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***ALTER EGO LIABILITY***

By Jay D. Fullman

**NATURE OF ALTER-EGO LIABILITY**

One of the primary reasons for forming a corporation is for the individual investors (shareholders) and the company to avoid personal liability for the acts and debts of the corporation. Individual owners of a general partnership, the general partners of a limited partnership, and the owners of sole proprietorships are all subject to personal liability for the obligations of those entities. And, if the individuals who control a corporation do not treat the corporation as a separate entity, those individuals can be held liable for the debts of the corporation under the theory of alter-ego liability.

The legal doctrine of alter-ego liability, or “piercing the corporate veil,” developed as a principal in equity, under the common law. Although this theory came from case law, rather than by statute, an alter-ego claim can be a very powerful tool in the business litigation arsenal. The potential for personal liability for corporate debts results in many cases settling that might otherwise not settle due to the existence of an allegation that the corporate shield against personal liability should be pierced to permit the court to act equitably.

**ESTABLISHING ALTER EGO IDENTITY**

Those who can be held liable for the obligations of a corporation include shareholders, directors, officers, and other related corporations and entities. There is no specific series of rules which govern whether the individual will be held liable under the alter-ego theory; each case is judged on its own circumstances. However, there are certain factors which courts have articulated regarding when individuals should be held liable for the acts of the corporation. Those factors include:

- The individual has an equitable interest in the corporation
- The individual has influenced corporate affairs
- The individual has commingled personal assets with corporate assets
- The individual has applied corporate funds for personal debts
- The individual has used corporate assets as his own
- The individual has agreed to be personally liable for corporate debts (e.g. as a guarantor on a loan)
- The individual receives large salaries or loans from the corporation
- The corporation failed to issue shares of stock
- The corporation failed to keep corporate minutes of (or failed to hold) meetings of shareholders and directors

- The corporation failed to elect officers or directors
- The corporation was inadequately capitalized (e.g. paying debts entirely out of cash flow)
- The corporation failed to maintain insurance
- The corporation failed to maintain adequate business records
- The corporation shares “assets” with the individual(s), e.g. sharing offices, cars, phones, phone numbers, employees; using the same attorney and accountant.

The courts, when evaluating a claim that the individual treated a corporation as his alter-ego, do not typically look at any one factor, but examine a combination of the factors listed. One of the key factors courts typically examine is whether the corporation was adequately capitalized. If no attempt was made initially to provide for the financial needs of the corporation, the court may disregard the separate corporate existence. If no provision is made for sufficient capital to meet the ongoing financial needs of the corporation, but the corporation relies entirely upon cash flow, the court will be more likely to impose alter-ego liability.

If you (or a company with which you are employed), are suing, or are contemplating suing, a corporation that may not have sufficient assets to pay its obligation to you, be certain to explore with your attorney whether any of the factors above exist. An alter-ego claim can be made against an individual behind the corporation by inserting the claim into a complaint which has not yet been filed, by amending a complaint already in litigation, and by bringing a post-judgment motion. If there are facts to suggest that an individual may be liable for the obligations of a corporate defendant, prompt action should be taken. The earlier the alter-ego claim can be raised, the greater the probability of getting a full hearing, and a favorable result.

## **AVOIDING ALTER-EGO LIABILITY**

For individuals in business, legally avoiding personal liability for the debts of the corporation is very important, and not too difficult to accomplish. Individuals who are major shareholders, officers, or directors of corporations should make every effort to avoid the factors listed above. Methods for avoiding the factors can be summarized as follows:

1. Provide adequate capitalization for the needs of the corporation, substantiated by a written business plan and projected cash flow statement;
2. Assure that corporate formalities are followed, including issuance of stock, conducting regular shareholders and directors meetings, and maintaining corporate minutes;
3. Keep an “arms-length” relationship with the corporation;
4. Do not commingle personal and corporate funds or assets; and
5. Assure that all actions taken on behalf of the corporation are done honestly and in good faith.

If you wish more information regarding alter-ego liability, desire advise regarding specific steps to try to prevent such a claim from being made against you, or need advise regarding incorporating a business, call Jay D. Fullman at (562) 694-6005.