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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Adding Business Owners To Judgment Got Easier In Calif.

Law360, New York (January 09, 2014, 6:22 PM ET) -- Individuals form limited partnerships, limited liability companies and corporations to limit their personal liability. These legal structures encourage entrepreneurs to take risks. The California Court of Appeal, Second Appellate District, however, has made it easier to add a business owner to a judgment that initially was entered only against the corporate or limited partnership entity he or she owns.

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 finding that the business owner could not be added to the judgment under an "alter ego" theory. The Court of Appeal required the limited partners, as well as current and former general partner entities, to be added to the judgment against the limited partnership.

In order to add a party to a judgment, the plaintiff must show that:

- the parties to be added as judgment debtors had control of the underlying litigation and were virtually represented in that proceeding,
- there is such a unity of interest and ownership that the separate personalities of the entity and the owners no longer exist, and
- 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, 509, 511. The first two elements were easily established in the Relentless case. The only issue on appeal was whether recognizing limited liability would lead to an inequitable result.

Relentless obtained a $180,000 judgment against Airborne for breach of contract. The plaintiff could not collect the judgment because Airborne had no assets. Airborne was a limited partnership. The limited partners were a husband and wife, Wayne and Linda Fulton.

The initial general partner during the time period in question was Airborne Turbine Inc. The Fultons were the sole shareholders and officers of ATI. During the trial of the Relentless case, 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 and their entities operated their business from the Fultons' home. The Fultons had partnership and shareholder meetings "several times a day" but kept minutes only of their annual meeting 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 by deciding to take a draw from Airborne "when the bills came up". There was no formal meeting before deciding to take a draw. The Fultons were the sole officers, members, shareholders, owners and operators of the business entities.

The Fultons freely transferred money from the businesses to the Fultons and there was some disregard for the legal formalities. The court had no problem finding that there was a unity of ownership and that the separate personalities of the entities and owners no longer existed.

The trial court, however, found that there was not sufficient evidence to show that an unjust or inequitable result would occur if Airborne was treated as separate from the Fultons, ATI and Paradise. The trial court appeared to rely heavily on the fact that there was no evidence that the Fultons transferred assets for purposes of avoiding payment of a judgment.

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

The court then held that "it would be inequitable as a matter of law to preclude Relentless from collecting its judgment by treating Airborne as a separate entity." Stated differently, the court stated that "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.

However, the only time a plaintiff would need to add business owners to a judgment would be if the judgment were not otherwise collectible.

In this way, the Court of Appeal's holding could be construed as effectively eliminating the third "alter ego" element. In this way, the Relentless case could make it somewhat easier to meet the requirements of adding business owners to a judgment against the entity they own. This is particularly true for entities whose owners control the operations of the business. So, what lessons can we learn from Relentless?

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

- Member-managed limited liability companies, 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 create at least the appearance of 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 is to be avoided.

- Business owners should refrain from paying personal bills with a corporate account.

- Businesses should consider having outside directors or managers.

- Consider having an outside firm conduct an "alter ego" audit.

—By James M. Burgess, Sheppard Mullin Richter & Hampton LLP

James Burgess is a partner in Sheppard Mullin's Century City, Calif., office.

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