



Sunset Aviation

2002 | Cited 0 times | California Court of Appeal | November 19, 2002

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Appellants/defendants DHS Aviation, Inc. (DHS) and Carey F. Daly II (Daly) appeal an amended judgment in favor of plaintiff/respondent Sunset Aviation, Inc. (Sunset) in Sunset's action against DHS for breach of contract. They contend the trial court erroneously applied the alter ego doctrine to add Daly as a defendant to the original stipulated judgment between DHS and Sunset.¹

BACKGROUND

Formation and Organization of DHS

On September 17, 1998, Christopher Miller, as incorporator, filed the articles of incorporation for DHS with the California Secretary of State. DHS was formed for the purpose of owning a corporate airplane to be used for charters and managed by Sunset, a business that operates charter planes and manages and maintains aircraft. Dan Drohan is president and sole shareholder of Sunset.

On October 13, 1998, Daly opened a DHS checking account at Union Bank. He was the only signatory listed on the account signature card.

On October 14, 1998, Daly, Miller, and Edward Mueller met at Daly's office at The Pathways Group² to complete the organization of DHS. Daly was named chairman and president of DHS, positions he held throughout DHS's existence. Mueller was named secretary, a position he held until his resignation sometime before January 2001. During its existence, DHS had no other officers or directors. The minutes of the October 14 meeting identify the principal place of DHS's business as Daly's residence. Mueller, as secretary, executed a certificate on October 14 that DHS adopted bylaws.

At the October 14 meeting, DHS was authorized to issue an aggregate of 1,000,000 shares of capital stock. Shares were to be valued at \$1.00 apiece; consideration for a share could be cash, cancellation of indebtedness for money lent to DHS, or both. In consideration for pre-incorporation expenses of approximately \$1,400, Daly was issued 1,400 shares. No other shares ever issued. There were also no subsequent shareholder or board of director meetings because Daly was the only director and



shareholder of DHS. Instead, he formalized his decisions with consents to action.

As a brand new corporation, DHS had no revenue to cover its operating costs. Daly's tax attorneys advised him that lending money to DHS for its initial operating expenses, with DHS then in debt to him, was preferable to making large investments into DHS in return for shares of stock. He anticipated that as the charter business took off, DHS would be able to repay his loans. He also anticipated that the two individuals whose surnames stand for the H and S of DHS would eventually "be coming in and investing" in DHS. There is no documentation of their anticipated investment, nor did DHS ever have investors.

On October 16, 1998, Daly, as sole director of DHS, executed a DHS consent to action by board of directors. It states, in part: "The undersigned member of [the DHS Board of Directors] comprising the entire Board, does hereby unanimously consent to the following stated actions. This consent shall have the same effect as a unanimous vote at a duly convened special meeting of the [Board], pursuant to the applicable provisions of the California General Corporation Statutes and the Bylaws of the Corporation. [¶] [DHS], until such time as it becomes self sufficient in its cash flow and in its profitability, will require additional funds to operate [its] business. [¶] [Daly] has agreed to [lend] funds to [DHS] from time to time when, in his judgment, it is prudent for him to do so. In return [DHS] has agreed to treat such funds [lent] to [it] as senior secured debt, collateralized by the assets of the corporation, both liquid and intangible. These loans shall aggregate on a balance due basis at the rate of 7.5% interest per annum, compounded daily."

In the ensuing months, Daly made loans to DHS when his bookkeeper informed him that DHS did not have sufficient funds to pay its bills. Throughout its existence, DHS had no source of funding other than loans from Daly.

In December 1998, Christopher Miller submitted an SS-4 IRS application for employer identification on behalf of DHS. The listed address for the applicant was the same address as The Pathways Group.

Purchase of the Aircraft

In early 1999, Daly asked Drohan to find a small airplane to buy for use by The Pathways Group.³ Drohan located a used Cessna Citation II (the Cessna) for sale by Scurlock Permian LLC and, as Daly's broker, negotiated an acceptable price for the Cessna. Once the price was agreed to, the particulars of the sale were arranged by Mueller.

On March 16, 1999, Mueller sent a memo to Daly concerning acquisition of the Cessna. Mueller noted that a proposed lease financing agreement with GE Capital Corporation (GE Capital) "is currently proposed in your name. Should that be changed to a corporate name?" Mueller also asked: "Which company do you want to use for the 'lease back?' I would still recommend [DHS]." Mueller also noted that GE Capital could be expected to ask Daly to guarantee the lease agreement if it

Sunset Aviation

2002 | Cited 0 times | California Court of Appeal | November 19, 2002

agreed to changing the lessee from Daly to a corporation.

a. The Purchase Agreement

On March 17, 1999, Daly, "an individual," and Scurlock Permian LLC executed a Used Aircraft Purchase Agreement (Purchase Agreement) whereby Daly agreed to purchase the Cessna for \$2,450,000. Daly's address on the Purchase Agreement is the same as The Pathways Group address. The Purchase Agreement states that Daly had deposited \$100,000 in escrow, to be used toward the purchase price. It also provides that Daly could assign his rights under the Purchase Agreement to GE Capital in connection with an initial financing or lease of the Cessna.

b. The Management Agreement

Also on March 17, Sunset, as lessee, and DHS, as lessor, entered into a one-year Aircraft Management Agreement (Management Agreement) whereby DHS would lease the Cessna to Sunset to use for charters to third parties. Sunset would pay DHS \$900 (later reduced to \$600) per flight hour for third-party charters. DHS would pay Sunset an annual management fee of \$85,000 (later reduced), payable in monthly installments, for flights taken by Daly or on behalf of The Pathways Group. DHS would be responsible for the Cessna's operating expenses, maintenance, storage, taxes, and insurance, and recurrent training for its pilots.

c. The Lease Agreement and Documents Related to Financing the Aircraft's Purchase

On March 18, 1999, Mueller executed numerous documents pertinent to the financing of the Cessna. As DHS's secretary, he executed a "Corporate Lessee's Board of Directors Resolution" that all DHS officers were authorized to enter into an Aircraft Lease Agreement (Lease Agreement) with GE Capital and to take any action necessary to effectuate the Lease Agreement.

On behalf of DHS, Mueller executed the Lease Agreement between DHS and GE Capital, whereby GE Capital agreed to pay the \$2,450,000 purchase price for the Cessna and lease it to DHS for nine years. DHS's monthly lease payments were approximately \$23,000.

The Lease Agreement incorporates an assignment between Daly and DHS, whereby Daly had assigned all his rights in the Purchase Agreement to DHS. Mueller executed this assignment on Daly's behalf as his attorney in fact and on DHS's behalf as its secretary.

The Lease Agreement also incorporates an assignment between DHS and GE Capital, whereby DHS had assigned all its rights in the Purchase Agreement to GE Capital. Mueller executed this assignment on behalf of DHS as its secretary.

As DHS secretary, Mueller executed a security deposit pledge agreement between DHS and GE



Sunset Aviation

2002 | Cited 0 times | California Court of Appeal | November 19, 2002

Capital, whereby DHS was to deposit \$550,000 with GE Capital to secure the payment and performance of all DHS's obligations under the Lease Agreement. Daly "personally supplied" this \$550,000 deposit to GE Capital on behalf of DHS.

Also on March 18, Daly executed an individual guaranty whereby he guaranteed the performance of all DHS's obligations to GE Capital under the Lease Agreement.

Post-Acquisition Activity

Wendy Suiter was Daly's secretary at The Pathways Group. She also worked as his secretary and bookkeeper for matters involving DHS. She was paid \$750 per month for the DHS work; payment was from the DHS bank account. Between May 1999 and January 2001, at Daly's direction, she prepared six checks to be issued to him or Daly Household Services from the DHS account; the checks totaled approximately \$60,500. Daly Household Services, dormant as of August 2001, was a corporation owned by Daly, which evolved into his investment account and lent money to DHS. Its source of funds was Daly's personal contributions.

Drohan sent all Sunset correspondence and bills concerning DHS to Daly or Suitor at The Pathways Group office.

In February 2000, Daly deposited \$26,000 into the DHS account so it could make payments to Sunset.

In April 2000, when the Management Agreement between Sunset and DHS expired, DHS was in arrears to Sunset for \$53,126.03. That same month the Cessna developed engine problems; Sunset arranged for repairs to be made. As of May 1, 2000, DHS had taken possession of the Cessna.

In May 2000, Suitor issued on the DHS account a \$2,000 monthly allowance check to Daly's daughter and a \$2,100 check to Sheldon and Associates for travel expenses incurred in conjunction with a business venture between Daly and Sheldon and Associates.

In August 2000, GE Capital repossessed the Cessna because DHS had failed to make several monthly payments required by the Lease Agreement.

In October 2000, Suitor received a check of approximately \$8,400 from Allen Aviation payable to DHS. The check was not deposited in the DHS account; it was instead paid to Daly and marked "payable to shareholder."

On April 24, 2001, Daly executed another consent to action by DHS board of directors. It states that Daly originally lent DHS substantial sums, including but not limited to the March 18, 1999 \$550,000 security deposit required to obtain the Lease Agreement with GE Capital; that at all times thereafter DHS was obligated to repay these loans; that DHS now wishes to assign to Daly, as if he had been the



Sunset Aviation

2002 | Cited 0 times | California Court of Appeal | November 19, 2002

original lessee, all its rights in the Cessna, the Lease Agreement, and any pending rights of DHS to arbitrate or litigate against GE Capital its rights under the Lease Agreement and any remedies awarded in any such arbitration or litigation; that in consideration for this assignment Daly forgives the \$550,000 loan used for the security deposit for the Lease Agreement and waives any indemnification DHS owes him based on his personal guarantee of payment of the Lease Agreement; and that all other loans from Daly to DHS remain due and owing.

As of May 2001, the DHS bank account had closed. On or about June 1, 2001, the corporate rights, privileges and powers of DHS were suspended, pursuant to Revenue and Taxation Code section 23302. When DHS ceased operating, it owed Daly more than \$1,100,000. As of August 31, 2001, Daly's outstanding loans to DHS, including interest, totaled \$1,132,995.58.

Litigation

In June 2000, Sunset brought a breach of contract action against DHS, alleging DHS owed it \$53,123.06 for outstanding storage, repair, maintenance and fuel expenses. In November 2000, DHS cross-complained for negligent management of the Cessna and fraud in the inducement of the DHS/GE Capital Lease Agreement. In May 2001, DHS executed a confession of judgment for \$53,123.06 and stipulated to entry of judgment on Sunset's complaint in the same amount, plus pre-judgment interest of \$5,428.74 and costs and attorney fees to be determined by motion. The trial court entered judgment in favor of Sunset, plus attorney fees and costs, and DHS dismissed its cross-complaint.

On July 5, 2001, Sunset filed a writ of execution of the judgment against DHS.

On July 18, 2001, Daly and DHS brought an action against GE Capital for damages and injunctive relief, based on GE Capital's failure to withdraw delinquent rent payments from the \$550,000 security deposit before repossessing the Cessna.

On August 2, 2001, the court granted Sunset's application for Daly to appear on behalf of DHS at a debtor's examination. At the August 28 examination, Daly testified that DHS was never solvent, that his personal loans were on the negative side of the DHS balance sheet, and consequently DHS had a "negative equity position from Day 1." He characterized DHS as "essentially sitting dormant right now." He also stated that DHS has no present debts except the Sunset judgment and a disputed debt to GE Capital. The latter reference was to the pending lawsuit of Daly and DHS against GE Capital.

Following the examination, Sunset moved to amend the judgment to add Daly as a judgment debtor, on the grounds DHS was the alter ego of Daly. It based its motion on Daly's control of the Sunset/DHS litigation, DHS's inadequate capitalization, and the fact Daly is identified as the purchaser of the Cessna and personally guaranteed the payments to GE Capital.



Sunset Aviation

2002 | Cited 0 times | California Court of Appeal | November 19, 2002

DHS opposed the motion with a declaration from a certified public accountant. The accountant opined that, based on his review of DHS documents and financial information, Daly conducted the business affairs of DHS in a manner consistent with the duties of the president and sole corporate shareholder of a corporation.

On November 14, 2001, the court filed its order granting Sunset's motion to amend judgment, and an amended judgment identical to the original judgment except for the addition of Daly as a judgment debtor effective as of May 18, 2001. It found it equitable to hold Daly personally liable for his corporation's breach of contract, i.e., to pierce the corporate veil, because, "for among other reasons," Daly, as president and sole shareholder, had complete control of DHS's business, but he never attempted to capitalize it. Rather, he made loans to DHS and withdrew money from DHS's accounts at his own discretion. Thus, DHS never had funds of its own, only loans from Daly, and therefore only debt.

The court further found that to characterize DHS as a separate entity would work an inequity on Sunset because Sunset would be forced to attempt to collect debts, properly owed by Daly, from a corporate shell. The court concluded that Daly's failure to capitalize DHS made all remaining issues moot.

DISCUSSION

Daly contends the court erred in holding him individually liable for DHS's breach of contract under the alter ego doctrine solely on the ground that he undercapitalized DHS. He further contends that, in any case, there was insufficient evidence of undercapitalization.

The alter ego doctrine "arises when a plaintiff comes into court claiming that an opposing party is using the corporate form unjustly and in derogation of the plaintiff's interests." (Mesler v. Bragg Management Co. (1985) 39 Cal.3d 290, 300 (Mesler).) Each case must be decided on its own circumstances, but there are two general requirements: (1) there must be such a unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist; and (2) if the acts are treated as those of the corporation alone, an inequitable result will follow. (Ibid.) The essence of the doctrine is that justice be accomplished. " `What the formula comes down to, once shorn of verbiage about control, instrumentality, agency, and corporate entity, is that liability is imposed to reach an equitable result.' [Citation.]" (Id. at p. 301.) Because society recognizes the benefits of individual limitation of business liability through incorporation, the corporate form will be disregarded only in narrowly defined circumstances and only when justice so requires. (Mesler, supra, at p. 301; Pacific Landmark Hotel, Ltd. v. Marriott Hotels, Inc. (1993) 19 Cal.App.4th 615, 628.)

Before the corporate entity may be disregarded, both essential factors-unity of ownership and interest and inequitable result-must be found. (Associated Vendors, Inc. v. Oakland Meat Co. (1962) 210 Cal.App.2d 825, 842 (Associated Vendors).) This determination is primarily for the trial court and



Sunset Aviation

2002 | Cited 0 times | California Court of Appeal | November 19, 2002

is reviewed on appeal according to sufficiency of the evidence standards. (H.A.S. Loan Service, Inc. v. McColgan (1943) 21 Cal.2d 518, 524; Associated Vendors, supra, at p. 842.)

Recommended factors to consider include, but are not limited to: commingling of funds and other assets; failure to segregate corporate and individual funds; unauthorized diversion of corporate funds to other than corporate uses; treatment by an individual of corporate assets as his own; failure to obtain authority to issue stock or to subscribe to or issue the same; ownership of all stock by a single individual; domination or control of the corporation by the stockholder; use of a single address for the individual and corporation; inadequacy of corporate capitalization; employment of the same employees and/or attorney; use of the corporation as a conduit for individual business; failure to maintain minutes or adequate corporate records; disregard of legal formalities and failure to maintain arm's length transaction with the corporation; total absence of corporate assets; and holding out by an individual that he is personally liable for the corporation's debts. (Associated Vendors, supra, 210 Cal.App.2d at pp. 838-840.)

Here, there were sufficient factors, which, when taken in combination, allowed the trial court to impose alter ego liability.

A. Unity of Ownership and Interest

Daly was not only the sole shareholder and director of DHS, he was also, from his perspective, its only officer once the Cessna was acquired. As he replied at the August 2001 debtor examination when asked when DHS last had a shareholder or board of directors meeting: "There is a Consent to Action each year because of the fact that I am the only officer and shareholder." Thus, no other person had a direct interest in DHS. (See McKee v. Peterson (1963) 214 Cal.App.2d 515, 531.)

The October 14, 1998 minutes state that DHS was authorized to issue one million shares of its capital stock. However, the Department of Corporations has no record of DHS ever seeking a permit to issue its stock or filing an exemption from such requirements. Even assuming DHS qualified for an exemption, it issued only a fraction-1,400-of those shares authorized to issue, and they issued to Daly. Although not conclusive evidence, the failure to issue stock is an indication that the operator of a corporation is in fact doing business as an individual. (See Claremont Press Pub. Co. v. Barksdale (1960) 187 Cal.App.2d 813, 816.) Furthermore, Daly's "payment" for the shares did not constitute a true investment of capital into DHS. The minutes state that consideration for shares may be cash and/or cancellation of loans to the company, and that the consideration for Daly's 1,400 shares was pre-incorporation expenses of \$1,400. However, Daly's "loan ledger," itemizing all his loans to DHS, has an October 16, 1998 entry for "Loan for Incorporation and Legal Bills" of \$1,400, and there is no entry on the ledger for repayment of that loan. Thus, it does not appear that he paid for the shares via cancellation of a loan he made to DHS.

DHS owned no corporate assets. The purpose of the business was to own and charter a plane, yet



Sunset Aviation

2002 | Cited 0 times | California Court of Appeal | November 19, 2002

Daly personally purchased the Cessna and, after the lease-back arrangements with GE Capital, DHS possessed it only as a lessee, with Daly personally responsible for its lease obligations to GE Capital.

DHS did not have an address separate from Daly's personal residence or his office at The Pathways Group, the company of which he is chief executive officer. It had no employees; instead, Daly's Pathways Group secretary handled any bookkeeping or secretarial matters involving DHS, and Pathways Group attorneys handled incorporation and other business-related matters for it.

Corporate records are sparse. There are the October 14, 1998 minutes, the October 16, 1998 and April 24, 2001 consents to action, and pre-printed bylaws adopted at the October 14, 1998 meeting. Salient information, such as number of directors and dates of meetings, was not included in the bylaws's designated sections for such information, nor did DHS comply with the bylaws's requirement for a chief financial officer or replacing a secretary, a required officer, who resigned.

Funds in the DHS bank account were used occasionally for Daly's personal expenditures, such as paying his daughter's monthly allowance or paying the travel expenses for a business venture unrelated to DHS. Funds were withdrawn from the DHS account and made payable to Daly personally or to another company owned by Daly. There are no corporate documents authorizing these withdrawals, nor is there documentation that these withdrawals were made to repay loans Daly had made to DHS.

Contrary to appellants' argument, capitalization, in the sense of sufficient funds to operate a particular kind of business (see *Automotriz etc. De California v. Resnick* (1957) 47 Cal.2d 792,797-798; *Associated Vendors*, supra, 210 Cal.App.2d at pp. 841-842), was inadequate. Daly acknowledged that DHS was never solvent and had a negative equity position from "Day 1." No investments were ever made in DHS, and, as noted, it owned no real or personal property. Its only source of capital was Daly's personal loans, which, as he testified, were "not [to be] confused as being an investment." ⁴

" `If a corporation is organized and carries on business without substantial capital in such a way that the corporation is likely to have no sufficient assets available to meet its debts, it is inequitable that shareholders should set up such a flimsy organization to escape personal liability. The 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. It is . . . recognized as the policy of the law that shareholders should in good faith put at the risk of the business un[e]ncumbered 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 [may be] a ground for denying the separate entity privilege.' " (*Automotriz etc. De California v. Resnick*, supra, 47 Cal.2d at p. 797.)

DHS had no such unencumbered capital. Pursuant to the October 16, 1998 consent to action that Daly executed as sole director of DHS, he had discretion to lend money to DHS only when he thought



it prudent to do so. Because Daly had no contractual obligation to satisfy possible DHS liabilities, DHS had no assured and certain reserves available to pay creditors. Furthermore, to the extent Daly's loans can be characterized as capital, they were encumbered by his designation of them as senior secured debt. All other creditors were junior to his right to repayment of those debts, if DHS ever obtained the means of repayment.

B. Inequitable Result

To meet the second requirement for application of the alter ego doctrine, there must be evidence of "some conduct amounting to bad faith [that] makes it inequitable . . . for the equitable owner of a corporation to hide behind its corporate veil." (Associated Vendors, *supra*, 210 Cal.App.2d at p. 842.)

Failure of the corporate organizers to provide a sound financial basis for the business they operate in corporate form can be a factor in determining whether the continued recognition of the corporation as a separate entity would work an injustice on the plaintiff. (See *Linco Services, Inc. v. DuPont* (1966) 239 Cal.App.2d 841, 844; *Temple v. Bodega Bay Fisheries, Inc.* (1960) 180 Cal.App.2d 279, 282-284.) As discussed, *ante*, DHS had no unencumbered capital, owned no tangible assets, issued very few shares of stock and only to Daly, and was "insolvent" from "Day 1."

In addition to the undercapitalization of DHS, Daly conditioned his loans to DHS on his being the senior secured creditor, thereby subordinating the claim of any other creditor to his claims. After Sunset filed its breach of contract action against DHS in June 2000, alleging DHS owed Sunset approximately \$53,000, Daly arranged to have approximately \$59,000 withdrawn from the DHS account and paid either to him or his investment company, Daly Household Services. According to Daly's ledger of loans to DHS, these payments were not to reimburse him for the loans he had made to DHS. As of December 2000, the DHS bank account was depleted. In April 2001, Daly, as director of DHS, assigned all rights of DHS in any DHS litigation against GE Capital to himself. Thus, when Daly, on behalf of DHS, agreed to the confession of judgment in May 2001, he impliedly knew there were no existing or future DHS funds to satisfy the judgment. The court could find that Daly's acts constituted the kind of bad faith that would make it inequitable for Daly to hide behind DHS's corporate veil.

Daly contends the court misapplied the alter ego doctrine because it based its conclusion only on the factors of undercapitalization and Daly's position as sole shareholder. Courts are indeed cautioned against relying too heavily on the factors of inadequate capitalization or concentration of ownership and control in isolation. (*Mid-Century Ins. Co. v. Gardner* (1992) 9 Cal.App.4th 1205, 1213 (Mid-Century).) However, Sunset asserted several grounds in its motion, and while the court's order specifies these two factors, it prefaces its discussion of them with the statement, "having considered the arguments of counsel and for among other reasons, good cause appearing, this court finds: [etc.]" (Emphasis added.) Thus, the court impliedly incorporated the other asserted factors into its ruling.

Sunset Aviation

2002 | Cited 0 times | California Court of Appeal | November 19, 2002

In any case, the appellate court must presume a judgment or order is correct on appeal, and indulge in all intendments and presumptions in favor of its correctness. (In re Marriage of Arceneaux (1990) 51 Cal.3d 1130, 1133.) We reiterate that the determination of alter ego is primarily the province of the trial court (Jack Farenbaugh & Son v. Belmont Construction, Inc. (1987) 194 Cal.App.3d 1023, 1032), and the record demonstrates multiple factors, which, taken together, were sufficient to permit the court to have concluded there was substantial evidence of alter ego liability. Sole ownership, management, and source of funding; transfers of money between corporation and sole owner; same address, employee and attorneys; and corporate inability to meet potentially large debts to non-owner creditors imply a common personality of corporation and individual. Unless the corporate entity of DHS is bypassed, Sunset, the only unpaid creditor of DHS, will suffer unfairly because of the corporate owner's conduct.

DISPOSITION

The judgment, as amended, is affirmed.

We concur:

Stevens, J.

Gemello, J.

1. Appellants' notice of appeal also lists an appeal from a tentative ruling denying their motion for reconsideration of the order granting Sunset's motion to amend judgment. However, they have not argued the propriety of that ruling in their briefing, so we shall not discuss it. (See Page v. Superior Court (1995) 31 Cal.App.4th 1206, 1214, fn. 4.)
2. The Pathways Group is a publicly traded corporation in the "high technology" business. It has offices in Santa Rosa, Honolulu, and Waterville, Washington. Daly is its chief executive officer and Mueller is its general counsel. Miller is an employee and officer of The Pathways Group. He is also an attorney whose firm has represented DHS in the current litigation.
3. Drohan and Daly met the previous summer when Drohan was a crewmember of a plane chartered by Daly through Sunset. Several weeks after that flight, Daly asked Drohan to help him find a plane he could use in his business. For unexplained reasons, a potential sale Drohan helped arrange was not consummated.
4. Appellants assert on appeal that in August 1999 Daly "invested" in DHS 400,000 shares of publicly traded Pathways Group stock, then valued at more than \$880,000. This evidence was first presented to the trial court in Mueller's declaration in support of appellants' motion for reconsideration of the order amending judgment. As noted in footnote 1, ante, appellants' motion for reconsideration was tentatively denied, and they have not challenged the ruling in their briefing. Therefore, this evidence has no bearing on the appeal. We cannot help observing, however, that appellants presented no explanation in their motion for reconsideration why they failed to present this evidence in conjunction with



Sunset Aviation

2002 | Cited 0 times | California Court of Appeal | November 19, 2002

their opposition to Sunset's motion to amend judgment. Nor did they present any corporate records of DHS showing receipt of the shares.

