Hot Topics in Insolvency Law: Alter Ego Claims[1]

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Introduction

This article will address some interesting recent developments in the use of alter ego law and related theories by bankruptcy trustees and other parties. The alter ego doctrine arises when a litigant claims that an opposing party is using the corporate form unjustly and in derogation of the litigant's interests, and that the court should not maintain the "fiction" of a separate legal entity. In certain circumstances, courts will disregard the corporate entity (also known as "piercing the corporate veil") and will hold individual shareholders liable for the actions of the corporation.[2] An alter ego claim generally requires establishing both: (1) a unity of interest and ownership such that the separate personalities of a corporation and its shareholder(s) no longer exist, and (2) if the culpable acts are treated as those of the corporation alone, an inequitable result will follow.[3]

Factors that courts consider in the alter ego analysis include the commingling of funds and assets, identical ownership (direct or indirect) of the entities, use of the same offices and employees, disregard of corporate formalities, identical directors and officers for sister corporate entities, and use of a corporate entity as a mere shell or conduit for the affairs of the individual or another entity.[4] "No one characteristic governs, but the courts must look at all the circumstances to determine whether the doctrine should be applied."[5]

While California case law has applied the alter ego doctrine to corporations, section 17101(b) of the California Corporations Code also provides that a member of a limited liability company ("LLC") can be held personally liable for the obligations of the LLC under comparable circumstances.[6]

As discussed below, there have been a number of recent developments in both federal and state law with respect to the scope of alter ego claims that may be pursued, as well as regarding who can properly assert such claims.

Pursuit of Alter Ego Claims by Bankruptcy Trustees or Creditors

Generally speaking, a bankruptcy trustee stands in the shoes of a bankrupt corporation and has standing to bring any suit that the debtor could have brought had it not filed bankruptcy.[7] When a trustee has standing to assert a claim, such standing is typically exclusive and divests all creditors of the power to bring the same claim.[8]

A recent decision by the Ninth Circuit Court of Appeals addresses the respective rights of a bankruptcy trustee and creditors to assert alter ego claims. In *Ahcom Ltd. v. Smeding*, the Ninth Circuit held that an individual creditor of a corporation in bankruptcy has standing to assert a claim against the company's sole shareholder on an alter ego theory.[9] In doing so, the Ninth Circuit overruled a number of lower court cases that had held that alter ego claims are property of the bankruptcy estate that can be pursued only by bankruptcy trustees (rather than creditors) to the extent that such claims allege injury to the corporation.[10] The *Ahcom* court found that "California law does not recognize an alter ego claim or cause of action that will allow a corporation and its shareholders to be treated as alter egos for purposes of all the corporation's debts."[11] In so ruling, the Ninth Circuit expressly relied on a 1985 California Supreme Court case, *Mesler v. Bragg Mgmt. Co.*[12]

However, the *Ahcom* court arguably misconstrued California law in stating that "no California court has recognized a freestanding general alter ego claim,"[13] as that is arguably what the California Supreme Court did in *Mesler.* There, the California Supreme Court reversed the lower court and ruled that a plaintiff should have been allowed to proceed on an alter ego claim, stating: "In the case at bar the court should have permitted plaintiff to plead the alter ego issue."[14] Indeed, following *Mesler* and its progeny, California courts have continued to recognize alter ego claims.[15]

Nevertheless, based on the holding in *Ahcom*, general alter ego claims apparently cannot be successfully pursued by a bankruptcy trustee or similarly situated person in federal courts within the Ninth Circuit. The *Ahcom* court, however, tempered its holding by recognizing that a bankruptcy trustee can still bring an action on behalf of a debtor where the company is injured due to conduct by shareholders typical of that alleged in alter ego claims (e.g., actions for conversion or fraudulent transfer) without requiring a separate alter ego claim.[16] Thus, a trustee conceivably can pursue alter-ego type relief against shareholders under the "strong arm" powers of section 544(b) of the Bankruptcy Code, which generally authorizes the trustee to "step into the shoes" of a creditor who could avoid the debtor's transfer of property or incurrence of an obligation under relevant law.

Alternatively, a bankruptcy trustee or other estate representative can pursue the same result as an alter ego claim by seeking the "substantive consolidation" of the assets of the shareholder with those of the corporate debtor. While a discussion of the doctrine of substantive consolidation is beyond the scope of this article, as a general matter, it allows a bankruptcy court -- in the exercise of its equitable jurisdiction -- to disregard the separate existence of entities and pool their assets and debts under either of two tests: (1) where creditors treat the entities as a single economic unit, rather than relying on their separate identity in extending credit; or (2) where the affairs of the entities are so entangled that consolidation will benefit creditors as a whole. [17] Thus, the facts giving rise to an alter ego claim, such as commingling of assets and liabilities between entities, frequently overlap with the required elements for substantive consolidation.

The recent case of *In re Tribune Co.,* 2011 Westlow 514220 (Banker D. Del), endorsed an alternative strategy, the court suggested that alter ego claims be pursued through the Chapter 11 plan. The court reasoned that even though a bankruptcy trustee cannot pursue claims belonging to individual creditors, a plan of reorganization may nevertheless appoint a litigation trustee to prosecute alter ego claims on their behalf.

Because the federal court decision in *Ahcom* is not binding on state courts, an alternative strategy for a trustee (or other plaintiff acting in a representative capacity) is to assert alter ego claims in state court, assuming applicable state law permits such claims. But, this approach may also be in doubt based on a recent decision from a California appellate court following the Ninth Circuit's ruling in *Ahcom*, at least to a certain extent. In *Shaoxing*, the appellate court held that an individual creditor of a corporation in bankruptcy could pursue alter ego claims against the corporation's shareholder, rejecting the argument that only bankruptcy trustees can assert such claims. [18]

In coming to its decision, the appellate court reasoned that the alter ego theory is a procedural remedy used to hold another party accountable for a company's liability on a claim, not a separate substantive claim:

> A claim against a defendant, based on the alter ego theory, is not itself a claim for substantive relief . . . but rather, procedural, i.e., to disregard the corporate entity as a distinct defendant and to hold the alter ego individuals liable on the obligations of the corporation where the corporate form is being used by the individuals to escape personal liability, sanction a fraud, or promote injustice. In applying the alter ego doctrine, the issue is not whether the corporation is the alter ego of its shareholders for all purposes, or whether the corporation was organized for the purpose of defrauding the plaintiff, but rather, whether justice and equity are best accomplished in a particular case, and fraud defeated, by disregarding the separate nature of the corporate form as to the claims in that case.[19]

Thus, a trustee (or other plaintiff acting in a representative capacity) should consider seeking alter ego relief as a remedy (e.g., through declaratory relief or similar means), rather than as a separate cause of action.

Importantly, the *Shaoxing* court recognized a bankruptcy trustee's continued right to pursue alter ego theories on behalf of a corporation based on the shareholder's injury to the corporation, ruling: "[t]he trustee of a bankrupt corporation can maintain an action against a defendant based on an alter ego theory if there is some allegation of injury to the corporation that gives the corporation a right of action against the defendant."[20] The appellate court gave examples of such claims, including a trustee's action against corporate shareholders to recover property to set aside fraudulent transfers or for conversion of the corporation's assets.[21]

Alter Ego Claims Against Trusts

There have also been interesting developments in the area of alter ego claims against trusts.

A. Introduction

Unlike a corporation, a trust is not considered a separate legal entity. "Legal title to property owned by a trust is held by the trustee....[a] trust... is simply a collection of assets and liabilities."[22] The creditors of the settlor of a *revocable* trust can reach the assets of the trust to pay the creditor's claims, whereas creditors generally cannot reach the assets of the settlor's *irrevocable* trust.[23]

When a debtor files a bankruptcy petition, "all legal or equitable interests of the debtor in property" become property of the debtor's bankruptcy estate.[24] The debtor's interests in trusts become property of the estate, except the debtor's interest in a "spendthrift trust," which is not property of the estate.[25] The "debtor's interest" in a revocable trust for purposes of a bankruptcy estate includes all assets of the trust. The "debtor's interest" in an irrevocable trust, however, is generally limited by the terms of the trust documents and thus may not include the assets of the trust. For example, the debtor's interest may be only in certain distributions,[26] or the debtor may have no interest.

B. In re Schwarzkopf: Alter Ego Claims Apply to Trusts

In *In re Schwarzkopf,*[27] the Ninth Circuit recently upheld the use of an alter ego theory, as well as a fraud theory, by a bankruptcy trustee to gain access to the assets of two irrevocable trusts. In this case, the debtors established two irrevocable trusts in 1992 (collectively, the "Trusts"), naming their minor child as the beneficiary. The first trust (the "Apartment Trust") was funded with assets in 1992, and the second trust (the "Grove Trust") was funded in 1997. The debtors named a friendly trustee for both Trusts ("Briones"). When the debtors filed a Chapter 7 petition in 2003, they scheduled $5.4 million in debts. At that time, the Trusts collectively held approximately $4 million in assets. Not surprisingly, the Chapter 7 bankruptcy trustee (the "Trustee") sought to recover the Trust assets for the benefit of the estate and its creditors, even though the Trusts were irrevocable and the debtors were not beneficiaries.

1. The Grove Trust Was the Alter Ego of the Debtors

The court held that the Grove Trust was the alter ego of the debtors, and thus the assets of that trust were property of the bankruptcy estate. The Ninth Circuit discussed the rule against "outside reverse piercing."[28] That rule generally prohibits holding a corporation liable as an alter ego for a shareholder's debt, and held that this rule did not apply to trusts (i.e., it is permissible to hold a trust liabile for the debt of an owner). Getting past this argument against alter ego liability, the court next rejected the argument that alter ego remedies were not available because the debtors were not owners or beneficiaries of the Grove Trust. The court found that debtors were able to direct Briones to use the trust to pay their personal expenses and otherwise did not treat the Grove Trust as a separate entity. By acting as the owners (although not as a trustee or a beneficiary), the court held that debtors were the "equitable owners" of the trust, and this was a sufficient foundation for alter ego liability. The Ninth Circuit held that the rule that actual vs. equitable "ownership" of the alter ego entity is required, which arguably applies in the context of corporations, does not apply in the context of trusts.

Note that *Ahcom*, as discussed above, held that creditors, and *not* the bankruptcy trustee, had standing to pursue alter ego claims against corporations. The *Schwarzkopf* opinion does not discuss *Ahcom*, but it allows bankruptcy trustees to pursue alter ego claims directly against trusts. This different rule presumably relates to the fact noted above that while a corporation is a formal separate entity, a trust is not.

2. The Apartment Trust Was Invalid Because it Was Created to Defraud Creditors

Unlike the Grove Trust, which was created in 1992 but not funded with assets until 1997, debtors funded the Apartment Trust with assets at the time it was created in 1992. The *Schwarzkopf* court did not apply an alter ego theory to reach the assets of the Apartment Trust, but rather it held that the trust was invalid from the outset because it was created with the intent to shield assets from creditors. The court relied on California Probate Code section 15203, which provides that "trusts may be created for any *lawful* purpose."

The decision added fraudulent transfer as a separate basis for allowing the bankruptcy trustee to reach the assets of the Apartment Trust, i.e., that the debtors had funded the Apartment Trust with intent to hinder, delay, or defraud creditors. The debtors argued that the bankruptcy trustee's fraudulent transfer action was time-barred by the seven-year statute of limitations under California Civil Code section 3439.09(c) since the lawsuit was filed more than seven years after the transfer of assets into the trust. The Ninth Circuit rejected the debtors' argument on the grounds that the fraudulent transfer of assets into the Apartment Trust created a "resulting trust" whereby the trust assets were deemed held by Briones from the outset for the benefit of the debtors and their creditors. The court determined that the statute of limitations for filing the action did not begin to run until Briones "repudiated" the resulting trust by answering the trustee's complaint and contending that the Apartment Trust was valid.

C. Trusts May Be Added to a Judgment as Judgment Debtors

In *Greenspan v. LADT, LLC,*[29] a California appellate court upheld the use of California Code of Civil Procedure ("CCP") section 187[30] to add a trust, as well as the individual owner and two other companies, to a judgment. In this case, the plaintiff obtained an $8.45 million judgment against two companies. During the litigation, the companies received proceeds of some $47 million, but when the plaintiff sought to enforce the judgment, the companies had no funds. When the plaintiff discovered that the funds had been transferred to two other companies, a trust, and the individual owner, plaintiff made a motion under CCP section 187 to add the related entities to the judgment as judgment debtors. The court granted the motion based upon its finding that the individual and his entities were a "single enterprise," and that the individual had control of the prior litigation and had been virtually represented.

The court in *Greenspan* also held that a trust itself cannot be liable as an alter ego because it is not a legal entity. However, the court allowed the *trustee* of the trust to be added to a judgment under CCP section 187 as a judgment debtor in his representative capacity, thus enabling the judgment creditor to reach the assets of the trust.

Conclusion

The Ninth Circuit's ruling in *Ahcom* is a significant decision in this area of the law, overruling prior authority that allowed general alter ego claims to be pursued by a bankruptcy trustee, and instead giving individual creditors standing to pursue such claims. In *Schwarzkopf*, the Ninth Circuit broke ground by permitting the bankruptcy trustee to utilize the alter ego doctrine directly against a trust, and the *Greenspan* court allowed a similar result by adding the trustee of a trust and other parties as judgment debtors to a judgment under CCP section 187.[31] As these cases illustrate, alter ego and related equity-based remedies continue to be dynamic and evolving areas of the law. ■

Endnotes

1 This article includes materials provided in connection with a Webinar hosted by The Insolvency Law Committee of the Business Law Section, State Bar of California, held on April 27, 2011.

2 *Mesler v. Bragg Mgmt. Co.*, 39 Cal. 3d 290, 300 (1985); *Accord Sonora Diamond Corp. v. Super. Ct.*, 83 Cal. App. 4th 523, 538 (2000).

3 *Mesler*, 39 Cal. 3d at 300.

4 *Sonora Diamond Corp.*, 83 Cal. App. 4th at 538.

5 *Id.* at 538-39.

6 Section 17101(b) provides: "A member of a limited liability company shall be subject to liability under the common law governing alter ego liability, and shall also be personally liable under a judgment of a court or for any debt, obligation, or liability of the limited liability company, whether that liability or obligation arises in contract, tort, or otherwise, under the same or similar circumstances and to the same extent as a shareholder of a corporation may be personally liable for any debt, obligation, or liability of the corporation; except that the failure to hold meetings of members or managers or the failure to observe formalities pertaining to the calling or conduct of meetings shall not be considered a factor tending to establish that a member or the members have alter ego or personal liability for any debt, obligation, or liability of the limited liability company where the articles of organization or operating agreement do not expressly require the holding of meetings of members or managers." Cal. Corp. Code § 17101(b).

7 *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1002 (9th Cir. 2005); *see generally* 11 U.S.C. § 541(a) (bankruptcy estate includes all property interests of the debtor); 11 U.S.C. § 704 (bankruptcy trustee's duties include liquidating property of the bankruptcy estate).

8 *Estate of Spirtos v. One San Bernardino Cnty. Super. Ct. Case*, 443 F.3d 1172, 1176 (9th Cir. 2006).

9 *Ahcom Ltd. v. Smeding*, 623 F.3d 1248, 1250-52 (9th Cir. 2010).

10 *See, e.g., CBS, Inc. v. Folks (In re Folks)*, 211 B.R. 378 (B.A.P. 9th Cir. 1997); *In re Davey Roofing, Inc.*, 167 B.R. 604 (Bankr. C.D. Cal. 1994).

11 *Ahcom*, 623 F.3d at 1250.

12 *Mesler*, 39 Cal. 3d at 290.

13 *Ahcom*, 623 F.3d at 1252.

14 *Mesler*, 39 Cal. 3d at 297.

15 *See, e.g., Zoran v. Chen*, 185 Cal. App. 4th 799 (2010) (reversing summary judgment for defendant on alter ego claims based on genuine factual issues regarding whether defendant's dominion and control of corporation gave rise to unity of interest); *Doney v. TRW*, 33 Cal. App. 4th 345 (1995) (relying on *Mesler* and recognizing viability of alter ego claims against parent company for acts of subsidiary).

16 *Ahcom*, 623 F.3d at 1252.

17 *See, e.g., U.S. Bancorp Mortg. Co. v. Bonner Mall P'ship*, 2 F.3d 899 (9th Cir. 1993).

18 *Shaoxing County Huayue Import & Export v. Bhaumik,* 191 Cal. App. 4th 1189, 1199 (2011).

19 *Shaoxing*, 191 Cal. App. 4th at 1198 (citations and quotation marks omitted).

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11 *Id.*

12 *Id.* at *10.

13 *Id.*

14 *Id.* at *20.

15 *Id.* at *13, 16.

16 It should be noted, however, that the BAP interpreted the operating agreement against the backdrop of the Colorado Limited Liability Company Act, which requires each member's consent to authorize an act of the LLC outside the ordinary course of business. *See* Colo. Rev. Stat. § 7-80-401(2)(c). California's Limited Liability Company Act contains no corresponding restriction, but rather emphasizes management business judgment and freedom of contract. *See, e.g.,* Cal. Corp. Code § 17005.

17 *See* Bankruptcy Appellate Panel for the Tenth Circuit Local Rule 8018-6. It should be noted that even published bankruptcy appellate panel decisions may not be binding. *See Bank of Maui v. Estate Analysis, Inc.*, 904 F.2d 470, 472 (9th Cir. 1990) (declining to rule on the authoritative effect of a BAP decision, but noting that "BAP decisions cannot bind the district [and circuit] courts themselves. As article III courts, the district [and circuit] courts must always be free to decline to follow BAP decisions and to formulate their own rules within their jurisdiction.").

18 *FKF Madison Park Group Owner, LLC,* 2011 Bankr. LEXIS at *2.

19 *Id.* at *4-5.

20 *Id.* at *8-9.

21 *Id.* at *4-5.

22 *Id.* at *5.

23 The exercise of the option reduced the individual members' 50 percent ownership interests to 32.5 percent each, preventing any one such member acting alone from controlling the LLC.

24 *Id.* at *6. The existence of involuntary bankruptcy cases, of course, reflects the fact that creditors do not always perceive their interests to be served by keeping a debtor out of bankruptcy.

25 *Id.* at *6-7.

26 *Id.* at *7.

27 *Id.* at *8-12.

28 *Id.* at *8.

29 *General Growth Properties*, 409 B.R. at 47-48.

30 *Id.* at 49.

31 *Id.* at 63-64.

32 *Id.* at 61-62.

33 *Id.* at 64 (*citing North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007)).

34 *Id.*

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20 *Id.* at 1198-99 (citation omitted).

21 *Id.* at 1199 (citation omitted).

22 *Stoltenberg v. Newman*, 179 Cal. App. 4th 287, 293 (2009).

23 Cal. Prob. Code §§ 18200, 19001.

24 11 U.S.C. § 541(a).

25 11 U.S.C. § 541(c)(2) ("A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under application of nonbankruptcy law is enforceable in a case under this title").

26 For example, in *In re Mack*, 269 B.R. 392 (Bankr. D. Minn. 2001), the court held that the assets, or "corpus," of a trust (a "Charitable Remainder Unitrust" or "CRUT") were not property of the estate. The bankruptcy trustee, however, obtained a ruling that because he stepped into the debtor's shoes, the trustee had the authority (1) to receive the annual CRUT distributions; (2) to replace the trustee of the CRUT; and (3) to amend the CRUT to comply with legal requirements. Note that the bankruptcy trustee in that case did not assert an alter ego claim or seek an order awarding the trustee the assets of the CRUT.

27 *Goodrich v. Briones (In re Schwarzkopf),* 626 F.3d 1032 (9th Cir. 2010).

28 *Postal Instant Press, Inc. v. Kaswa Corp.,* 162 Cal. App. 4th 1510 (2008). This case held that "outside reverse piercing" of the corporate veil generally cannot be used to satisfy the debt of an individual shareholder. The opinion from this case provides that this "rule" is a general guideline and not invariable, which is consistent with the case-specific equitable nature of alter ego relief (under which an individual shareholder may be liable for a corporate debt where the individual has unjustly disregarded the corporate form, as discussed above).

29 191 Cal. App. 4th 486 (2010).

30 This statute provides: "When jurisdiction is . . . conferred on a Court . . . all the means necessary to carry it into effect are also given; and in the exercise of this jurisdiction, if the course of proceeding be not specifically pointed out by this Code or the statute, any suitable process or mode of proceeding may be adopted which may appear most conformable to the spirit of this Code."

31 *Greenspan* and *Schwarzkopf* both distinguish the decision in *Postal Instant Press, Inc. v. Kaswa Corp.,* 162 Cal. App. 4th 1510 (2008), which held that "outside reverse piercing" of the corporate veil cannot be used to satisfy the debt of an individual shareholder.