



## CREDITORS CAN NOW SEEK TO PIERCE THE CORPORATE VEIL DESPITE BANKRUPTCY OF CORPORATION AND OBTAIN JUDGMENTS AGAINST THE PRINCIPALS OF A COMPANY

### INTRODUCTION:

A common complaint of creditors when a debtor files bankruptcy is that the owners of the corporation or limited liability company looted the company, taking out valuable assets, then filed bankruptcy leaving a defunct shell. These types of claims were made with great frustration since the Trustee in Bankruptcy, the person appointed by the Bankruptcy Court to protect the creditors, was seldom willing to seek to “pierce the corporate veil” and seek personal liability for such acts against the owners of the company. As one client put it, “Bankruptcy allows these fellows to steal freely from the creditors and walk away free.”

That may change in a new case that the Ninth Circuit just handed down. Put simply, a creditor now has the right to seek “alter ego” theories against shareholders of a bankrupt corporation. The basics of this new right are discussed in this newsletter.



### SYNOPSIS:

Since under prior law, the corporation's bankruptcy Trustee could not assert general “alter ego” claims against shareholders under California law, the Court held that the actual creditors could do so directly. Ahcom Ltd. v. Smeding (9th Cir. Oct. 21, 2010, Docket No. 09-16020). The “alter ego” theory allows a creditor to claim that the shareholders acted in such ways that it would be a fraud upon creditors to allow the corporate shell to bar personal liability. See our articles on [“Limited Liability Entities.”](#)

This opens up new methods for creditors to seek to impose liability upon shareholders and radically alters the landscape for collection efforts.

## Background and the Holding:

Since at least 1997, when In re Folks 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. They argued successfully for years that only the bankruptcy trustee “owned” the right to sue...and the bankruptcy trustee, as discussed below, was seldom interested in even trying to pursue that claim. 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 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 was 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 rationale of the lower court was simple: since the trustee stands in the shoes of the bankrupt corporation, it 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.

However, the higher court reasoned 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. In short, not only the corporation “owns” the claim.

The Court rejected two bankruptcy cases that were built upon what the Court concluded 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 (Bankruptcy 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 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.*

## THOUGHTS:

Note that the relief described applies only to California courts and is based on California law, albeit by a Federal decision. This now allows creditors not only to seek to proceed against owner debtors, who may not have sufficient sums to pay attorneys to defend themselves, but must alter the entire cost benefit analysis confronted by both the debtor considering bankruptcy and the creditor who examines the remaining assets of a bankrupt estate. See our article on [Debt Collection](#).

As with all new law, several years will have to pass before the courts interpret all aspects of this matter and determine the plethora of rights and obligations that apply. What the District Court ruled...that only the Trustee can bring an action to pierce the veil since only the Trustee has standing...is no longer the law. State Courts will no longer bar such actions against the principles even if the underlying corporation is in bankruptcy.

Note the holding does not just state that creditors have standing - it states the Trustee does NOT have standing. Thus, only third parties are left to seek to pierce the corporate veil.

How this new fact of life is to be utilized by debtors and creditors both in litigation and in tactical decisions prior to bankruptcy and litigation are matters that will ultimately depend on the close analysis of each situation by the parties, their attorneys, and the courts. One thing is for certain: the likely escape from such actions via bankruptcy is no longer automatically available for corporate fiduciaries.

