

# EARLE LAW OFFICES

A PROFESSIONAL CORPORATION  
19925 STEVENS CREEK BOULEVARD  
POST OFFICE BOX 1925  
CUPERTINO, CALIFORNIA 95015

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WWW.EARLELAW.COM

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408.786.1060

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## Business Entities for California Real Estate Investors

by Anthony F. Earle, Esquire\*

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It has been argued that the American legal system unduly promotes and encourages a litigious society, with California often cited as evidence for the validity of this argument. Other states, in turn, often consult – and frequently follow – California legal precedent when addressing for themselves legal issues which California has previously considered. For this reason, it is important for real estate investors – whether they invest in California or other states – to be aware of the conflicting and sometimes inconsistent rulings by California courts on the issue of whether to recognize or disregard the asset protection qualities of business entities used to hold real estate assets.

Long before Limited Liability Companies (LLC's) and other legal entities were commonly used to hold real estate for the purpose of asset protection, the “alter ego” legal doctrine arose in the law to “pierce the corporate veil” in cases where the “corporate-separateness” of legal entities had been used to commit fraud or to otherwise shield an entity's owners from the entity's violation of law. When a court uses the alter ego doctrine to pierce a corporate veil, the legal protections of an LLC or other legal entity are disregarded and the owners of real property held by the entity are treated as individuals for the purpose of civil litigation.

In addition to using the alter ego doctrine to pierce the corporate veil in cases where the owners of an LLC or other entity have committed fraud – which constitutes a legitimate and uncontroversial use of the doctrine – several California courts have applied the doctrine to cases where no law was violated nor

fraud committed. The justification courts have given for this expansion of the doctrine is that invoking the court's “equitable” powers as a means to apply the doctrine is necessary to prevent an “unfair” result.

In one such case, Mesler v. Bragg Management Co., 39 Cal.3d 290, 300-301 (1985), the California Supreme Court held that a group of affiliated real estate entities that were technically exempt from a local rent control ordinance because each entity held title to four rental units or less, could nonetheless be treated as a single entity for purposes of the rent control ordinance. The court found no evidence of fraud or bad faith on the part of the defendant entities or their managers, and the defendants produced an expert declaration stating that the use of separate entities to own individual properties is exceedingly common in the real estate industry. In justifying this result, the court said that even though “there are legitimate purposes for the way Defendants are organized does not preclude a finding that with respect to the [rent control ordinance] it would be inequitable to recognize Defendants' separate existence. Id., at 300-301.

By disregarding the legal distinctions between the entities and their owners, the court in Mesler effectively substituted its notion of “fairness” for the law as enacted by the California legislature.

Judicial change in the law, like many other types of change, is usually incremental and gradual. Given recent trends in the law, it seems more likely than not that California courts will continue to decide cases based on what lawyers in black robes consider

“fair” and “unfair”, rather than on the actual text of laws. Thus, it is entirely foreseeable that many California courts will further expand the use of the alter ego doctrine, so as to apply the doctrine in new, different, and more far-reaching contexts.

Earle Law Offices provides trial and appellate litigation, as well as non-litigation, legal services in the areas of bankruptcy, business law, constitutional and civil rights law, family law, real estate law, tax law, and trusts and estates.

\* Mr. Earle is licensed to practice law in all California state trial and appellate courts, the United States Supreme Court, the United States Court of Appeals for the Fourth and Ninth Circuits, federal trial courts in the Northern District of California, and the United States Tax Court. He has served as a Judge Pro Tempore for the Santa Clara Superior Court, and is also a licensed Real Estate Broker.

Mr. Earle received his law degree from the Santa Clara University School of Law, where he served as an Editor of the school’s Law Review, and where he received awards for academic excellence. He received his undergraduate degree, with honors, in business administration from the University of La Verne.

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