

# THE CORPORATION OR LLC: HOW MUCH PROTECTION FROM A CREDITOR?

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A corporation, and since 1994 in California, a limited liability company (LLC), are considered a separate and distinct legal entities from their owners. However, there is a body of law (the alter ego doctrine) that allows those owners (shareholders of corporations; members of LLCs) to be held personally responsible for the corporation's (or LLC's) obligations by holding the corporation or LLC to be merely an "alter ego" of the shareholders.

Because LLC case law is not yet developed (LLCs being so new), the remainder of this article will speak only of corporations - although the article applies to both corporations and LLCs.

The alter ego doctrine is usually applied to closely held (or family held) corporations and is never applied to publicly held corporations. The doctrine has been applied to the issues of unpaid taxes, unissued stock, and parent/subsidiary corporation relationships.

If it is determined that a wholly-owned subsidiary is merely a conduit for its parent or is financially dependent on its parent corporation, the doctrine might be applied. The blurring of the distinct separateness of two corporations, where one becomes merely a "department" of the other, is what causes liability.

### Necessary Findings

Before applying the doctrine, a trial court must make the factual findings: 1) that such a union of the corporation and its shareholders is evident that separation no longer exists; and 2) that it would be wrong to treat the corporation's acts as its acts alone.

As to the absence of separation (#1 above), the issue of undercapitalization is a major factor. The second finding (above) is considered the ultimate test of a court, which must find it wrong, or inequitable, to not hold the shareholders liable for the corporation's obligations. Inadequate capitalization, again, allows a court to find this second factor. Additionally, misrepresentation of the corporate structure to creditors allows a court to find this second factor.

### When Corporations Are Effective

Because a court must sit in equity to decide a case of application of the alter ego doctrine, only cases that will not result in injustice will go forward. A proof of the injustice to the shareholder, of not respecting the existence of the corporation, would be adequate to stop the application of the doctrine. The corporate form is also respected if facts show the existence of an innocent holding company corporation or its shareholders who do not own enough shares to control its board. Finally, innocent third parties who are related to the corporation or its shareholders should not be held liable.

### Factors Considered by Courts

The following are factors that have been determined in trials to be relevant in making a determination that the alter ego doctrine should be applied to disregard the corporate entity. The existence of one or two factors will not necessarily require a court to act. Instead, the greater the number of factors that are relevant to a case, the more likely the application of the doctrine:

\* Commingling of corporate money or assets with those of shareholders, \* unauthorized diversion of corporate funds to activities that are not corporate activities or uses, \* a shareholder's treatment of the corporate assets as his/her own personal assets, \* failure to obtain the authority of the board to issue stock in the corporation, \* a person stating to the public that s/he is personally liable for debts of the corporation, \* failure to maintain minutes or adequate corporate records, \* confusion of the records of separate entities (e.g. two corporations or a corporation and the individual owner(s)), \* identical equitable ownership in two entities, \* the same person or persons controlling two separate entities, \* the same people comprising the board of directors and responsible officers of two entities, \* 100% ownership of an entity by one person or the members of a family, \* the use of the same office or business location, \* employment of the same employees or attorney [scratch: "attorney"], \* failure to adequately capitalize a corporation, \* total absence of corporate assets accompanied by undercapitalization, \* use of the corporation as a mere shell or a conduit for a single venture or as a shell or conduit for the business of an individual or another corporation, \* concealment and misrepresentation of the identity of the responsible (real) owner, manager and financially interested person(s), \* concealment of personal business activities, \* failure to maintain arm's length relationships among related entities ("related" meaning entities that are owned or controlled by the same person(s)), \* use of the corporate entity to procure labor, services or merchandise for another person or entity, \* diversion of assets from a corporation by or to a stockholder or another person or entity to the detriment of creditors, \* the manipulation of assets and liabilities between entities so as to concentrate the assets in one and the liabilities in the other, \* contracting with a third party with the intent to avoid performance by use of a corporate entity as a shield against personal liability, \* use of the corporation as a subterfuge for illegal transactions, and finally but not conclusively, \* the formation and use of a corporation to transfer to it the existing liability of another person or entity.

Again, it is the number and combination of such factors, not the existence of just one or two them, that determines the likelihood of a court invoking the alter ego doctrine and holding an owner responsible for the debts of the corporation.