

Piercing the Corporate Veil

by Dale Alberstone, Esq.

From time to time apartment owners vest title to their property in the name of a corporation for which they are the sole shareholders. That is typically done with the expectation that if a large judgment is awarded in favor of a tenant or injured third party (such as in a case where compensatory and punitive damages are entered in favor of a tenant who was violently assaulted following the failure of the landlord to provide reasonable security for such a foreseeable act), only the assets of the corporation (typically the apartment building), and not the individuals will be liable for the damages.

The theory is that since a corporation is a legal entity which has its own separate existence from that of the shareholders, a corporate debt (such as a court judgment) should not become the debt of the corporation's shareholders.

Owners who contemplate forming a corporation for purposes of insulating themselves from personal liability to a tenant, guest or business invitee of the residential complex should bear in mind the following matters.

Individual Liability

First, the individual persons who are personally responsible for managing and maintaining the building (which are often the shareholders themselves) are personally liable for their own negligence independently of the vesting of title or the ownership of the property. Thus, if the individual corporate shareholder actively manages the building but fails to take steps to prevent the recurrence of foreseeable violent assaults on his property (such as by improving lighting, repairing broken locks, hiring a security guard, increasing the height of exterior walls or other steps as may be reasonably warranted to prevent the recurrence of violent conduct), that individual, in addition to the corporation itself, will be personally liable to the injured party.

Piercing the Veil

Second, and the issue which is the focus of this month's article, the injured individual may seek to hold the shareholders personally liable by piercing the corporate veil under what is known as the "Alter Ego" doctrine.

Historically, we humans have gone to great lengths to shield ourselves from harm. In merry Old England, knights were clothed in suits of armor to protect themselves from the swords of their assailants.

In today's more civilized world, the weaponry is often litigation with a piercing of the shield being the judgment of the court. In order to protect against such judgments, owners sometimes form a corporation and raise it as a shield against the plaintiff's accusations.

If an individual shareholder was not responsible for preventing the injury (such as, all aspects of the security of the building were handled by an outside management company and the individual had no notice of the lack of reasonable security), the shareholder might avoid liability against a substantial judgment, thereby leaving the award solely against the corporation. (Typically, a landowner will be liable for a failure to provide reasonable security even if he engages a professional management company to maintain his building.)

In the very recent case of Baize v. Eastridge Companies decided by the California Court of Appeal on August 25, 2006, the justices explained that a corporation's separate nature as an independent entity may be disregarded under the Alter Ego doctrine and its corporate veil pierced

when two general conditions are met: “(1) That there be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, and (2) that, if the acts were treated as those of the corporation alone, an inequitable result will follow.”

The court also explained that “since the separate personality of the corporation is a statutory privilege, it must be used for legitimate business purposes and must not be perverted.” The court held that when “the separateness of the corporation is abused, it will be disregarded and the corporation looked at as a collection or association of individuals, so that the corporation will be liable for the acts of the stockholders or the stockholders will be liable for acts done in the name of the corporation.”

Situations which shareholders should avoid in order to best preserve the corporate protection are the following. The more of these items that exist, the more likely it is that a court will find that the corporate shield should be pierced and the shareholders held personally liable:

1. Money and assets of the corporation are commingled with those of the individual shareholders.
2. The shareholders fail to segregate their own funds from those of the corporation.
3. The shareholders fail to adequately capitalize the corporation when it is formed such that the corporation may not be able to meet its anticipated debts. Note: The advice of a good accountant would be helpful to determine the adequacy of capitalization.
4. The corporation fails to issue stock to the individuals.
5. The corporation fails to hold annual meetings of the Shareholders and Board of Directors and fails to maintain corporate records and minutes.
6. The individual shareholder holds himself out as being personally liable for the debts of the corporation, such as when he contracts with a roofer in his own name to construct a new roof or he leases a laundry room in his own name to a laundry company.
7. The corporation is used as a mere shell or instrumentality for a single venture or business of the individual.
8. The corporation disregards various legal formalities and fails to maintain an arms-length relationship among related entities or individuals.
9. There exists a diversion or manipulation of assets from the corporation to a shareholder or other person to the detriment of creditors.
10. The corporation is formed with the intent to avoid performance by the corporate entity or the corporation is formed for purposes of carrying on illegal transactions.
11. The shareholder withdraws rents deposited into the corporate account without regard to the fact that the rents belong to the entity, rather than to the individual.
12. The shareholder frequently deposits his/her own funds into the corporate account so as not to bounce checks or so as to render the corporation financially solvent to pay its debts.
13. The shareholder uses a single address for the individual and the corporation.
14. The shareholder acts in bad faith.

Because the doctrine of Alter Ego is based on principles of equity, the court will evaluate each case separately to ascertain which, if any, of the above elements exist, and whether, because of the apparent unity of interest and ownership between the corporation and the shareholders, an inequitable result would occur if the corporation’s shield is not pierced.

Another important consideration, though beyond the scope of this article, is the taxation implications if the apartment building is held in a corporate name. Readers should confer with a qualified accountant to evaluate tax ramifications.

Conclusion

As you can see, the use of a corporation to hold title to multifamily residential properties is not necessarily the panacea of protection that shareholders may expect. If you do form a corporation to acquire or hold title to your buildings, I encourage you to carefully consider the checklist set forth above in order to enhance the probability that your corporation's legal separation will be preserved.

Dale Alberstone is a prominent real estate attorney who has practiced real property and business law in Century City for the past 30 years. He has been appointed to periodically serve as a judge pro tem of the Los Angeles Superior Court and is a former arbitrator for the American Arbitration Association. He also testifies as an expert witness for and against other attorneys who have been accused of legal malpractice. Mr. Alberstone has been awarded an AV rating from Martindale-Hubbell. An AV rating, registered through Reed Elsevier, reflects an attorney who has reached the heights of professional excellence and is recognized for the highest levels of skill and integrity.

The foregoing discussion is intended as a general overview of the law and may not apply to the reader's particular case. Readers are cautioned to consult an advisor of their own selection with respect to any particular situation. Address correspondence to Dale S. Alberstone, Esq., ALBERSTONE & ALBERSTONE, 1801 Avenue of the Stars, Suite 600, Los Angeles, California 90067. Phone: (310) 277-7300.