

COURTS ARE WIDENING THE CRACKS IN THE CORPORATE SHIELD

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The lack of due diligence regarding potential business partners and failure to negotiate adequate contractual protections can have numerous ramifications, which are usually negative. One common mistake is entering into agreements with nominal corporate entities that have marginal assets.

The use of legal entities as a means of protecting individuals from personal liability is a time honored business tactic. Too often, when relationships sour, a party obtains a judgment against what once was thought to be a financially responsible enterprise only to find out it is unable to satisfy its obligations. This often results in frustration, abandonment of the judgment or a whole new and expensive lawsuit alleging fraudulent transfer. There are, however, other methods to efficiently seek redress against the solvent persons who caused the losses.

These methods were the subject of two recent Court of Appeal cases, coincidentally decided by different courts on the same day, which articulate two tactics for pursuing those who seek to evade financial responsibility by the use of entities to shield their assets.

Often, it is not until a lawsuit is won that plaintiffs discover that the corporation that they have been doing business with has insufficient assets to respond in damages. The Court in *Misik v. D'Arco* (2011 DJDAR 11250) held that the trial court may use its general powers to effectuate justice pursuant to Code of Civil Procedure section 187 to amend the judgment to add a judgment debtor who is found to be an alter ego of a corporate defendant. This can be best accomplished by a simple motion filed any time before a final judgment is entered, pursuant to C.C.P. §1908(b). In *Misik*, however, the bad news was only discovered after final judgment so the motion was filed pursuant to §187 to amend the judgment after it was final to add an individual (D'Arco) as a judgment debtor, contending he was the alter ego of the corporation. This procedure applies to any person or entity which controls an action individually or in cooperation with others, who has a proprietary interest in the matter, and has notice of the trial. In *Misik*, the plaintiff sued D'Arco and his corporation for fraud and breach of contract. The court trial resulted in a judgment only against the corporation for breach of contract and the trial court refused to add D'Arco as a judgment debtor because no judgment for fraud was obtained against him.

The Appellate Court, however, reasoned that the alter ego doctrine does not require proof of fraud. D'Arco had 100% ownership of the entity and the evidence showed he controlled the corporate defendant, which proved after trial to have no assets. The Appellate Court applied a traditional alter ego analysis finding there was sufficient unity of interest and ownership and that adherence to the fiction of separate existence would sanction a fraud. Thus, the *Misik* case illustrates a procedural avenue to amend a judgment after it is final against those who have controlled an insolvent corporate defendant.

Another collection tactic was approved in *Phillips Spallas & Angstadt LLP v. Fotouhi* (2011 DJDAR 11309). There, a law firm obtained a judgment against a departing partner (Fotouhi) for breach of the partnership agreement after Fotouhi left his law partnership with its major clients and formed a new partnership with several associates of his old firm. After an arbitration award and a failed attempt by Fotouhi to discharge the award in bankruptcy, Fotouhi, who had vowed plaintiffs would never collect a dime, then formed a law corporation which "bought" the assets of his new law partnership.

Plaintiffs obtained a judgment based on the arbitration award. Plaintiffs thereafter sought a charging order against defendant's interest in his new law partnership and an order extending the charging order to the corporation as a "continuation" of the partnership. They also sought to amend the judgment to add the partnership and corporation as alter egos. The trial court refused the request to add the new partnership and corporation as judgment debtors, presumably because they did not exist at the time of the original arbitration award. It did, however, rule that the charging order against the partnership could be enforced against the corporation as a successor in interest to the partnership. The trial court used C.C.P. §187 to disregard the illusory distinction between the corporation and the partnership and to give effect to the charging order. The Appellate Court upheld the trial court finding that while a corporation's assets are generally not available to satisfy a judgment against a shareholder, the trial court was really satisfying the partnership's obligation to honor the charging against Fotouhi's interest in the partnership by applying the charging order to the corporation as a "name continuation" of the partnership.

In sum, the use of corporate shell games as a shield against execution is undergoing strict scrutiny. Courts are showing a willingness to disregard, upon motion, the corporate shield for both prejudgment attempts to financially incapacitate the corporate defendant or post-judgment attempts to shift assets from a person or entity to a new entity, obviating the need to file a second lawsuit to pursue assets of the new entity. Thus, the clear trend is to allow the expanded use of C.C.P. §187 to help a judgment creditor to collect on the judgment against those who control and manipulate assets in an effort to forestall collection. These tools give a properly represented plaintiff solid remedies beyond having to file a new complaint alleging fraudulent transfer and short-circuit the gamesmanship of elusive debtors.