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Client Alert

Under the legal doctrine of alter ego, may shareholders of a corporation in bankruptcy be held liable to the corporation's creditors for all purposes? Not in California, according to a recent opinion by the United States Court of Appeal for the Ninth Circuit.

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Ninth Circuit Allows Debt-Specific Alter Ego Claims Against Bankrupt Corporation's Shareholders

Normally, shareholders of a corporation are not liable for the corporation's debts. But when shareholders use a corporation in ways that are unfair or fraudulent, courts apply the alter ego doctrine to “pierce the corporate veil,” disregarding the separate existence of the corporation and holding the shareholders liable to the corporation's unsatisfied creditor. The doctrine applies to closely-held corporations where there is a unity of ownership and interest between the corporation and a single or small group of shareholders, and the shareholders themselves do not treat the corporation as a separate legal entity. Courts look to such factors as disregard of corporate formalities, inadequate capitalization, and shareholders diverting corporate assets to themselves or otherwise treating the assets of the corporation as their own.

Relying on the alter ego doctrine, an enterprising creditor in *Ahcom, Ltd. v. Hendrik Smeding* sought to hold Hendrik Smeding and his wife liable for an arbitration award owed by their family corporation, Nuttery Farms, an almond grower in Northern California which had filed for bankruptcy. The Smedings (apparently no country bumpkins) moved to dismiss the case on the grounds that Ahcom was asserting a claim that harms all of Nuttery Farms' creditors, not just Ahcom, and thus was a claim exclusively held by Nuttery Farms' bankruptcy trustee. The trial court agreed, and dismissed the case. But the Smedings' triumph was short-lived.

The Ninth Circuit Court of Appeal reversed, finding that California law did not recognize a generalized theory of alter ego liability. Citing no less an authority than the California Supreme Court, the appellate court concluded, “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 of the corporation's debts.” The California Supreme Court, shifting its analogy from psychiatry to construction, explained the alter ego doctrine this way: “It is not that a corporation will be held liable for the acts of another corporation because there is really only one corporation. Rather, it is that under certain circumstances a hole will be drilled in the wall of limited liability erected by the corporate form; for purposes other than that for which the hole was drilled, the wall still stands.” *(Mesler v. Bragg Management Co.*) Thus, the Ninth Circuit found that Ahcom did have standing to sue the Smedings and attempt to prove that a hole should be drilled in the wall of Nuttery Farms specifically for their benefit; i.e., that the Smedings used Nuttery Farms to defraud Ahcom, or that respecting the separate corporate existence of Nuttery Farms would be uniquely unfair to Ahcom.

And you thought Einstein's theory of general relativity was tough.

Another peculiar feature of California's alter ego doctrine, also approved by the California Supreme Court in *Mesler,* is that a creditor can settle with a corporation, and still recover against the corporation's alter ego shareholders. In other words, the corporation may be treated as one and the same as its shareholders for one purpose, but not another. In the context of bankruptcy, this suggests a creditor can make a claim in bankruptcy, accept a partial payment of its claim through the bankruptcy court, and then sue the corporation's shareholders for the difference. That's the bad news for shareholders of a bankrupt California corporation. The good news is that the shareholders generally may be immune to an alter ego claim by a bankruptcy trustee on behalf of all of the corporation's creditors, because the trustee would have to prove the corporate form of organization was fraudulent or unfair as to each creditor.

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