhuhai factory complex, which, as Ho testified, were owned by another UAL subsidiary. The cost of the telephones charged to Greatsino was set by these entities. Smoothline personnel processed the orders for the telephones that Greatsino had received from NAFT. In 1999, Greatsino subcontracted the manufacturing of the telephones to a manufacturing complex in Doumen, China (the "Doumen Complex"). UAL had acquired the Doumen Complex at the time it acquired Greatsino and had subsequently sold it at a substantial profit. In late 1999, after NAFT ceased ordering from Greatsino, Greatsino became a dormant company.

UAL Group Offices

Plaintiffs concede that beginning in August 1997, Greatsino, Smoothline, Systems Asia, Central Base, Global Assets, and other UAL subsidiaries occupied the same office space in Hong Kong. Yuen testified that because it has no staff, UAL did not itself occupy any office space. Plaintiff's claim that Systems Asia charged each subsidiary rent based on how much office space the subsidiary occupied. Yuen was unable to say, however, whether Systems Asia made a profit on the rent it charged. Ko testified that Systems Asia and the subsidiary would typically agree on a fair rent. Plaintiffs have provided no documents indicating that rental agreements were ever reduced to writing.

Discovery of Plaintiffs' Financial Documents

At a conference on February 27, 2002, a schedule was set for discovery on the propriety of

piercing the corporate veil of either Smoothline or Greatsino to reach UAL. Discovery was to be completed by June 28. In response to plaintiffs' complaint that NAFT's request for production of documents was overly expansive and burdensome, a conference was held on April 26. The plaintiffs represented at the conference that they were reviewing 700 boxes of documents in Hong Kong and that while most of the documents were detailed back-up documents for individual transactions, they would soon be producing from those boxes audited financial statements and the general ledger for transactions between the companies in the UAL group of companies and that these documents would be sufficient to explain the finances of the companies. It asked that it not be required to produce the hundreds of boxes of detailed back-up documents. The Court ruled that the back-up documents for individual transactions need not be produced so long as the plaintiffs produced the financial records customarily kept by businesses which reflect and explain the intragroup transfers. In connection with a discovery dispute in June, the plaintiffs represented that they had produced almost 18,000 pages of documents showing every financial transaction between the entities. By Order dated July 10, discovery was extended until September 20 for the sole purpose of conducting depositions.

The adequacy of the production of financial documents from UAL, Greatsino, and Smoothline, however, remained in dispute. By letter dated August 15, NAFT stated that plaintiffs' 18,000 page document production consisted primarily of a general ledger showing transactions between Smoothline, Greatsino and other UAL entities. This ledger contained few notations describing the purpose or nature of the transactions, but made it appear that the only vendors Smoothline or Greatsino used to perform their obligations for NAFT were other UAL companies, and that virtually all Smoothline and Greatsino funds were drained away by payments to these entities. NAFT further stated that a small portion of plaintiffs' production consisted of annual reports and financial statements for UAL, Smoothline, and Greatsino. NAFT requested that plaintiffs be ordered to produce internal books of account and outside accountant work papers to explain the "missing step" between the general ledger and the annual reports and financial statements. NAFT reported that the plaintiffs had refused this request on the ground, inter alia, that the companies did not do any internal auditing and therefore the requested documents did not exist.

In a letter to the Court dated August 19, plaintiffs' counsel responded to NAFT's request. Specifically, plaintiff's counsel stated:

NAFT apparently believes that some interim step is taken which would explain the particular reason for each of the transactions shown on the ledgers. However, there is no missing step between the ledgers and the financial statements (which are constructed directly from the ledgers). Information showing the purpose of each of the transactions on the produced ledger documents [is] contained in voluminous backup documents. Specifically, such information can be found in certain "voucher" documents that are created for, and at the time of, each transaction. In compliance with the Court's directive, our clients produced the ledgers reflecting each transaction entered into as well as documents showing the final adjustments to those ledgers. Those specific documents are the very ones used to create the financial documents. The documents produced, moreover, are the standard financial records maintained by the three entities.

By Order dated August 21, NAFT's August 15 request was denied. In denying the request, the August 21 Order noted that plaintiffs "represented that there are no internal books of account other than the general ledger and that their financial statements are produced directly from that ledger."

UAL Group Books and Records

A multi-million dollar manufacturing company like the UAL Group, components of which produce audited financial statements, must have the standard accounting documents that are necessary to make a general ledger comprehensible. Such documents include a trial balance, bank reconciliation, reconciliation of intra-group transfers, and subsidiary ledgers for accounts receivable and accounts payable.

Plaintiffs' deposition testimony indicates that, at least with respect to Smoothline, such intermediate ledgers do, or did, in fact exist, and that they were used in the preparation of Smoothline's financial statements and annual reports. Ho testified that Smoothline prepares bank reconciliation forms. He further testified that subsidiary ledgers, such as accounts receivable ledgers, accounts payable ledgers, and inventory ledgers, were also prepared, but he did not specify by whom. Furthermore, Yuen testified that Systems Asia, which performs an administrative function within the UAL group, creates bank reconciliation documents.

It appears, based on the gaps in the production of documents by UAL, Smoothline, and Greatsino that subsidiary ledgers and the other summary financial records customarily kept by businesses of this size were prepared and maintained on behalf of UAL's companies by another UAL subsidiary, probably Systems Asia, which plaintiffs' expert describes as the "administrative arm of the UAL Group." The testimony offered by the parties' accounting experts leaves little doubt that such documents had to exist to permit the preparation of financial statements and tax returns. It would have been prohibitively expensive for outside accountants to create the ledgers for themselves from the

voluminous back-up documents reflecting individual transactions. Also, UAL and Greatsino did not have staff to prepare these documents, and of course, did not produce any during discovery. Indeed, the plaintiffs' own accounting expert opines that these documents must exist. (2) He concludes that Systems Asia must have the documents since it provided the accounting services for the UAL Group. (3)

The failure to produce the books and records of the plaintiffs had a profound effect on NAFT's ability to illuminate the relationship between either Smoothline or Greatsino and UAL. The damage from the absence of critical financial records was aggravated by the inability or unwillingness of the plaintiffs' witnesses to shed light on the financial arrangements among the companies. The officers and agents of the plaintiffs were unable to explain in their depositions the reason for many of the intracompany transfers or even such basic information as the elements that determined the price of the goods and services that Smoothline and Greatsino purchased from their sister companies in the UAL Group.

The Financing of Smoothline and Greatsino

Among the financial documents which plaintiffs did produce are approximately fifteen credit facilities for Smoothline, Greatsino, and other UAL subsidiaries for the years 1994 through 2000. These documents, particularly those from 1997 on, provide strong evidence of the integration of Smoothline and Greatsino with UAL. Of these credit facilities, approximately the first ten, dating from June 1994 to December 1996, provided financing that could be used by Smoothline only. Many of these facilities were guaranteed by UAL.

In 1997, Global Assets was established to serve what plaintiffs refer to as a "treasury function" within the UAL group of subsidiaries. Ho and Ko are directors of Global Assets. Beginning in October 1997, the next five credit facilities each made financing available to multiple UAL subsidiaries and were guaranteed by UAL. For example, a credit facility provided by Hang Seng Bank dated August 22, 1997, made financing available to Smoothline, Greatsino, Central Base, and Englehart. A credit facility provided by Standard Chartered Bank dated October 13, 1997 made financing available to five UAL "group companies:" Smoothline, Greatsino, Central Base, Englehart, and Global Assets. Three of these five credit facilities are addressed to UAL. Three are addressed specifically to the attention of Ho as "Company Secretary." The other two are addressed specifically to the attention of Ko, one referring to him as "Chairman."

These five credit facilities typically permitted any single UAL subsidiary to draw down a substantial portion, if not all of the amount provided by the facility. Plaintiffs have provided no documents or testimony to explain the process by which UAL subsidiaries apportioned among themselves these lines of credit. Plaintiffs state instead that there was never an unresolvable dispute between any two subsidiaries as to their level of borrowing.

The credit facilities provided by Standard Chartered Bank expressly required that Smoothline and Greatsino submit audited financial statements. Greatsino's financial statements are unaudited. Plaintiffs have not explained why Standard Chartered Bank nevertheless agreed to extend credit to Greatsino despite its inability to produce audited financial statements.

Smoothline's Financial Statements

Plaintiffs produced Smoothline's general ledger and audited financial statements for the years 1994 through 1999. Smoothline's 1994 financial statement appears to indicate that it was granted an unsecured, interest-free loan from UAL in the amount of HK$18 million. (4) There is no indication in subsequent financial statements that this loan was repaid. Smoothline was profitable through 1997, with a total shareholders equity of HK$63,890,123 in that year. In 1998, however, Smoothline lost money. Its shareholders equity was negative HK$57,966,909. In 1999, its shareholders equity was negative HK$117,704,262. By comparison, the UAL group of companies as a whole announced a profit of HK$14,388,000 in its consolidated financial statements for the year 1997, and of HK$70,559,000 for the year 1999. For the year 1998, the group was unprofitable.

Smoothline's financial statements indicate that it became unprofitable because its cost of sales exceeded its sales revenue. While it appears that Smoothline may have had some manufacturing capacity of its own, it is also clear that even then it purchased components from the UAL subsidiary Central Base. In 1997, its cost of sales was HK$542,776,000, while it sales revenue was HK$611,186,000. In 1998, its cost of sales was HK$637,716,000, while its sales revenue was HK$578,381,000. In 1999, its cost of sales was HK$190,358,000, while its sales revenue was HK$152,000,000. Plaintiffs have produced no information regarding Smoothline's costs per unit sold. When asked at his deposition, Ho was unable to explain how prices were determined among UAL subsidiaries. When asked the same question, Yuen responded that pricing consisted of "[c]ost plus something," but admitted that he did not know what that "something" was.

Smoothline's 1995 general ledger shows several large transfers in round numbers between Smoothline and other UAL subsidiaries; for example, a transfer to Systems Asia Limited ("Systems Asia"), a Hong Kong corporation, of HK$12,700,000; from Systems Asia of HK$10,000,000; to UAL of HK$1,800,000; and to Smoothline Philippines, Inc., a Philippines

corporation, of HK$3,315,578. Smoothline's general ledgers for 1996 through 1999 also contain numerous large transfers, with increased activity in 1998 and 1999. Smoothline is now dormant and has assets amounting to no more than HK$100,000.

Greatsino's Financial Statements

Plaintiffs produced Greatsino's general ledger for the period 1997 through 2000 and unaudited financial statements for the period 1996 through 1999. Greatsino had no manufacturing capacity of its own, but rather subcontracted the manufacturing of its telephones to other UAL subsidiaires. For the year 1997, Greatsino's profit was HK$7,895,732. Its cost of sales was HK$142,649,984, while its revenue from sales was HK$153,084,067. For the year 1998, when it began to sell telephones to NAFT, Greatsino had a loss of HK$19,209,793. Its cost of sales for that year was HK$332,661,737, while its sales revenue was HK$326,225,098. For the year 1999, Greatsino had a loss of HK$82,810,076. Its cost of sales was HK$250,819,209, while its sales revenue was HK$186,719,383. Greatsino's balance sheet for 1999 also shows a "loan from a fellow subsidiary" in the amount of HK$70,659,289. Plaintiffs have provided no explanation of this entry.

Greatsino's general ledgers for the period 1997 through 1999 show numerous intercompany transfers, including substantial transfers, ranging in amounts from HK$5 million to HK$100 million, from Greatsino to other UAL subsidiaries. Like Smoothline, Greatsino is dormant and has assets amounting to no more than HK$100,000.

Discussion

UAL may be compelled to arbitrate its CRU disputes as the alter ego of Greatsino or Smoothline. See Thomson-CSF, S.A. v. American Arbitration Ass'n, 64 F.3d 773, 776 (2d Cir. 1995). The parties dispute whether the veil-piercing principles of Hong Kong and the British Virgin Islands or of New York should apply, and dispute the requirements under foreign law for piercing the corporate veil. Plaintiffs and defendant do not dispute, however, that New York law sets a higher standard for veil-piercing than the relevant foreign law, and that if the veil between UAL and Greatsino and UAL and Smoothline should be pierced under New York law, it follows a fortiori that it should be pierced under foreign law.

New York would apply the law of the place of incorporation in determining whether to pierce the corporate veil. Fletcher v. Atex, Inc., 68 F.3d 1451, 1456 (2d Cir. 1997). Nonetheless, because Smoothline and Greatsino are alter egos of UAL under the more exacting standards described in New York corporate law, it is unnecessary to resolve the dispute about the content of foreign law.

Under New York law, the party seeking to pierce a corporate veil must "make a two-part showing: (i) that the owner exercised complete domination over the corporation with respect to the transaction at issue; and (ii) that such domination was used to commit a fraud or wrong that injured the party seeking to pierce the veil." American Fuel Corp. v. Utah Energy Dev. Co., Inc., 122 F.3d 130, 134 (2d Cir. 1997). See also Freeman v. Complex Computing Co., Inc., 119 F.3d 1044, 1052-53 (2d Cir. 1997). Proof of fraud is a necessary element; "the element of domination and control never was considered to be sufficient of itself to justify the piercing of a corporate veil." Id. at 1053.

I. Domination

Courts typically consider at least ten factors in determining whether domination exists:

(1) the absence of the formalities and paraphernalia that are part and parcel of the corporate existence, i.e., issuance of stock, elections of directors, keeping of corporate records and the like;

(2) inadequate capitalization;

(3) whether funds are put in and taken out of the corporation for personal rather than corporate purposes;

(4) overlap in ownership, officers, directors, and personnel;

(5) common office space, address and telephone numbers of corporate entities;

(6) the amount of business discretion displayed by the allegedly dominated corporation;

(7) whether the related corporation dealt with the dominated corporation at arms length;

(8) whether the corporations are treated as independent profit centers;

(9) the payment or guarantee of debts of the corporation by other corporations in the group; and

(10) whether the corporation in question had property that was used by another corporation as if it were its own.

Wm. Passalacgua Builders, Inc. v. Resnick Developers S., Inc., 933 F.2d 131, 139 (2d Cir. 1991). "No one factor is decisive." Freeman, 119 F.3d at 1053. In applying these factors, the general principle followed by courts is that "liability is imposed to reach an equitable result." Brunswick Corp. v. Waxman, 599 F.2d 34, 35 (2d Cir. 1979) (citation omitted) Nonetheless, New York is reluctant to pierce the corporate veil and NAFT bears the burden to show that the dominated company's "separate identity [has been] so disregarded, that it primarily transacted the dominator's business rather than its own." William Wrigley Jr. Co. v. Waters, 890 F.2d 594, 600 (2d Cir. 1989).

There can be little doubt that UAL exercised domination over both Smoothline and Greatsino. At all relevant times, the UAL Group was essentially one company with several specialized divisions. Smoothline and Greatsino specialized in sales, specifically, in the sale of products manufactured by other UAL divisions. This is especially clear in the case of Greatsino, which had no manufacturing capability of its own, none of the accounting books and records typically kept by corporations, and one employee.

There was and is substantial overlap of directors and personnel among these entities, and in particular between Smoothline, Greatsino, and UAL. Ko, Yap, Chan, and Ho have each been both UAL directors and directors of Smoothline. Ho is also the sole director of Greatsino. Indeed, Ho conceded that he is the sole employee of Greatsino, notwithstanding the fact that it was reporting sales revenue of hundred of millions of Hong Kong dollars. All of Greatsino's functions other than those performed by Ho were performed by other personnel within the group of UAL subsidiaries.

Furthermore, while not apparently formally a director of Smoothline, Ko acted as its "de facto" head in his communications with Schweitzer. Even if Ko did not himself write the November 10 and November 26 Letters, it is indicative of the blurring of the boundaries between the UAL subsidiaries that some other employee would consider it appropriate to sign Ko's name to a document dealing specifically with Smoothline, and in the case of the November 10 Letter, to do so on UAL letterhead. See Weinreich v. Sandhaus, 850 F. Supp. 1169, 1179 (S.D.N.Y. 1994) (principals' use of letterhead of one company on behalf of a second company suggests that they acted on behalf of both). See also David v. Glemby Co., 717 F. Supp. 162, 167 (S.D.N.Y. 1989). Similarly, plaintiffs concede that Yap, who was a UAL director at the time, acted as the "de facto" managing director of Greatsino when he negotiated the terms of Greatsino's production of 900 megaherz telephones for NAFT. As did Ko, Yap used UAL letterhead to propose certain terms of Greatsino's relationship with NAFT.

Beginning in August 1997, Smoothline and Greatsino shared office space with other UAL subsidiaries. To the extent that UAL did not itself occupy any office space, this was because its directors occupied the office space of UAL subsidiaries in performing the duties associated with their positions in those subsidiaries. Furthermore, the informal process by which Systems Asia established a "fair rent" indicates the extent to which UAL's subsidiaries did not deal with each other at arms length.

The five credit facilities dating from October 1997 are especially strong evidence of domination. These facilities were guaranteed by UAL and designed so that multiple UAL subsidiaries could draw funds from them. Furthermore, plaintiffs failed to produce any documents establishing a protocol for the apportionment of these lines of credit among the subsidiaries named in them. See United States v. Afram Lines (Int'l), Inc., No. 91 Civ. 1062 (JSM), 1997 WL 423063, at *3 (S.D.N.Y. 1997) (single credit facility was obtained for all of the companies)

Plaintiffs' failure to produce standard accounting documents for Greatsino and Smoothline is further evidence that these companies were not independent, fully-functioning firms, but were rather divisions in a larger organization. NAFT's expert has testified that firms of Greatsino's or Smoothline's size, taking in hundred of millions of HK dollars in revenue, typically have an internal accounting department that prepares interim accounting records, such as trial balances, bank reconciliation forms, expense workpapers, and subsidiary ledgers, to reconcile and corroborate the entries in the general ledger. Plaintiffs' expert agrees that given the scale of Greatsino's and Smoothline's business, such accounting documents must exist. Plaintiffs' own witnesses have stated that such documents do exist. They were not produced during discovery, however, on the representation that Smoothline, Greatsino, and UAL do not have such documents. It is reasonable to conclude, based on this representation, that standard accounting documents for Smoothline and Greatsino do exist, but are prepared by and remain in the possession of the accounting division of the UAL Group, which is likely Systems Asia. Smoothline's and Greatsino's apparent reliance on another subsidiary within the UAL Group to perform their basic accounting tasks is strong evidence that they were not independent companies.

Finally, Smoothline's and Greatsino's numerous unexplained intercompany transfers to

and from other UAL subsidiaries strongly suggest that they did not engage in arms length transactions and that they were not treated as independent profit centers. Plaintiffs have failed to explain how internal prices were established among the UAL subsidiaries. Plaintiffs have also failed to explain the nature or purpose of UAL's loan to Smoothline or the loan from a "fellow subsidiary" to Greatsino. With respect in particular to Greatsino, its cost of sales appear to have increased dramatically in 1998 and 1999 as compared to its sales revenue. It is not clear how dramatically, however, because plaintiffs failed to provide any information on Greatsino's per unit costs. In any case, based on the information plaintiffs have provided, and in particular, on the fact that the UAL Group was highly profitable in 1999, it is reasonable to conclude that funds were being shifted out of Greatsino in 1998 and even more so in 1999 not in the form of dividends to UAL, but rather in the form of inflated costs being paid to UAL subsidiaries which were subcontracted to manufacture telephones for Greatsino.

Plaintiffs' argue that Smoothline and Greatsino were adequately capitalized by repeated large transfers from UAL, became unprofitable only because of NAFT's hard bargaining on price, and declined into dormancy only as a result of NAFT's decision to cease purchasing telephones from them. These transfers underscore, however, the degree to which Smoothline and Greatsino relied on UAL for their survival as going concerns. Furthermore, without accounting documents or testimony to explain the numerous intragroup transfers recorded on Smoothline's and Greatsino's general ledgers, it is impossible to determine whether they were unprofitable and failed because of NAFT or because profits from the transactions with NAFT were moved to other companies in the UAL Group in the form, for example, of inflated costs. Since the evidence that would answer this is exclusively within the custody and control of the plaintiffs, it is fair to infer that the truth is unfavorable to the plaintiffs. Given all the other evidence that points to the systemic abuse of the corporate form throughout the UAL Group's conduct of intragroup business, it is reasonable to conclude that assets were deliberately shifted out of Smoothline and Greatsino in anticipation of future judgments.

II. Fraud

Having shown domination, NAFT must also show that this domination "was used to commit wrong, fraud, or the breach of a legal duty, or a dishonest and unjust act in contravention of plaintiff's legal rights, and that the control and breach of duty proximately caused the injury complained of." Freeman, 119 F.3d at 1053. NAFT has shown that Smoothline and Greatsino have been left dormant and essentially judgment proof.

Plaintiffs argue that Smothline and Greatsino are impoverished as a result of NAFT's decision to cease doing business with them. As already discussed, plaintiffs have failed to support this claim. Rather, based on plaintiffs' submissions, it is reasonable to infer that among the numerous unexplained intercompany transfers documented in the general ledgers were transfers designed to drain money from Smoothline and Greatsino, most likely in the form of higher prices paid to Smoothline's and Greatsino's subcontractors and components suppliers. This activity is sufficient to constitute a fraud or wrong for purposes of piercing the corporate veil. See Thrift Drug v. Prescription Plan Service Corp., 1 F. Supp.2d 387, 388 (S.D.N.Y. 1998) (controlling shareholder's manipulation of corporation's accounts to shield assets from creditors); Freeman v. Complex Computing Co., Inc., 979 F. Supp. 257, 260 (S.D.N.Y. 1997) (shifting of assets by equitable owner of corporation to make corporation judgment proof constitutes fraud or wrong justifying veil-piercing). (5)

Conclusion

For the reasons stated, defendant's renewed motion to compel arbitration with respect to UAL is granted.

References

1) UAL filed a petition to the Supreme Court, New York County, under the caption In the Matter of the Application of Universal Appliances Ltd. and Greatsino Electronic Ltd. For a Judgment Staying the Arbitration Commenced by North American Foreign Trading Corp. Defendant removed the action to this Court under the caption In the Matter of the Application of Smoothline Ltd. and Greatsino Electronic Ltd. for a Judgment Staying the Arbitration Commenced by North American Foreign Trading Corp.
2) The plaintiffs did not have their auditors, Ernst & Young, provide expert testimony in this case. Accountants from Ernst & Young would have been in a position to describe accurately what books and records are maintained by UAL, Greatsino, and Smoothline and to explain the intragroup transfers. Instead, plaintiffs chose an expert who reviewed only the material produced in discovery. He reasoned that since Hong Kong law requires companies to keep proper books and records, and since Ernst & Young had issued "clean" audit reports for Smoothline and UAL, then at least Smoothline and UAL must have had proper books and records.

3) The parties do not address whether UAL, Smoothline, and Greatsino had an obligation to produce in discovery the books and records held by Systems Asia for their benefit.
4) The exchange rate at the time was approximately 7.8 HK dollars to 1 U.S. dollar.
5) Because NAFT has shown that Smoothline and Greastino are alter egos of UAL, it is unnecessary to consider Smoothline's argument that UAL is equitably estopped from disclaiming its obligation to arbitrate.

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