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Chasing the Money: Pursuing a Debtor's Shareholders under Alter-Ego Liability Theory *page 14*

By Kavita Gupta



On the Inside

**Are All Trusts Equal under
§ 523(a)(4)? An Examination
of PACA and Other Statutorily
Created Trusts** *page 24*

By Deborah L. Thorne and Kevin G. Collins

**Landlord Rejection-Damage Claims:
Lawyering Using Graphic
and Mathematical Expressions**

page 26

By Josiah M. Daniel, III

**Winter Leadership Conference
Exhibitor and Sponsor Directory** *page 50*

**Winter
Leadership
Conference
Issue**

BY KAVITA GUPTA

Chasing the Money

Pursuing a Debtor's Shareholders under Alter-Ego Liability Theory

A creditor sues a closely held corporation. Suspecting that the corporation's shareholders are improperly using the corporate form to limit their liability, the creditor adds the shareholders as defendants to its lawsuit to hold them personally liable. The corporation then files for bankruptcy and the automatic stay¹ suspends the creditor's action. What happens to the creditor's alter-ego claim against the shareholders?

For years, various courts held that the bankruptcy trustee² had exclusive standing to pursue alter-ego liability claims against a corporate debtor's shareholders, thereby divesting creditors of the right to proceed with such claims when the corporation filed for bankruptcy.³ However, recent decisions in the Fifth and Ninth Circuits⁴ have challenged these prior rulings. As a result, creditors can, in certain cases, proceed with their alter-ego claims against corporate shareholders despite the corporation's bankruptcy filing.



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Alter-Ego Liability Theory

Although one or more individuals can assume the corporate form to do business as a separate legal entity, the corporate form must be used for legitimate business purposes. When the corporate form is abused, a court may disregard it, rendering the shareholders personally liable for acts done in the corporation's name.⁵ Any party, even the corporation itself, can sue a corporation's shareholders under an alter-ego liability theory to hold them personally liable for the corporation's legal obligations. To assert such a claim, a party must allege: (1) a unity of interest and ownership between the corporation and its equitable owner(s) such that the separate personalities of the corporation and the shareholder do not in reality exist; and (2) an inequitable result if the acts in question are treated

as being those of the corporation alone.⁶ Courts, when determining whether there is a viable alter-ego claim, consider a number of factors, such as the commingling of funds and other assets of the two entities, use of the same offices and employees, disregard of corporate formalities, identical directors and officers, and use of one as a mere shell or conduit for the affairs of the other.⁷ "No one characteristic governs, but...courts must look at all the circumstances to determine whether the doctrine should be applied."⁸

Standing to Assert Alter-Ego Claims after a Corporation Files a Petition

When a corporation files for bankruptcy, the trustee "stands in the shoes of the bankrupt corporation and has standing to bring any suit...[it] could have instituted had it not petitioned for bankruptcy."⁹ State law determines whether a claim against a third party belongs to the creditor or to the trustee.¹⁰ When a trustee has standing to assert a corporation's claim, that standing is exclusive and divests all creditors of the power to bring the claim.¹¹

A Trustee's Standing to Pursue Alter-Ego Claims

The law governing a trustee's exclusive standing to bring an action against a corporation's shareholders (thereby divesting creditors of the power to sue those parties) has evolved over time. In *Caplin v. Marine Midland Grace Trust Co.*,¹² the U.S. Supreme Court held that the trustee was generally limited to asserting claims owned by the debtor.¹³ In *Stodd v. Goldberger*,¹⁴ the California Court of Appeals ruled that a trustee had standing to assert alter-ego liability claims against the corporation's shareholders if it could allege that they had engaged in conduct that injured the corporation.¹⁵ The court then enumerated examples of shareholder conduct that injured the corporation, such as fraudulent

1 11 U.S.C. § 362.

2 Section 1107(a) gives a debtor in possession the same rights and powers as a chapter 11 trustee. 11 U.S.C. § 1107.

3 See *Kalb, Voorhis & Co. v. Am. Fin. Corp.*, 8 F.3d 130 (2d Cir. 1993); *Steyr-Dalmier-Puch of Am. Corp. v. Pappas*, 852 F.2d 132 (4th Cir. 1988); *In re Schimmelpeninck*, 183 F.3d 347 (5th Cir. 1999); *Koch Ref. v. Farmers Union Central Exch. Inc.*, 831 F.2d 1339 (7th Cir. 1987); *CBS Inc. v. Folks (In re Folks)*, 211 B.R. 378 (B.A.P. 9th Cir. 1997); and *In re Davey Roofing Inc.*, 167 B.R. 604 (Bankr. C.D. Cal. 1994).

4 See *In re Seven Seas Petroleum Inc.*, 522 F.3d 575, 587 (5th Cir. 2008), and *Ahcomi Ltd. v. Smeding*, 623 F.3d 1248, 1252 (9th Cir. 2010).

5 See, e.g., *Mesler v. Bragg Mgmt. Co.*, 39 Cal.3d 290, 300 (1985). Moreover, in California, "[a] claim against a defendant, based on the alter-ego theory, is not itself a claim for substantive relief, e.g., breach of contract...but rather, procedural, i.e., to disregard the corporate entity as a distinct defendant and to hold the alter-ego individuals liable on the [corporation's] obligations...where the corporate form is being used by the individuals to escape personal liability, sanction a fraud, or promote injustice." *Hennessey's Tavern Inc. v. Am. Air Filter Co.*, 204 Cal.App.3d 1351, 1359 (1988) (emphasis added).

6 See, e.g., *Sonora Diamond Corp. v. Sup. Ct.*, 83 Cal.App.4th 523, 536 (2000).

7 *Sonora*, 83 Cal.App.4th at 538-39.

8 *Id.* at 539.

9 *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1002 (9th Cir. 2005).

10 *Butner v. United States*, 440 U.S. 48, 54-55 (1979).

11 *Estate of Spiritos v. One San Bernardino County Superior Court Case Numbered SPR 02211*, 443 F.3d 1172, 1176 (9th Cir. 2006).

12 406 U.S. 416 (1972).

13 *Caplin*, 406 U.S. at 428. See also *Stodd v. Goldberger*, 73 Cal.App.3d 827, 833 (1977).

14 73 Cal.App.3d 827 (1977).

15 *Stodd*, 73 Cal.App.3d at 833.

continued on page 74

Chasing the Money: Pursuing Debtor's Shareholders under Alter-Ego Theory

from page 14

transfers of corporate assets, conversion of corporate assets and deposits of corporate funds into a shareholder's personal bank accounts.¹⁶

A Trustee's Exclusive Standing to Pursue "General" Alter-Ego Claim

After *Caplin* and *Stodd*, various courts ruled that if a shareholder's alleged misconduct could be interpreted as an injury to the corporation *in general*, then the trustee had exclusive standing to assert an alter-ego claim against the shareholder. For example, in *In re Schimmelpennick*,¹⁷ the Fifth Circuit ruled that the trustee had exclusive standing to assert a creditor's alter-ego claim. There, the creditor had asserted a generalized injury to the debtor's bankruptcy estate. The court reasoned that giving exclusive standing to the trustee would ensure that the bankruptcy estate would not be wholly or partially consumed for the benefit of one creditor or a small number of creditors.¹⁸

In *In re Davey Roofing Inc.*,¹⁹ a creditor sued a bankrupt corporation's principal under an alter-ego liability theory in a California state court, seeking to hold him personally liable for a debt that the corporation owed to the creditor.²⁰ Because the creditor's allegations included a claim that the principal had misappropriated corporate assets for his own benefit, the bankruptcy court ruled that the creditor had alleged a general injury to the corporation itself. Therefore, the corporation had exclusive standing to assert alter-ego claims and all creditors were bound by the outcome of its alter-ego action.²¹ Similarly, in *In re Folks*,²² a creditor pursuing an alter-ego claim against a corporation's individual shareholder in a bankruptcy court alleged that he had failed to observe corporate formalities and used corporate bank accounts and funds for personal expenditures. The Ninth Circuit Bankruptcy Appellate Panel determined that these allegations constituted a "general claim" for alter-ego liability, rather than a claim asserting a "particularized injury" to the creditor itself. It ruled that the alter-ego claim constituted property of the corporation's bankruptcy estate and that the trustee had exclusive standing to assert such a claim on behalf of himself and all of the creditors.²³

Shift Away from Trustee's Exclusive Standing to Pursue "General" Alter-Ego Claims

Both the Fifth and Ninth Circuits have recently shifted away from the view that a trustee has exclusive standing to pursue "general" alter-ego claims or alter-ego claims asserting a "generalized injury" to the corporation. For example, in *In re Seven Seas Petroleum Inc.*,²⁴ the Fifth Circuit rejected

the "notion that a claim belongs to the estate or is otherwise only assertable by the trustee merely because it could be brought by a number of creditors, instead of just one."²⁵ It distinguished between a creditor's interests in the claims of the debtor against a third party—which were enforced by the trustee, and the creditor's own direct claim against the third party—which only the creditor could enforce.²⁶

Moreover, in *Ahcom Ltd. v. Smeding*,²⁷ the Ninth Circuit rejected the *Davey Roofing* and *Folks* courts' focus on allegations of a "general" alter-ego claim, or "generalized injury" to the corporation as the determinant of whether a creditor or the corporation had standing to bring an alter-ego claim against a corporation's shareholders. In *Ahcom*, a creditor obtained an arbitration award against a corporation, which then filed for bankruptcy.²⁸ The creditor sued the corporation's shareholders in a California state court to enforce the arbitration award, alleging that they were personally liable under an alter-ego liability theory.²⁹ The corporation removed the creditor's action to district court, which ruled that the shareholders' alleged misconduct had harmed all of the corporation's creditors and not just the specific creditor that had filed the suit. Therefore, it determined that the creditor's alter-ego claim was property of the bankruptcy estate and that the trustee had exclusive standing to pursue the claim.³⁰

On appeal, the Ninth Circuit reversed, ruling that California law did not recognize a "general" alter-ego claim, which allowed a corporation or its shareholders to be treated as alter-egos for purposes of all the corporation's debts.³¹ Moreover, contrary to *Davey Roofing* and *Folks*, the Ninth Circuit determined that the California appellate court in *Stodd* had simply distinguished between which "alter-ego" claims could be properly brought by the trustee and which could not.³² For example, allegations of fraudulent transfers, conversion of corporate assets by shareholders and depositing of corporate funds into personal bank accounts all constituted examples of misconduct resulting in injury to the corporation. Therefore, because the corporation had standing to pursue actions for such injuries, the trustee had exclusive standing to pursue these same actions when the corporation filed for bankruptcy.³³

However, neither the corporation nor the trustee had standing to pursue alter-ego claims for conduct that resulted in injury to a specific creditor. In *Ahcom*, the creditor's action to enforce an arbitration award against the corporation was not the result of an injury to the corporation, but instead arose from an injury to that specific creditor. Thus, notwithstanding the corporation's bankruptcy case, the creditor had standing to assert an alter-ego claim against the corporation's share-

16 *Id.* at 834.

17 193 F.3d 347 (5th Cir. 1999).

18 *Schimmelpennick*, 183 F.3d at 360.

19 167 B.R. 604 (Bankr. C.D. Cal. 1994).

20 *Davey Roofing*, 167 B.R. at 606.

21 *Id.* at 606.

22 211 B.R. 378 (B.A.P. 9th Cir. 1997).

23 *Folks*, 211 B.R. at 387-88.

24 522 F.3d 575 (5th Cir. 2008).

25 *Seven Seas*, 522 F.3d at 588.

26 *Id.* (citing *Steinberg v. Buczynski*, 40 F.3d 890, 893 (7th Cir. 1994)).

27 623 F.3d 1248 (9th Cir. 2010).

28 *Ahcom*, 623 F.3d at 1249.

29 *Id.*

30 *Id.* at 1249-50.

31 *Id.* at 1252.

32 *Id.*

33 *Id.*

holders because its action had nothing to do with the corporation's bankruptcy proceeding.³⁴

Similarly, in *Shaoying County Huayue Import & Export v. Bhaumik*,³⁵ a creditor sued a corporation in California state court for breach of contract.³⁶ It later added the corporation's shareholder as a defendant, asserting that he was the alter-ego of the corporation.³⁷ The corporation filed for bankruptcy and attempted to stay the action against the shareholder,³⁸ arguing that the trustee had sole standing to pursue an alter-ego claim against him.³⁹ Citing *Stodd and Ahcom*, the California appellate court ruled that the trustee could not pursue an alter-ego claim without alleging injury to the corporation that gave the corporation a right of action.⁴⁰ Because the creditor had asserted a breach-of-contract claim against the corporation and alleged that the shareholder was personally liable as the corporation's alter-ego, the creditor was not seeking to assert a right of action belonging to the corporation.⁴¹ Therefore, the creditor's alter-ego claims were not property of the bankruptcy estate, and its alter-ego action against the shareholder was not subject to the automatic stay.⁴²

Practical Implications

The *Seven Seas*, *Ahcom* and *Shaoying* decisions reflect a shift in how courts in the Fifth and Ninth Circuits determine who has standing to pursue an alter-ego liability remedy after a corporation commences a bankruptcy case. A trustee no longer has exclusive standing to assert alter-ego claims and divest creditors of the right to pursue such claims against the corporation's shareholders. Accordingly, these decisions have added several layers of complexity to a corporation's decision to file a bankruptcy case, claims analysis and the classification of claims in a chapter 11 plan. These complexities include, without limitation:

- A prospective corporate debtor must recognize that the automatic stay no longer bars certain categories of alter-ego claims against its shareholders—*e.g.*, a creditor's action for breach of contract or to enforce a judgment. Accordingly, such actions will continue post-petition, potentially impairing management's ability to right the corporate ship during the bankruptcy case. Therefore, a corporate debtor commencing a bankruptcy case in reliance on the automatic stay risks an adverse ruling that a creditor has standing to file or continue to prosecute an action against the corporation's shareholders;
- Officers and shareholders who are targets of these outside-the-corporate walls alter-ego claims may assert indemnity claims against the debtor under the standard provisions that are commonly included in articles of incorporation and bylaws. They may also have indemnity rights under D&O insurance policies; and
- An unsecured creditor that has recourse to nonstate assets may hold a claim that is not "substantially simi-

lar" to other unsecured claims. Therefore, in jurisdictions where, for example, *Ahcom* holds sway, a debtor may have to separately classify the claims of those creditors who have alter-ego claims rights under § 1122.

Consequently, a practitioner representing a corporation should, prior to filing a bankruptcy petition, evaluate the viability of creditors' alter-ego claims against each of the corporation's shareholders and, if necessary, advise them to retain counsel to defend against such claims. Depending on the circumstances, shareholders or officers might consider filing for bankruptcy concurrently with the corporation to stay any litigation against them and to ensure that the creditors' claims (including those against the shareholders based on alter-ego liability) remain subject to the bankruptcy claims process.

For a creditor, the authorities discussed herein may provide a vehicle for a possible recovery from a corporate debtor's shareholders because certain alter-ego actions against the shareholders are not subject to the automatic stay. Moreover, the automatic stay does not shield a debtor corporation from having to respond to discovery that is reasonably calculated to lead to admissible evidence against the shareholders for alter-ego liability.⁴³ **abi**

⁴³ See *Gruner v. Miller (In re Miller)*, 262 B.R. 499, 502 (B.A.P. 9th Cir. 2001).

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³⁴ *Id.*
³⁵ 191 Cal.App.4th 1189 (2011).
³⁶ *Shaoying*, 191 Cal.App.4th at 1193.
³⁷ *Id.*
³⁸ *Id.* at 1194.
³⁹ *Id.*
⁴⁰ *Id.* at 1196-99.
⁴¹ *Id.* at 1199.
⁴² *Id.*