



## Bankruptcy e-Bulletin

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Dear Insolvency Law Committee Constituency List members:

This eBulletin is a follow-up to the ILC case report on *Ahcom Ltd. v. Smeding* dated November 2, 2010. In our regular monthly meeting and in discussions afterward, members of the ILC raised various concerns about the case and potential responses. The case report is first repeated; then, the discussion points follow.

**Note:** This eBulletin and the discussion points below are not legal advice. The ILC, its members, and the authors of this eBulletin take no position on the issues discussed below, which are an amalgam of hypothetical arguments and questions that were part of a lively debate, and which are not intended to be a complete treatment of the issues.

**SUMMARY: Since Corporation's Bankruptcy Trustee Cannot Assert General Alter Ego Claim Against Shareholders Under California Law, Creditor Has Standing to Do So. *Ahcom Ltd. v. Smeding* (9th Cir. Oct. 21, 2010, Docket No. 09-16020)**

In what promises to be a major change to bankruptcy practice, the Ninth Circuit has held that a creditor of a corporation in bankruptcy has standing to assert a claim against the corporation's sole shareholders on an alter ego theory. Since at least 1997, when *In re Folks*, discussed below, was decided, it has been standard practice for principals of debtor corporations who find themselves sued on alter ego grounds to move to dismiss for lack of standing, on the theory that the alter ego claim was property of the estate and no longer belonged to the individual creditor. Indeed, it was not unusual for principals being sued to put their corporation into bankruptcy so they might invoke the automatic stay and possibly protect themselves from alter ego claims.

In *Ahcom*, after successfully obtaining an arbitration award against the

corporation, Ahcom sued the sole shareholders in California state court to collect on the award after the corporation filed bankruptcy. The shareholder defendants could only be liable to Ahcom if the corporate veil is pierced. The shareholders removed the collection action to the district court, which dismissed the case without leave to amend on the basis that the alter ego claim is exclusive to the trustee.

On appeal, the 9th Circuit reversed. The trustee stands in the shoes of the bankrupt corporation and has standing to bring any suit that the debtor could have brought had it not petitioned for bankruptcy. When the trustee has standing to assert a claim, that standing is exclusive and divests all creditors of the power to bring the claim. This means that if under California law an alter ego claim is a general claim belonging to the corporation, then it could only be asserted by the trustee. If alter ego is a particular claim for an individual claimant, then the individual claimant would have standing to assert the claim.

Examining California law, the 9th Circuit concluded that no California court has recognized a freestanding general alter ego claim that would require a shareholder to be liable for all of a company's debts and, in fact, the California Supreme Court stated that such a cause of action does not exist. Mesler v. Bragg Mgmt. Co., 702 P.2d 601, 606-607 (Cal. 1985). Rather, an alter ego claim is an issue of whether in the particular case presented and for the purposes of such case justice and equity can best be accomplished and fraud and unfairness defeated by a disregard of the distinct entity of the corporate form.

The Court rejected two bankruptcy cases that were built upon what the Court analyzed was an incorrect interpretation of Stodd v. Goldberger, 141 Cal.Rptr. 67 (Cal. App. 1977). In Stodd, a bankruptcy trustee sued the debtor shareholders on an alter ego theory. The trial court dismissed the action, and the court of appeal affirmed, holding that a trustee cannot maintain an action based upon an alter ego theory absent some allegation of injury to the corporation giving rise to a right of action in the corporation against the defendants. *Id.* at 71. Relying upon Stodd, the bankruptcy court in In re Davey Roofing, Inc., 167 B.R. 604, 608 (Bankr. C.D. Cal. 1994) held that a corporation can proceed on an alter ego claim against its shareholders as long as it alleges some injury to the corporation. The BAP adopted this reasoning in CBS, Inc. v. Folks (In re Folks), 211 B.R. 378, 387 (B.A.P. 9th Cir. 1997), holding that only the trustee, and not CBS, could assert a general alter ego claim on behalf of the corporation.

The Ahcom Court explained that the mistake that both Davey and CBS made was in presuming that Stodd stood for the proposition that there is a

general alter ego claim under California law. A more precise reading of Stodd indicates that the Stodd court listed examples of particular injury to the corporation where the trustee would have standing to assert claims on behalf of the corporation. Since there is no freestanding general alter ego claim that would require a shareholder to be liable for all of a company's debts, a trustee has no standing to sue for such claim, and therefore an individual creditor has standing to assert an alter ego claim for a particular injury. Since according to the 9th Circuit there is no freestanding general alter ego claim that would require a shareholder to be liable for all of a company's debts, a trustee has no standing to sue for such claim, and therefore an individual creditor has standing to assert an alter ego claim for a particular injury.

#### **DISCUSSION POINTS:**

- **Potential problems arising from *Ahcom*.** One of the concerns with *Ahcom* is that it can create uncertainty: can every creditor now scramble in a race to assert alter ego liability on their own separate claims? How might that outcome be avoided?
- **Can *Ahcom* be distinguished?** *Ahcom* states that "no California court has recognized a free-standing general alter ego claim," and it holds that the lower courts misinterpreted *Mesler*, 39 Cal.3d 290, 702 P.2d 601 (Cal. 1985). The ILC members discussed whether *Mesler* might be interpreted more broadly in different situations. On the one hand, *Mesler* states that alter ego claims do not demolish the "wall of limited liability erected by the corporate form" but only serve to "drill[]" a "hole" in that wall; and on the other hand *Mesler* states more broadly that the "separate personality of the corporation is a statutory privilege" and "[w]hen it is abused it will be disregarded and the corporation looked at as a collection or association of individuals, so that the corporation will be liable for acts of the stockholders or the stockholders liable for acts done in the name of the corporation." *Id.* at 300-01 (citations and internal quotation marks omitted). Perhaps the breadth of the alter ego doctrine depends on the precise facts. In *Mesler*, a "general" application of the alter ego doctrine would have shielded one of two alleged tortfeasors based on a settlement with only one of them, and the California Supreme Court held that this would not serve the alter ego doctrine's policy of "promoting justice." *Id.* at 301. In *Ahcom*, in contrast, the bankruptcy trustee's basis for asserting a broad application the alter ego doctrine is unclear – *i.e.*, were multiple creditors harmed by the alleged disregard or misuse of the corporate form, or only the appellant?
- **Resort to State courts?** If *Ahcom* cannot be distinguished, then

perhaps a bankruptcy trustee could bring an alter ego action in a California court, which is not bound by *Ahcom*. But then what about removal? Would removal survive a remand challenge, in view of case law narrowly interpreting the bankruptcy courts' jurisdiction? *See, e.g., In re Ray*, \_\_\_ F.3d \_\_\_ (9<sup>th</sup> Cir. 10/25/10) (Docket No. 09-60005).

- **Could the automatic stay apply notwithstanding *Ahcom*?**

Perhaps a bankruptcy trustee who does not have a "general" alter ego claim (per *Ahcom*) could come up with at least one other type of claim (a "specific" alter ego claim, or a breach of fiduciary claim) against the same persons who are alleged to be alter egos of the debtor. In that event would the automatic stay protect the estate's interests by barring individual creditors' alter ego suits against the persons who are alleged to be alter egos of the debtor, or against their property (which, under the alter ego or veil piercing approach, is property in which the debtor arguably has an interest)?

- **Could injunctive relief help?** Alternatively, if the automatic stay would not apply, would the bankruptcy court issue an injunction to prevent a scramble for assets, at least until the trustee's rights could be determined? How would such an injunction be sought – would the trustee have to name all creditors of the estate as defendants? *See generally Solidus Networks, Inc. v. Excel Innovations, Inc. (In re Excel Innovations, Inc.)*, 502 F.3d 1086, 1096 (9th Cir. 2007).

- **Can careful pleading help?** The bankruptcy trustee's strong-arm powers include those of a *hypothetical* judgment creditor (or bona fide purchaser of real estate, etc.) (11 U.S.C. 544(a)) and the trustee steps into the shoes of certain *actual* creditors holding allowable claims (11 U.S.C. 544(b)(1)), provided that there is a "transfer" or an incurrence of an "obligation" of the debtor. So the trustee can try to frame any alter ego claims to come within these provisions. But avoidance actions may be more difficult to plead – *e.g.*, for fraudulent transfers the trustee must establish either actual intent to defraud or insolvency and lack of reasonably equivalent value. Are other claims available?

- ***Gheewalla* and *Berg* may help:** Creditors have been held to have no direct claims for breach of fiduciary duty, but derivative claims may exist. *See generally No. Am. Catholic Ed. Prog. Found. v. Gheewalla*, 930 A.2d 92 (Del. 2007); *Berg & Berg Enter., LLC v. Boyle*, 178 Cal. App. 4th 1020 (6th Dist. 2009). Derivative claims belong to the corporation, so could the Trustee bring claims for breach of fiduciary duties and use that as a basis for an alter ego claim that is not "free standing" and therefore is not barred by *Ahcom*?

- **Substantive Consolidation?** Could a bankruptcy trustee obtain the same result as alter ego claims via substantive consolidation of the assets of a principal or equity holder (even if not a bankruptcy debtor) with those of the Debtor? *See, e.g., Alexander v. Compton (In re Bonham)*, 229 F.3d 750 (9th Cir. 2000). Substantive consolidation can be difficult to obtain, but its factual underpinnings can be similar to those of alter ego liability (e.g., commingling of assets and liabilities).
- **Creditors' voluntary surrender of separate alter ego claims?** Could a plan of reorganization or liquidation require an assignment of creditors' alter ego claims as a condition of receiving some or all distributions under a plan? Would such a provision be enforceable if accepted by the requisite majorities, or if the plan were crammed down, or must each creditor be given a choice to opt out?

Thank you for your continued support of the Committee.

Best regards,

Insolvency Law Committee

*The original case report above was prepared by Leib Lerner of Alston & Bird LLP and Iain A. Macdonald of Macdonald & Associates. Contributors to the Discussion Points included Neil W. Bason of Duane Morris LLP, Gary M. Kaplan of Farella Braun + Martel LLP, Molly Baier of Reed Smith LLP, Elizabeth Berke-Dreyfus of Wendel, Rosen, Black & Dean LLP, and Uzzi Ranaan of Danning, Gill, Diamond & Kollitz LLP.*

The Insolvency Law Committee of the Business Law Section of the California State Bar provides a forum for interested bankruptcy practitioners to act for the benefit of all lawyers in the areas of legislation, education and promoting efficiency of practice. For more information about the Business Law Standing Committees, please see the standing committee's web page: <http://businesslaw.calbar.ca.gov/StandingCommittees.aspx>

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