HOW TO AVOID DEBT BY REINCORPORATING AFTER BANKRUPTCY – NOT!

By: Shelley M. Liberto, Esq.

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It is surprising how many companies look to bankruptcy relief to avoid corporate debt while staying in business. Although the idea of reincorporating after filing for Chapter 7 liquidation may seem a prudent business strategy, it is likely to provoke the interest, if not the ire of creditors whose claims were apparently "discharged" out from under them. And rightly so. In fact, corporate debts are not discharged in a Chapter 7 liquidation proceeding. Furthermore, if the debtor is merely reconstituted under a different business structure, savvy and persistent creditors and their attorneys may very well recover their accounts in full. But to do so, a creditor's attorney must first navigate his or her way through an obstacle course of bankruptcy and alter ego law. This article aims to highlight major issues encountered by creditor counsel assigned to recover accounts from debtors who use the bankruptcy/reincorporation tactic.

Bankruptcy Law Considerations

In an alter ego matter recently handled by the author, the American Red Cross pursued a claim in state court for unpaid invoices on the sale of blood products against a medical clinic that, after being sued in state court, filed for Chapter 7 bankruptcy relief. The clinic then shifted its entire business to another corporation with identical shareholders, directors, officers, employees, and place of business. The second corporation merely picked up where the first one left off in a manner that could not be perceived by the clinic's patients and the public at large. The Red Cross then amended the complaint to join the second corporation as a defendant. Although it would seem obvious that the second entity should stand for the debts of the first, it was necessary first to establish two legal conclusions based in bankruptcy law: (1) The claim was not "discharged" in the Chapter 7 proceeding; and (2) The claim of the Red Cross was not the property of the bankruptcy trustee and the Red Cross was therefore free to pursue the claim for its own benefit in state court.

Although Chapter 7 was in play, the Red Cross was not required to appear in bankruptcy court for any reason whatsoever to pursue its claims in state court. This was so because as a clear matter of bankruptcy law, corporate debts are never discharged in a Chapter 7 liquidation, and any attempt to seek a discharge would be denied even in the absence of a formal objection to discharge by the creditors. The primary legislative concern underlying the Bankruptcy Code in denying discharge is to prevent businesses from evading liability by liquidating a debtor corporation and resuming business free of debt. 11 U.S.C. § 727(a)(1). See NLRB v. Better Building Supply, 837 F.2d 377 (9th Cir. 1988) for a thorough treatment of the policy behind § 727(a)(1). The more difficult defense for a creditor's attorney to dispatch is a claim that the original debt incurred by the bankrupt became the property of trustee in bankruptcy for the benefit of all creditors, thereby denying an individual creditor the right to recover on its particular claim.

"Individual" vs. "General" Claims of Bankruptcy Creditors

Section 704(1) of the Bankruptcy Code vests the right and duty of a bankruptcy trustee to collect and liquidate the property of the estate of a bankrupt corporation which, under §541, includes legal claims. A debtor may therefore challenge a creditor's right to recover a debt owned by the trustee. The defense of non-ownership of the claim is framed as one of "standing" to sue in state court. Not all alter ego claims belong to the bankruptcy estate, however. The issue is whether an alter ego claim is of "general" benefit to the entire estate, or merely "personal" to the individual creditor. As explained by the Ninth Circuit in CBS v. Folks, 211 B.R. 378, 387 (1997), a cause of action is "personal" if the claimant itself is harmed and no other claimant or creditor has an interest in the cause. On the other hand, if the alter ego claim could be brought by any creditor of the debtor, the trustee is the proper person to assert the claim and the creditors are bound by the outcome of the trustee's action. By way of illustration, a "general claim" for the benefit of the creditors at large would be a typical alter ego claim against a principal who absconded with corporate funds, the recovery of which would be returned to the estate and distributed to all creditors according to rules of priority of distribution. A creditor may therefore only pursue a "personal" claim, but not a "general" claim that is the property of, and for the benefit of the entire estate and all creditors at large. Applying these principles to the Red Cross example, the Red Cross claim was "personal" to it, and not a claim that could be asserted by other creditors because the nature of the debt was a UCC sale of its goods to the bankrupt corporation. The clinic's defense that the Red Cross could not pursue its claim for its own benefit in state court therefore failed.

Once the bankruptcy issues are dispatched, the alter ego action as between the bankrupt corporation and the reconstituted corporate entity takes on a more routine litigation profile. The operative principle used to access the assets of a corporation that is the alter ego of another corporation is generally known as "enterprise liability."

The "Enterprise Theory" of Alter Ego Corporations

Piercing the corporate veil as between a bankrupt and a reconstituted corporation requires application of common principles of alter ego with the added feature of demonstrating that they are a common enterprise. Because the various theories of alter ego liability are equitable in the nature, no actual fraud need be shown. The creditor need only show that although the business operates under two corporate structures, there is but one enterprise. Las Palmas Associates v. Las Palmas Center Associates, 235 Cal.App.3d 1220 (1991). There is no distinct set of "factors" to be applied by a court to pierce the two corporate veils. A court need merely find that the corporations operate as one business and an injustice would result by allowing the enterprise to escape the debt of its bankrupt entity. Each case is to be considered under its own specific circumstances. See, Associated Vendors v. Oakland Meat Company, 210 Cal.App.2d 825 (1962) for a survey of the sorts of facts courts use to support a finding of enterprise liability. A court may even find enterprise liability as between a dissolved corporation that is reconstituted as a partnership wherein the partners are the same persons as the shareholders of the dissolved entity. Gordon v. Aztec Brewing, 33 Cal.2d 514 (1949). With regard to the "injustice" element, courts have found that the manipulation of the affairs of a company in such a manner as to make it judgment proof, or to concentrate the assets in one and the liabilities in another is adequate. Associated Vendors at 838; McCombs v. Rudman, 197 Cal.App.2d 46 (1961).

In the case of the reconstituted medical clinic, the Red Cross had little difficulty in demonstrating that the bankrupt and solvent corporate entities were a single enterprise. The clinic continued as a single business without interruption at the same location serving the same patients under a similar name operated by the same medical professionals. The Red Cross also defeated the clinic's defense that the reconstituted corporation was not liable for its predecessor's debts under principles of successor liability.

Successor Corporation Liability

Generally, when one corporation sells or transfers all of its assets to another corporation, the latter is not liable for the debts and liabilities of the former. The rule absolves the successor corporation of liability for its predecessor's debts unless: (1) The purchaser assumes the debts; (2) the transaction is a bona fide merger; (3) the purchasing corporation is merely a continuation of the selling corporation; or (4) the transaction is entered into fraudulently to escape liability for debts. Ortiz v. South Bend Lathe, 46 Cal.App.3d 842 (1975). Under the Red Cross example, the reconstituted entity claimed that it had purchased the assets of its bankrupt predecessor pre-bankruptcy, and therefore could not be held liable for its predecessor's debts. The "assets" transferred, however, consisted merely of $2,000 in used fixtures and furniture. The defense failed to account for consideration that should have been paid for the clinic's greatest asset, its customer lists and patient pool which were the source of its revenue stream. Lacking adequate consideration for this purchase of "assets," the successor corporation had taken ownership of a business without adequate payment which, in theory, should have been applied to extinguish the debt owed to the Red Cross. Facts showing that the "purchase" resulted in a mere continuation of the same business without payment of adequate consideration therefore caused the defense to fail.

Conclusion

Notwithstanding the obvious inequity of using bankruptcy and corporate reconstitution to avoid debt, the tactic remains a popular one. Business debtors and debtor counsel perilously implement the tactic in reliance on corporate formalities alone. They do so in hopes that the business will continue to thrive while avoiding the creditors who gave it viability in the first place. Creditors and creditor counsel should nevertheless be able to recover their accounts, in what is otherwise a straightforward collection matter, by applying fundamental principles of bankruptcy and enterprise liability.

Shelley M. Liberto is a business litigation and intellectual property attorney practicing of counsel to the law firm of Callahan & Blaine in Santa Ana, California.