

TRIANO & BYRNE

PIERCING THE CORPORATE VEIL

A PUBLICATION BY THE LAW OFFICES OF TRIANO & BYRNE



One of the most important reasons to form a corporation is to protect your personal assets from liability if your business is sued. Indeed, a corporation is a legal entity that acts as a shield for you, a small business owner or corporate shareholder, against the spear of legal liability from the actions taken by the corporation. In legal language, this “shield” is called the “corporate veil”. However, in some circumstances, California courts have disregarded the corporation to hold you, the shareholder, personally liable. In fact, you may not be safe even if the corporation was named as the sole defendant in the original complaint. Over the past several years, we have had repeated success in going after the shareholders, or the individuals behind the corporation, after receiving a judgment that held only the corporation liable. In fact, we were able to hold a corporation’s sole shareholder personally liable and collect on a judgment against defendants who thought they could hide behind their corporation for the damages they caused our clients – even though the original judgment was solely

against the corporation! The bottom line is: even though you may think that your corporation will protect you against personal liability, it may not.

This newsletter’s purpose is to inform you, as small business owners and corporate shareholders, how to maintain a corporation so that it can protect you against personal liability. We understand that you make money doing what you do best rather than sitting with us in our office or in a courtroom while paying us by the hour. Our belief and commitment is to prescribe an ounce of legal prevention so you are able to avoid the cost of a pound of litigation cure, and conduct your business without the interruption and expense of trial.

In many ways, creating a corporation is like giving birth to a child: the “fun” only begins with the incorporation. Much like caring for a child, a corporation must be fed, nurtured, and continuously cared for in order to survive and protect you from personal liability. A corporation that is not maintained is just a

paper entity, and does not provide much legal protection. It is only the properly maintained, viable, and "healthy" corporation that will shield you from personal liability. In this newsletter, we will describe the various things you must do to keep your corporation in full health.

"Feeding" Your Corporation

Like a child, a corporation needs proper nutrition and ongoing attention in order to prosper and remain healthy. However, a corporation is "fed" with capital – a corporation must have enough cash and assets in order to function, not only for the sake of your business, but also to maintain its ability to shield you from personal liability. In fact, continuously "feeding" your corporation to maintain a legally adequate level of capital is critical for a corporation's health and its ability to shield you from personal liability.

California courts have placed significant weight on this issue, and have ruled that "inadequate capitalization" or "under capitalization" may be the sole basis for a judgment creditor to "pierce the corporate veil" and hold you personally responsible. For instance, in *Automotriz del Golfo del Cal. S.A. de S.V. v. Resnik*, a California trial court found that the shareholders of a failed automobile dealership were responsible for the corporation's debt because the corporation never received an "adequate" level of capital. The Court found that because the dealership generated over \$100,000 in business every month and was initially financed with only \$5,000, the corporation could not reasonably expect to cover its business debts. As a result, the Court ruled that the corporation was under capitalized, and held the dealership's shareholders personally responsible for its debts. It was as if the owners of the automobile dealership had left their corporation so malnourished that it was too "weak" to shield them against personal liability. The lesson here is: If you do not feed your corporation, it will die, and a dead corporation cannot protect you.

"Nurturing" Your Corporation

Like raising children in a household, a corporation must have and follow certain "house rules." For corporations, these rules are set forth in the Articles of Incorporation and the corporate bylaws.

The Articles of Incorporation are similar to the corporation's "Birth Certificate" because the filing of the Articles with the California Secretary of State signifies the formal creation of the corporation in California. In addition, these Articles may contain rules and procedures that the corporation must follow throughout its existence. The corporate bylaws are similar to the corporation's "house rules" as they are written by the Board of Directors or by the majority of the shareholders after the corporation has already been created. Corporate bylaws are highly customizable, and can even expand, retract, or otherwise modify responsibilities that are otherwise created by default under California law.

Like maintaining discipline at home, a corporation must follow its own house rules. Generally, these rules will define how often there must be scheduled meetings for the Board of Directors, how often there must be scheduled meetings for the shareholders, how the Board of Directors and shareholders must be notified of the meetings, the procedure by which anything can be accomplished during these meetings, and how the meeting must be recorded in corporate minutes. For instance, it is important for you to hold regular and timely meetings and keep a record of those meetings. The bylaws and the Articles may also establish whether and how often the financial records and corporate must be disclosed to the shareholders.

It is extremely important for you, your directors, and shareholders of your corporation to follow the rules set down in the Articles of Incorporation and your Bylaws. A corporation that does not follow its own rules and procedures is punished by losing its ability to protect its shareholders from personal liability, almost like how children lose their privileges after breaking their "house" rules.

Giving the Corporation its own Things

Essentially, the Court must find that the corporation conducts itself independently and separately from its shareholders and directors, and that the corporation has always acted as its own entity and conducts business on its own behalf rather than for its shareholders or directors.

This is similar to how parents provide their child with their own room with their own things. Courts have long held that if corporations share too much with their shareholders, they will be treated as the *same entity*, and the corporate protection will be lost. The facts to establish this type of treatment by the courts can seem very innocent. In fact, we have been able to establish that the shareholder and corporation were one and the same through different unrelated questions throughout the course of the trial. These questions and facts were so insidious that an entire case to “pierce the corporate veil” had been established before the opposing counsel was even aware of what we were doing, and we were able to hold those defendants personally liable when they had planned to hide behind their corporation.

Therefore, you must keep corporate funds distinct and separate from the funds of their shareholders and directors. In fact, mixed shareholder and corporate funds – that is, commingled – have served as strong indicator that the shareholder may also be held personally liable for the corporation's debt. In order to keep corporate funds separate from shareholder funds, the corporation should maintain its own financial records and bank accounts. Further, even the use of corporate tools, vehicles, assets, or the personal use of any corporate property may be used to hold you personally liable. Corporate funds should be used only for corporate purposes, and all transactions between the shareholders and the corporation must be neutral and done at arms length.

In other words, if you treat the corporation as your own personal checkbook, or if you use corporate assets for your personal benefit, then the Courts will go to your personal accounts to pay for those corporate debts.

Keeping Your Corporation Independent

At home, there is never any doubt that a parent and their teenager are two separate people, each with their own individual wants and needs. Both may even keep you up at night worrying about proper parenting. A corporation must be viewed in the same manner. As a small business owner, the bottom line is this: there must always be a clear delineation between your personal affairs and the affairs of the corporation. In fact, the California courts have always been more inclined to hold the shareholders personally liable when the affairs of the corporation are intertwined with the shareholders' personal affairs. In legal terms, this is called the “Alter Ego” rule: the more that a corporation seems like the “alter ego” of its shareholders, the more likely it is that the shareholders and corporation will be treated as the same entity.

There is no single deciding factor in determining whether your corporation may be considered your “alter ego.” In fact, California courts have often considered a number of different issues when deciding whether or not to pierce the corporate veil. In that sense, it is almost as if the courts were deciding upon your corporation's overall health – a single symptom may not indicate a serious illness, but a series of symptoms would indicate such poor corporate “health” that it would justify holding the shareholders personally liable. In the past, we have been like predators going after “sick” corporations to bring in the shareholders' personal assets to make sure our clients get paid. As our clients, we want you and your corporation to remain “healthy” to avoid that same fate.

In applying the “Alter Ego” rule, courts have even held a shareholder personally liable

simply because he represented that he would be liable for the debts of the corporation. Courts have also considered when all stock in a corporation is owned by one individual or members of a single family, whether the corporation was used to conceal the shareholders' personal activities, or if there are any other directors or officers in the corporation. Courts have even considered whether the shareholder used the same office or business location as the corporation and whether the shareholder had the same employees as the corporation to determine the personal liability of the shareholder. Again, the more things that you share with your corporation, the more likely it is that your corporation and you will be treated as the same entity, and the more likely that the courts will allow corporate creditors to go after your personal assets.

In *C. Talbot v. Fresno-Pacific Corporation*, the California Court held the shareholder personally liable for the debts of her corporation for violating a series of the factors discussed above. The Court found that because *Fresno-Pacific Corporation's* sole shareholder did not clearly delineate the differences between her affairs and the corporation's affairs, had commingled their funds, and had intentionally used the corporation to defraud her own creditors, the shareholder simply did not treat the corporation as a separate entity. As a result, *Fresno-Pacific Corporation* was found to be the shareholder's "Alter Ego" and was disregarded by the court, thus leaving the shareholder personally liable. To draw a lesson from this case, in order for the corporation to exist and protect you from personal liability, you must also treat the corporation as if it exists as a separate being.

remain diligent as small business owners; do not wait for legal trouble or other corporate debt to threaten you with personal liability. Much like how an illness is much easier to treat when it is diagnosed early, a corporation may be nurtured back to health with a little preventative legal TLC and cooperation with its Board of Directors and shareholders. Otherwise, once a corporation has become seriously "sick," it may cause permanent damage that no amount of litigation "cure" may solve.

Healthcare for Your Corporation

California courts have often held shareholders liable for corporate debts, even if the shareholders have merely forgotten to maintain their corporate status or have failed to follow their own bylaws and procedures. It is essential for you to always

Contact us so that we may diagnose, and if necessary, treat any issues that may threaten the health of your corporation and deprive you of its protection and advise you regarding your corporate practice and procedure so that you are personally protected from corporate debt.