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WHITE PAPER ALERT

California Alter Ego Liability

Adding Business Owners To An Existing Judgment In California

Limited partnerships, LLCs, and corporations are formed to limit personal liability. But in California the Second Appellate District just made it easier to add a business owner to a prior judgment entered only against the entity.

In Relentless Air Racing LLC v. Airborne Turbine Ltd. Partnership (Dec. 31, 2013) 2d Civil No. B244612, the Second Appellate District reversed the trial court's ruling that a business owner could not be added to the judgment under an "alter ego" theory. The Court of Appeal ordered the limited partners, as well as current and former general partner entities, added to the judgment against the limited partnership.

Traditionally, to add a party to a judgment, the plaintiff must prove:

1. The parties to be added as judgment debtors controled the underlying litigation and were virtually represented in that proceeding,
2. There is such a unity of interest and ownership that the separate personalities of the entity and the owners no longer exist, and
3. An inequitable result will follow if the acts are treated as those of the entity alone.

Greenspan v. LADT LLC (2010) 191 Cal.App.4th 486, 508-511. The first two elements were factually established in the Relentless case. Airborne was a limited partnership. The limited partners were a husband and wife, Wayne and Linda Fulton. Relentless obtained a $180,000.00 judgment against Airborne for breach of contract. However, plaintiff could not collect the judgment because Airborne had no assets.

The initial general partner during the time period in question was Airborne Turbine Inc. Mr. and Mrs. Fulton were the sole shareholders and officers of ATI. During the Relentless trial, the Fultons changed Airborne's general partner from ATI to Paradise Aero Inc. The Fultons were the sole shareholders and officers of Paradise. The Fultons directed and controlled Airborne's defense of the Relentless case.

The Fultons operated their businesses all from their home. The Fultons partnership and shareholder meetings took place "several times a day" but they kept minutes only of their annual meetings - once a year. The Fultons used funds from Airborne to pay ATI's utility bills in lieu of rent based on an "oral agreement".

The Fultons used Airborne's money to pay the Fulton's personal bills. They took draws from Airborne "when the bills came up". There was never a formal meeting before taking these draws. The Fultons were the sole officers, members, shareholders, owners, and operators of all the business entities.

The Fultons freely transferred money between the businesses and to themselves, and there was some disregard for the legal formalities. The court had no problem finding there was a unity of ownership and the separate personalities of the entities and owners no longer existed, satisfying prongs 1 and 2 of the alter ego examination.

The only issue on appeal was whether recognizing limited liability led to an inequitable result.

The trial court found there was insufficient evidence showing an unjust or inequitable result if Airborne was treated as separate from the Fultons, ATI, and Paradise. The trial court specifically noted there was no evidence the Fultons transferred any assets to avoid payment of a judgment.

Nevertheless, the Court of Appeal held a plaintiff need not prove a defendant acted with "wrongful intent," such as avoiding payment of a judgment. According to the Court of Appeal, the defendant's intent is irrelevant and the only issue is whether recognizing the corporate form would lead to an inequitable result.

The court then went further afield holding "it would be inequitable as a matter of law to preclude Relentless from collecting its judgment by treating Airborne as a separate entity." And "there is an inequitable result if the Fultons, ATI and Paradise are not added as judgment debtors" because the judgment would not be collected otherwise. In simple terms – since the plaintiff will not be paid otherwise, we will ignore the separate entities.

The Court of Appeal's holding seems to effectively eliminate the 3rd alter ego element. The Relentless case will make it easier to meet the requirements of adding business owners to a judgment against an entity they own. This is particularly true for entities whose owners control the operations of the business. In order to lessen the chances of such a post judgment ruling, or the inclusion of parties as "alter ego" defendants we recommend clients understand:

- Business owners can be added to a judgment after it is entered even if they were not named as parties in the case. This is not new, but it is useful to remember. The Fultons wrongly assumed they could not be personally liable. If they appreciated their personal exposure, they might have handled the case differently.

- Member-managed LLCs, closely held corporations, wholly owned subsidiaries, and limited partners with few limited partners who control the general partner may not have the liability protection they assume they have. In these situations, the first element of control over the litigation may be easy to prove.
- Business owners should evidence separateness by having separate physical space for business operations, separate books and records, formalized agreements between commonly held business entities (particularly if costs are to be shared), separately documented shareholder/member/limited partner meetings, and formal compensation guidelines. Activity that blurs the distinction between the corporate forms must be avoided.
- Business owners should not pay personal bills from a corporate account.
- Businesses should consider having non-owner directors or managers.
- Business owners should consider having an outside firm conduct an "alter ego" audit.

Be careful out there and, please contact us with any questions.

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