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Beware Distinctions Between Veil Piercing And Alter Ego

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Law360, New York (May 13, 2015, 10:27 AM ET) -- Outside of the bankruptcy context, there is little practical need to focus on the distinctions between corporate veil-piercing and alter-ego causes of action because the practical implications of each ruling are the same: The plaintiff is able to reach the assets of another entity in addition to those of the defendant when seeking to satisfy its judgment. The litigants, and by extension their lawyers, often pay little attention to whether the basis for the judgment was the vicarious liability of the third party (as in the case of a veil-piercing determination) or a finding that the third party and the defendant were in reality the same entity (as in the case of an alter-ego determination). New York bankruptcy cases have consistently shown, however, that these two separate theories of liability have significantly different implications for an individual debtor who has been the target of a veil-piercing or an alter-ego claim.

Veil Piercing vs. Alter Ego

A determination authorizing a plaintiff to pierce a corporate veil will result in a principal or an affiliate of the defendant being vicariously liable for the defendant's obligations to the plaintiff. In order to establish a veil-piercing claim, a plaintiff must prove that the principal or affiliate of the defendant exercised complete domination over the defendant with respect to the transaction at issue, and that the domination was used to commit a fraud or wrong that resulted in injury to the plaintiff. A finding that a principal or an affiliate was the defendant's alter ego will result in the defendant and its alter ego being treated as a single entity.

In order to prevail on an alter-ego claim, a plaintiff must establish that there was such a unity of interest and control between the defendant and the other entity that they cannot really be said to be two separate entities. See Rohmer Assoc. Inc. v. Rohmer, 830 N.Y.S.2d 356, at *1 (App. Div. 2007). An alter-ego determination does not make one entity vicariously liable for the debts of another. Rather, it results in disregarding the separateness of the entities as a legal fiction and treats them as one in the same entity.

Where the target of a veil-piercing claim has become a debtor in a bankruptcy proceeding, a court may conclude that the automatic stay of § 362 of the Bankruptcy Code enjoins the prosecution of state court litigation against the debtor's affiliate. This is because a liability ruling against the debtor's affiliate could have an adverse impact on property of the estate if a basis for piercing the debtor's corporate veil is established.

Cases have shown that where a plaintiff has asserted claims against a primary obligor as well as veil-piercing claims against the obligor's principal or affiliate, it is not sufficient to merely sever the claims and proceed solely against the primary obligor if the principal or affiliate subsequently commences a bankruptcy proceeding. Plaintiffs who proceed in this manner run the risk that the bankruptcy court will conclude that prosecution of the state court litigation against the primary obligor was in violation of the automatic stay. This may result in a determination that any liability ruling rendered after the principal or affiliate's filing is void ab initio, notwithstanding the time and expense expended litigating the state court proceeding against the primary obligor to judgment.[1] Therefore, plaintiffs counsel would be well-advised to not only seek severance of the claims against the principal or affiliate upon the bankruptcy filing, but to also seek an order of the bankruptcy court modifying the automatic stay prior to continuing with the state court litigation against the primary obligor.

While the continuation of litigation against a primary obligor also implicates the automatic stay where an alter-ego claim has been asserted against a principal or an affiliate that has commenced a bankruptcy proceeding, the stay is not implicated on the basis that a liability ruling against the primary obligor could have an indirect adverse impact on the debtor's estate, but rather, on the basis that if an alter-ego determination is made, the assets of the primary obligor will become part of the debtor's bankruptcy estate.

Unlike a veil-piercing determination, however, where a debtor-principal is an individual, a finding that the debtor was the alter ego of the primary obligor may subject to scrutiny the debtor's actions in connection with the operation of the primary obligor when the court considers the debtor's entitlement to a discharge under § 523(a) (which excepts from discharge certain debts of an individual debtor) and § 727(a) (which provides for a complete denial of a discharge where an individual debtor has engaged in certain types of inappropriate conduct) of the Bankruptcy Code.[2]

The Cases

In re Pitts

In Mokuba N.Y. LLC v. Pitts (In re Pitts),[3] plaintiffs sued in New York state court an individual and several corporations of which he was the sole director, agent, shareholder and principal. The plaintiffs' claims were based on fraud, breach of contract, breach of express and implied warranty, and breach of the covenant of good faith and fair dealing. The plaintiffs' complaint included allegations that the individual had controlled the corporate defendants and disregarded their corporate identities (and requested that their corporate identities be merged for purposes of their liabilities), that their corporate veils be pierced, and that the individual be held liable for the corporate defendants' acts. The plaintiffs filed a motion for a default judgment in state court. Shortly thereafter, the individual filed a petition under Chapter 7 of the Bankruptcy Code.

The state court determined that the automatic stay prohibited the plaintiffs from proceeding against the individual and entered a default judgment as to all issues of liability against the corporate defendants. The state court made no findings that the individual-debtor had participated in any fraud or was responsible as a matter of law for the corporate defendants' actions.

In the individual's bankruptcy case, plaintiffs filed a nondischargeability action seeking to have certain debts owed by the debtor deemed nondischargeable pursuant to Bankruptcy Code § 523(a)(2)(A), and moved for summary judgment. The debtor then moved to have the state court judgment entered against the corporate defendants deemed void ab initio, arguing that the automatic stay applied to the actions against the corporate defendants and that therefore the plaintiffs' actions in state court constituted a willful violation of the stay imposed by § 362(a)(1).

The bankruptcy court denied the debtor's motion, holding that the state court had correctly concluded that the automatic stay did not apply to the corporate defendants. The bankruptcy court found that as there had been no determination on the issues of veil-piercing or alter-ego theories of liability between the debtor and the corporate defendants, the state court judgment had no impact on the individual debtor or his bankruptcy estate. Therefore, plaintiffs did not commit a willful violation of the stay by continuing to participate in the state court action after the debtor filed for bankruptcy, and should not be liable for sanctions.

However, the bankruptcy court went on to consider the debtor's argument that even if there was no willful stay violation, the stay should nonetheless prohibit plaintiffs from using the state court judgment in the adversary proceeding. The bankruptcy court held that if it were to ultimately rule that cause existed to pierce the corporate veil of the corporate defendants, the post-petition proceedings in state court might be deemed to have violated the stay, rendering the state court judgment void ab initio. The court thus reasoned because if plaintiffs were successful in piercing the corporate veil, the state court judgment against the corporate defendants would have an immediate, adverse effect on the debtor.

In re Adler

As in Pitts, the plaintiffs in Adler v. Ng (In re Adler) sued in New York state court an individual and the corporations he owned and controlled. Plaintiffs asserted claims based on fraud, breach of contract, and corporate veil piercing. The individual subsequently filed for Chapter 7 protection. The state court stayed the case against the individual but proceeded against the corporate defendants and entered judgment against them after trial on the merits.

In the debtor's bankruptcy case, plaintiffs filed a nondischargeability action pursuant to Bankruptcy Code §§ 523(a)(2)(A), (a)(4), and (a)(6), and objected to the debtor's discharge pursuant to §§ 727(a)(2), (a)(3), (a)(4)(A), and (a)(5). The bankruptcy court granted plaintiffs' summary judgment motion, giving collateral estoppel effect to the state court judgment, finding that the debtor's debt was nondischargeable, and denying the debtor's discharge. The debtor appealed, and the district court reversed and remanded, holding that the state court judgment was not entitled to preclusive effect in the adversary proceeding because the claims against the debtor had been severed, and there were genuine issues of fact as to the debtor's omissions on his schedules and statements.[4] On remand, the bankruptcy court found that the corporate veil should be pierced and held the debtor liable for the corporate defendants' obligations.[5]

In a separate decision, the bankruptcy court held that the automatic stay applied retroactively to the state court judgment against the corporations because once the corporate veil had been pierced, the liability determination against the corporations had resulted in an adverse impact on the debtor's estate.[6] Thus, the bankruptcy court ruled that the state court judgment violated the stay and was void ab initio. In that opinion, the court also concluded that the debtor was the alter ego of the corporate defendants and that therefore the separateness of the entities should be disregarded. As a result of the alter-ego determination, the court considered the debtor's conduct in the operation of the corporations when considering whether the debtor was entitled to a discharge under § 727(a).

Finding that in connection with the operation of the business the debtor had concealed property, failed to justify inadequate corporate records, failed to explain the loss of assets, and made a false oath and account, the court denied the debtor a discharge under § 727(a). The plaintiffs appealed the court's determination that the state court liability ruling was void ab initio, and the debtor appealed the ruling denying him a discharge.

The district court denied both appeals, affirming the bankruptcy court's decision on both counts.[7] The district court found that the bankruptcy court had not erred in ruling that the state court liability determination was void ab initio or in ruling that the alter-ego determination made the debtor's actions in connection with operation of the corporations subject to scrutiny in determining whether the debtor was entitled to a discharge.

In re Mihalatos

As in both Pitts and Adler, the plaintiffs in Agai v. Mihalatos (In re Mihalatos)[8] sued an individual and a corporation of which he was an owner, in New York state court, alleging breach of contract. After trial, the state court entered judgment against both the individual and the corporate defendant. Plaintiffs then commenced post-judgment proceedings in state court to pierce the corporate veil between the individual and the corporate defendant. Before judgment was rendered in the state court post-judgment proceeding, the individual defendant commenced a Chapter 7 case. Plaintiffs sought relief from the automatic stay to proceed with the veil-piercing claim in the post-judgment proceedings. The individual defendant, now a debtor, did not object to the lifting of the stay, and did not raise any opposition in the state court proceeding, thinking that it was unnecessary as he was already personally liable on the corporate judgment.

After the state court granted summary judgment on the post-judgment veil-piecing claim, the plaintiffs commenced an action in the individual's Chapter 7 case seeking to deny the debtor a discharge pursuant to Bankruptcy Code §§ 727(a)(3), (a)(4)(A), and (a)(5). Plaintiffs asserted that as a result of the veil-piercing determination in the state court proceeding, the debtor's bad acts in connection with the operation of his business could now be considered when determining the debtor's entitlement to a discharge.

The bankruptcy court denied plaintiffs' summary judgment motion, stating that while the allegations in the state court complaint were compelling, it was "not prepared to find on summary judgment that the state court clearly made the required 'alter ego' finding or that it was implicit in [the state court] holding."

Conclusion

These cases make clear that corporate veil piercing and a finding of alter ego are distinct doctrines and may have very different consequences in an individual debtor's bankruptcy case. As explained in Adler and Mihalatos, where a veil-piercing allegation is made between a debtor and a nondebtor corporate entity, a bankruptcy court may hold that a state court action against the nondebtor is subject to the automatic stay, because a liability ruling against the nondebtor could have an adverse impact on the debtor's estate. Where an alter-ego allegation is made, a bankruptcy court may conclude that an action against a nondebtor is stayed because an alter-ego determination would render the nondebtor's assets part of the bankruptcy estate. Moreover, when the debtor is an individual, an alter-ego determination will subject to scrutiny the debtor's actions in connection with the operation of the nondebtor when the court considers the debtor's entitlement to a discharge.

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[1] See Mokuba N.Y. LLC v. Pitts (In re Pitts), 2009 WL 4807615 (Bankr. E.D.N.Y. Dec. 8, 2009) (finding that post-petition state court proceedings might be a violation of the stay and the judgment void ab initio if plaintiffs were to successfully pierce the corporate veil, because the judgment against the non-debtors would have an immediate, adverse effect on the debtor).

[2] See Adler v. Ng (In re Adler), 518 B.R. 228 (E.D.N.Y. 2014). Only individual debtors may receive a discharge. See § 727(a)(1). The provisions of § 523(a) and § 727(a) are also applicable to individual debtors in Chapter 11. See §§ 1141(d)(2) and (d)(3)(C).

[3] 2009 WL 4807615 (Bankr. E.D.N.Y. Dec. 8, 2009).

[4] 395 B.R. 827 (E.D.N.Y. 2008).

[5] 467 B.R. 279 (Bankr. E.D.N.Y. 2012).

[6] 494 B.R. 43 (Bankr. E.D.N.Y. 2013).

[7] 518 B.R. 228 (E.D.N.Y. 2014).

[8] 2015 WL 996977 (Bankr. E.D.N.Y. Mar. 3, 2015).