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Civil LITIGATION

The alter ego theory and piercing the corporate veil

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Business owners use incorporation to lawfully limit their personal liability for their businesses' debts and obligations. However, where a corporate entity is so dominated by an individual and the entity is so ignored that it primarily transacts the individual's business instead of its own, it will be called the individual's alter ego and the corporate form will be disregarded to achieve an equitable result, *Rohmer Associates v. Rohmer*, 36 A.D.3d 990 (3rd Dept. 2007).

That rule has been applied to limited liability companies as well as traditional corporations. It is not necessary to plead or prove fraud in order to pierce the corporate veil under the alter ego theory. In fact, the U.S. Court of Appeals for the Second Circuit has ruled that it would be error to instruct a jury that a plaintiff is required to prove fraud to pierce the corporate veil. See, *Passalacqua Builders, Inc. v. Resnick Developers South, Inc.*, 933 F.2d 131 (2nd Cir. 1991).

While a showing of fraud is not necessary, what is required is proof that a corporation is being used by an individual to accomplish his own and not the corporation's business, and that the business owner's control is being used to perpetrate a wrongful or unjust act.

The critical question is whether the corporation is being used as a "shell" by the individual business owner to advance his own purely personal interests at the expense of another party, typically a judgment creditor, *Port Chester Electrical Construction Corp. v. Atlas*, 40 N.Y.2d 652 (1976).

The factors relied upon by New York's courts in applying the alter ego theory include the use of alleged corporate funds for personal purposes, commingling corporate and personal funds, shuttling funds between personal and corporate accounts, the use of common telephone numbers and office space, using the corporation as a "shell" to advance personal rather than corporate interests, and otherwise abusing the corporate form.

Where a judgment creditor of a corporation is successful in piercing the corporate veil, the proof often includes facts showing that the dominating owner concealed corporate assets and used corporate funds to pay his personal bills and effectively strip the assets of the corporation to enrich himself, while making the corporation judgment proof.

Creditors traditionally pierce the corporate veil to hold a controlling shareholder personally liable for a corporate debt. However, where the business entity and its controlling owner are alter egos, under the Reverse Piercing Doctrine, the piercing flows in the opposite direction and makes the corporation liable for the debt of the individual business owner.

When a court finds that a business entity and its owner are alter egos it concludes that, in reality, they have a single personality. Therefore, as long as the required showing is made the direction of the piercing (traditional or reverse) is immaterial. "In both situations, there is a disregard of the corporate form, and the controlling shareholders [or owners] are treated as alter egos of the corporation and vice versa," *Sweeney, Cohn, Stahl & Viccaro v. Kane*, 6 A.D.3d 72, 76 (2nd Dept. 2004).

Although proof of fraud is not required to pierce the corporate veil, proof of fraud clearly strengthens the argument that the corporate form must be disregarded. One of the most compelling showings is what the Third Department has described as the "classic indicia of fraud": transfers of corporate funds to a family member. See, *In the Matter of Federal Deposit Insurance Corporation v. Conte*, 204 A.D.2d 845 (3rd Dept., 1994).

Such a transfer is fraudulent because it reflects the wrongful intent of the transferor to defraud a creditor by transferring a corporate asset to a family member without consideration, placing funds beyond the reach of judgment creditors, and retaining control of the funds after the transfer for personal purposes.

Finally, in making an alter ego determination, a court is concerned with reality and not form, *Wajilam Exports v. ATL Shipping*, 475 F.Supp.2d 275 (S.D.N.Y. 2006). The focus is on the actual conduct of the dominating business owner and the impact of that conduct on innocent parties such as judgment creditors.

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Consequently, the courts have rejected efforts to use accounting mechanisms to shield assets from judgment creditors. For example, where the judgment debtor is the controlling shareholder of a corporation and has used the corporate bank account for personal transactions and made transfers of corporate funds to his wife, balance sheets and tax returns showing those transactions as business income paid to the owner are not dispositive.

If the alleged "income" is never deposited in the owner's personal bank account, thereby shielding the alleged "income" from the business owner's judgment creditors, the balance sheets and tax returns will be disregarded and the corporation and its owner will be treated as alter egos.

In conclusion, there is clearly nothing wrong with forming a corporation to protect the personal assets of the business owner; that is a chief purpose for forming a corporate entity. However, the use of the corporate form for that purpose is a privilege. Once that privilege is abused, it will be forfeited.

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