

Ninth Circuit Finds No General Alter-Ego Cause of Action under California Law

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On Oct. 21, 2010, the Ninth Circuit Court of Appeals rejected the assertion that California law provides for generalized alter-ego causes of action against a corporate debtor's shareholders.² The court held that a claim against a defendant based on an alter-ego theory is a procedural claim rather than "a claim for substantive relief,"³ and attributed contrary authority to an incorrect interpretation of a 1977 California appellate court decision.⁴ The Ninth Circuit's decision in *Ahcom Ltd. v. Smeding* effectively eliminates the once-assumed exclusive authority of bankruptcy trustees in California to bring causes of actions seeking to hold shareholders liable for general corporate misconduct perpetrated to the common detriment of the debtor corporation's creditors. Although the *Ahcom* decision is discussed further below, a rudimentary discussion of alter-ego claims is warranted.⁵

General vs. Particularized

The "alter-ego doctrine," or "piercing the corporate veil," is a principle whereby corporate form is judicially disregarded in order to assert liability against those who utilize the corporation as a mere conduit for their own intentional acts.⁶ The doctrine is generally a means to the end of reaching a corporation's shareholders for the purpose of holding the latter liable for the former's debts.⁷ Generally, the doctrine is equitable in nature and designed to prevent the unjust result that would arise when holding a corporation liable although there is "such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist."⁸ As an equitable doctrine, a court's determination that the

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corporate form should be disregarded is based on a case-by-case analysis in light of a variety of factors (*e.g.*, commingling of funds, unauthorized diversion of funds, treatment by an individual of corporate assets as his or her own, etc.).⁹

Some courts have further segregated this form of the alter-ego doctrine into alternate causes of action: general alter-ego claims and particularized alter-ego claims.¹⁰ An alter-ego claim is "personalized" if the alleged injury is unique to an individual claimant, and he or she alone has an interest in the cause of action.¹¹ In contrast, jurisdictions recognizing a general alter-ego cause of action generally refer to a claim arising from no particularized injury that could be asserted

quent to the arbitration, NFI petitioned for bankruptcy protection, thus causing Ahcom to attempt enforcement of the arbitration award against NFI's sole owners, Hendrik and Lettie Smeding (the "appellees").¹⁶ Ahcom alleged, among other things, a claim based on the alter-ego doctrine in an effort to hold the appellees liable for NFI's debts.¹⁷ In district court, the appellees moved to dismiss the complaint, arguing that the alter-ego claim was for injury that affected all creditors rather than Ahcom particularly, and thus was a general alter-ego claim that could be asserted exclusively by the bankruptcy trustee.¹⁸ Agreeing with the appellees, the district court dismissed the complaint without leave to amend, and Ahcom appealed to the Ninth Circuit.¹⁹

In a brief opinion, the Ninth Circuit reversed the lower court's decision and remanded back the district court, unequivocally stating that "California law does not recognize an alter-ego claim or cause of

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by any of a debtor's creditors; rather, the injury is one that affects all creditors as a whole.¹² As state law is determinative regarding to whom a claim belongs,¹³ the Ninth Circuit confronted the latter of these two alternate theories pursuant to California law in *Ahcom*.

The Ahcom Decision: Folks, Davey and Stodd

Ahcom Ltd. contracted with California-based Nuttery Farms Inc. (NFI) for the purchase of almonds, and NFI allegedly failed to uphold its production obligations under the contract.¹⁴ Ahcom, a U.K.-based corporation, obtained an arbitration award against NFI in a German-based court of arbitration and later sued in California state court in order to enforce the arbitration award domestically.¹⁵ However, subse-

action that will allow a corporation and its shareholders to be treated as alter egos for purposes of all the corporation's debts."²⁰ The court supported its rationale by stating that no court in California has recognized a "freestanding" general alter-ego cause of action that holds shareholders liable for corporate debts, and that even California's highest court has "stated that such a cause of action does not exist."²¹

The Ninth Circuit attributed the mistaken belief that California law provided a trustee with the exclusive right to assert a general alter-ego claim on behalf of all creditors on a misinterpretation of the holding in *Stodd v. Goldberger*,²² a 1977 decision.²³ Specifically, the Ninth Circuit discussed the 1994 decision of the U.S. Bankruptcy Court for the Central District of California in *In re Davey Roofing Inc.*,²⁴ and the 1997 decision of the Ninth Circuit Bankruptcy Appellate Panel in *CBS Inc. v. Folks (In re Folks)*.²⁵

¹ The views expressed herein are those solely of the author.

² See *Ahcom Ltd. v. Smeding*, No. 09-16020, 2010 WL 4117736 (Oct. 21, 2010).

³ *Id.* at *3 (quoting *Hennessey's Tavern Inc. v. Am. Air Filter Co.*, 204 Cal. App.3d 1351 (Ct. App. 1988)).

⁴ *Id.* at *3-4 (citing *Stodd v. Goldberger*, 73 Cal.App.3d 827 (Ct. App. 1977)).

⁵ And I do mean rudimentary.

⁶ 1 *Fletcher Encyclopedia of the Law of Corporations*, § 41.10 (updated 2008).

⁷ See *Wu v. Tseng*, Civil Action Nos. 2:06cv346, 2:06cv580, 2007 WL 201087, at *7 (E.D. Va. Jan. 24, 2007). The doctrine may also be utilized to hold a corporation liable for the debts of its sole shareholder, or to displace liability between sister corporations. *Id.*

⁸ *Associated Vendors Inc. v. Oakland Meat Co. Inc.*, 210 Cal.App.2d 825, 837 (Ct. App. 1962).

⁹ See *id.* at 838-40 (collecting cases and factors).

¹⁰ See, e.g., *Ginger Root Office Assoc. LLC v. Farmer (In re Advanced Packaging and Prod. Co.)*, 426 B.R. 806, 819 (C.D. Cal. 2010).

¹¹ See *Koch Refining v. Farmers Union Cent. Exchange Inc.*, 831 F.2d 1339, 1348 (7th Cir. 1987).

¹² See *St. Paul Fire and Marine Ins. v. PepsiCo Inc.*, 884 F.2d 688, 701 (2d Cir. 1989).

¹³ See *Butner v. U.S.*, 440 U.S. 48, 54-55 (1979).

¹⁴ *Ahcom Ltd. v. Smeding*, No. 09-16020, 2010 WL 4117736, at *1 (9th Cir. Oct. 21, 2010).

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Ahcom*, 2010 WL 4117736 at *1.

²⁰ *Id.* at *4.

²¹ *Id.* (citing *Mesler v. Bragg Management Co.*, 702 P.2d 601, 606-7 (Cal. 1985)).

²² 73 Cal.App.3d 827 (Ct. App. 1977).

²³ *Ahcom*, 2010 WL 4117736 at *3-4.

²⁴ 167 B.R. 604.

²⁵ 211 B.R. 378.

Both decisions held that a corporation and its trustee in bankruptcy, may proceed against its shareholders on a general alter-ego theory provided that it does so alleging injury to the corporation itself.²⁶ These decisions, according to the Ninth Circuit, were erroneously based on the court's declaration in *Stodd* that a trustee "cannot maintain an [an alter-ego theory] absent some allegation of injury to the corporation giving rise to a right of action in it against defendants."²⁷ The *Stodd* court clarified this passage by outlining examples of such injuries, including recovery of fraudulent and preferential transfers and actions for shareholder conversion of corporate property.²⁸ According to the Ninth Circuit, the *Davey* and *Folks* courts misread *Stodd* to erroneously find that an allegation of any injury to the corporation was sufficient and that such allegation gave rise to a general alter-ego claim.²⁹

General Alter-Ego Cause of Action as Estate Property

Generally, courts finding that a trustee has standing to bring generalized alter-ego causes of action do so based on the assertion that the claim is property of the debtor's estate.³⁰ Property of a debtor's bankruptcy estate includes "all legal and equitable interests of the debtor in property as of the commencement of the case."³¹ The scope of what is included as estate property is broadly construed and includes causes of actions held by the debtor upon commencement of the bankruptcy proceeding.³² In that sense, the trustee "stands in the shoes of the bankrupt corporation and has standing to bring any suit that the bankrupt corporation could have instituted had it not petitioned for bankruptcy."³³ If there is a

cause of action that may be instituted by the trustee as property of the estate, the automatic stay prohibits individual creditors from bringing "similar extraneous" lawsuits.³⁴ However, the trustee's standing is limited in that the trustee may only bring those actions that are estate property and may not sue third parties on behalf of the debtor's creditors.³⁵ The Supreme Court strengthened this limitation on the causes of action that a bankruptcy trustee may bring, stating that:

Congress has established an elaborate system of controls with respect to indenture trustee and reorganization proceedings, and nowhere in the statutory scheme is there any suggestion that the trustee in reorganization is to assume the responsibility of suing third parties on behalf of debenture holders. The language in fact indicates that Congress had no such intent in mind. The statute, 11 U.S.C. § 567(3), gives the trustee the right, and indeed imposes the duty, to investigate fraud and misconduct and to report to the judge the potential causes of action "available to the estate"...there is nothing in the section that enables him to collect money not owed to the estate.³⁶

Problems arise when trying to determine whether the claim rightfully belongs to the creditor or to the debtor upon commencement of the bankruptcy case, and these questions depend largely on each state's law.³⁷ States in which courts have found a general alter-ego claim to be included in estate property appear to do so in order to benefit the corporate debtors' estate, and ultimately its creditors.³⁸ In contrast, those courts denying the existence of a generalized alter-ego

claim as property of the debtor's estate do so based on the fact that alter-ego causes of action are designed to protect third-party creditors rather than the debtor corporation and therefore belonged to the individual creditors rather than the debtor.³⁹

In order to view this question in another light, it may be framed differently. Rather than asking, "to whom does the claim belong," it can simply be asked, "can a corporation pierce its own corporate veil?"⁴⁰ Of course, these alternate questions are birds of the same semantic feather, as they both rely on ownership of the claim, but courts have addressed the issue both ways. At least two courts have found it inconsistent to allow a corporate debtor, whose formal existence is based on a desire to shield its shareholders from personal liability, to affirmatively "destroy the very protection for which it was created" by "denying the corporation its own corporate existence."⁴¹

Conclusion

The Ninth Circuit decision in *Ahcom* may have provided definitive authority regarding whether a general alter-ego cause of action exists under California law. However, in doing so, the court reversed what many believed to be well settled law—that a bankruptcy trustee has the exclusive right to bring such actions. It is unclear what consequences will arise from the court's decision. It is not clear if courts confronted with the question of alter-ego liability in the future will advance the Ninth Circuit's holding and deny the trustee the ability to assert such a claim, thus retreating from what was once thought to be well-settled jurisprudence. What may be clear (for now, at least) is that while shareholders of a corporate debtor in California may have one less worry with regard to the debtor's trustee, that worry may be replaced with creditors asserting that they have suffered particularized injury in an effort to utilize alternate means of recovering on their claims. ■

²⁶ *Ahcom*, 2010 WL 4117736 at *3-4; see also *Davey*, 167 B.R. at 608; *Folks*, 211 B.R. at 387.

²⁷ *Ahcom*, 2010 WL 4117736 at *4 (quoting *Stodd*, 73 Cal.App.3d at 833).

²⁸ *Id.*

²⁹ *Id.*

³⁰ *In re Icarus Holding LLC*, 391 F.3d 1315, 1319 (11th Cir. 2004); see also *St. Paul Fire & Marine Ins. Co. v. PepsiCo Inc.*, 884 F.2d 688, 700-5 (2d. Cir. 1989); *Koch Refining v. Farmers Union Cent. Exch. Inc.*, 831 F.2d 1339, 1343-47 (7th Cir. 1987); *In re S.I. Acquisition*, 817 F.2d 1142, 1153 (5th Cir. 1987); *In re City Communications Ltd.*, 105 B.R. 1018, 1020 (Bankr. N.D. Ga. 1989).

³¹ 11 U.S.C. § 541(a).

³² See *U.S. v. Whiting Pools Inc.*, 462 U.S. 198, 205 n.9 (1983).

³³ *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1002 (9th Cir. 2005) (internal citations omitted).

³⁴ *Icarus*, 391 F.3d at 1319.

³⁵ *Smith*, 421 F.3d at 1002.

³⁶ *Caplin v. Marine Midland Grace Trust Co. of N.Y.*, 406 U.S. 416, 428 (1972). Although the *Caplin* court was interpreting the plain language of the Bankruptcy Act rather than the current Bankruptcy Code, the reference to congressional intent, and Congress' subsequent failure to overrule *Caplin* in the enactment of the Code, make the court's analysis relevant.

³⁷ See *Butner v. U.S.*, 440 U.S. 48, 54-55 (1979).

³⁸ See *In re Elegant Custom Homes Inc.*, No. CV 06-2574-PHX-DGC, 2007 WL 1412456, at *3 (D. Ariz. May 14, 2007).

³⁹ See, e.g., *In re Transcolor Corp.*, 296 B.R. 343 (Bankr. D. Md. 2003); see also *Jones v. Teilborg*, 727 P.2d 18 (Ariz. Ct. App. 1986).

⁴⁰ See, e.g., *Sims v. Breckenridge (In re Hermitage Health Care)*, No. 00-12535, 2002 WL 113873, at *1 (Bankr. N.D. Cal. Jan. 16, 2003).

⁴¹ *In re Mattress N More Inc.*, 231 B.R. 104, 109 (Bankr. N.D. Ga. 1998); see also *Elegant Custom Homes*, 231 B.R. at 109.

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