

Warning: Strategic Business Formations Can Help Isolate Liability, But Only if Maintained

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A recent Arizona court decision serves as a reminder for businesses that have layered corporations in an attempt to isolate liabilities that they need to maintain each of these entities as if they were stand-alone companies.

In *Activator Methods v. Future Health*, Activator and Future entered into a marketing agreement. Based upon Future's failure to pay, Activator terminated the agreement and ceased doing business. The owners of Future incorporated another entity in Delaware, Future-Delaware, and resumed its operation. When Activator brought suit in Arizona against Future, Future-Delaware, and the principals of the companies, the owners sought to dismiss the action as the facts plead did not show that Future and Future-Delaware were the alter egos of the owner. The Court held that since owner used the corporate funds as his own and corporate formalities were disregarded, there was sufficient evidence to provide the Arizona court jurisdiction to hear the matter.

The same principles apply if one corporation owns another. If the two entities are not treated as two separate and distinct businesses, and the corporate formalities are not observed, a court can treat them as one entity, or an alter ego of each other. When this occurs, corporate protections are lost and owners become personally liable for the actions of the corporation.

Overall, a corporation's liability veil may be pierced in circumstances of:

- Inadequate capitalization
- Disregard of corporate formalities and segregation of corporate records
- Commingling of finances

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Our business attorneys help business owners avoid alter ego doctrine liability by ensuring that the business structure aligns with operational procedures and objectives. To determine the best California business formation structure for your California business, contact Robert Freedman or Peter Bauman us at (818) 473-5720 or email your request to cbusinesslawreport@tharpe-howell.com.